Letter of Comment No: 18
File Reference: 1100-163
Date Received: 7/1/02

July 1, 2002

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Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
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Norwalk, Connecticut, 06856-5116

Re: File Reference No. 1100-163: Proposed Statement of Financial Accounting Standards, Amendment of Statement 133 on Derivative Instruments and Hedging Activities

Dear Ms. Bielstein:

We are pleased to have the opportunity to provide comments on the Exposure Draft of a Proposed Statement, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (the Exposure Draft or "ED"), and the related implementation guidance for FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133), and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), hereinafter referred to collectively as the "proposed guidance". We generally agree with the Board's proposals and so have limited our comments to three major areas where we believe the Board could modify its proposals in a manner that would significantly lower implementation costs without significant conceptual compromise.

Definition of a Derivative

We support the Board's objective of identifying and separately accounting for a derivative's financing element while providing the option to bifurcate a slightly off-market derivative into its financing and derivative components. Setting bright lines is, however, troubling to constituents and, presumably, the Board. Establishing general guidance as to what constitutes a derivative, supplemented by indicators of what constitutes a financing element would be more in line with setting broad general principles while avoiding rules-based accounting guidance. We believe that the guidance in Statement 133 Implementation Issue No. A1, *Initial Net Investment,* can be refined to provide this guidance, without the need to create new guidance or set a bright line. However, we agree with the concept in the Board's proposal that *any* significant financing component should be subject to bifurcation.

While we understand the Board's reasons for distinguishing between an option-based contract and a non-option-based contract in defining what constitutes a derivative under the proposed guidance, it is not always clear to us how to distinguish between the two. At the margin, such contracts are indistinguishable. To illustrate this point, we use two examples.

Deep out-of-the-money embedded options
The first example is the "capped" interest rate swap illustrated in Example 1 of proposed Statement 133 Implementation Issue No. D2, *Applying Statement 133 to Beneficial Interests in Securitized Financial Assets.* While we agree there is an embedded option in the swap in that example, it is extremely far out of the money – indeed so far out that the option component is unlikely to impact the valuation of the interest rate swap between arm's length parties. In such circumstances, it does not seem useful or meaningful to consider such contracts to be "option-based" for accounting purposes.

Deep in-the-money embedded options
At the other end of the spectrum are options that are extremely deep in the money (like penny warrants). In such circumstances, the "option's" fair value is the same as that of a forward contract (and can be valued using the same methodologies). Such contracts are essentially financing arrangements (since exercise is essentially certain) and are economically indistinguishable from prepaid forward contracts.

To resolve our concern, we suggest that the Board broaden slightly its proposed language in the footnote to be added to paragraph 6(b) to clarify that an otherwise non-option-based contract that has an *embedded* option of nominal fair value at inception should be considered to be a non-option-based contract. This proposal would not affect the classification of stand-alone options of nominal fair value and is intended to make the Board's proposal easier to implement. We also suggest that an otherwise option-based contract that has an initial fair value that is essentially the same as that of a forward contract with similar terms (strike price, settlement date, etc.) should be evaluated as a non-option-based contract in its entirety.

Beneficial Interests and applying the Guidance to Special-Purpose Entities

We understand that the Board is trying to reconcile the provisions of Statement 133 with the provisions of Statement 140 and is unwilling to continue to exempt beneficial interests from the provisions of Statement 133. However, the proposed guidance in this area is very complex, will be difficult and costly to implement, and would appear to provide little incremental benefit to financial statement users, since most beneficial interests that would be affected by this guidance are already carried at fair value on the investors' balance sheets. Understanding that the Board is unlikely to fundamentally modify its proposal, our comments are offered for the purpose of improving the operationality of the proposed guidance.

Scope
There is some confusion regarding the scope of the various proposed staff implementation issues. Proposed Statement 133 Implementation Issue No. B12, *Beneficial Interests Issued by Qualifying Special-Purpose Entities* (QSPE), clearly is intended to apply only to QSPEs. In contrast, proposed Implementation Issue D2 appears to apply to all beneficial interests arising from a securitization under the provisions of

Statement 140. In addition, much of the guidance in these two proposed Implementation Issues appears to overlap or is repetitive.

We do not believe the evaluation of a beneficial interest should hinge on the qualifying status of the *special-purpose entity (*SPE). From an investor's perspective, the distinction between beneficial interests issued by a qualifying SPE as opposed to another type of entity is often not readily apparent or relevant. Further, we are concerned that distinctions created by applying different models to the evaluation of interests in QSPEs versus other entities would result in similar or identical investments being accounted for differently even though the economics to the investor are the same.

For these reasons, we believe Implementation Issue B12 can be eliminated without jeopardizing the Board's goal of applying Statement 133 to beneficial interests. If Implementation Issue B12 is retained, it should focus only on those distinctions that are unique to evaluations of interests in qualifying SPEs.

Evaluating the Terms and Conditions of a Beneficial Interest
Implementation Issue D2 contains the following language:

> In evaluating whether a beneficial interest that does not meet the definition of a derivative has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider the terms of the beneficial interest itself and the aggregate sources of cash flows that are available to service the interest. That is, beneficial interest holders must consider whether the nature and extent of cash flows generated by the securitized financial instruments are or are not consistent with the stated terms of the interest. Further, the consideration of whether a beneficial interest contains an embedded derivative that must be bifurcated should include the priority of interests (that is, the "cash waterfall"), the relative concentration of risks across various tranches of securities issued by the securitization vehicle, and the nature of any additional credit enhancement or other guarantee available to the interests.

This language has caused significant concern in the preparer community – perhaps because it is difficult to reconcile with the Board's general concept in this area that a beneficial interest holder should not have to understand the detailed holdings of an investment in a SPE to determine the appropriate accounting under Statement 133. However, we also sense the Board is concerned that a strict "no-peek" concept could be misused by constituents. To resolve this issue, we suggest the excerpted paragraph in Implementation Issue D2 be replaced by the following language:

> In evaluating whether a beneficial interest that does not meet the definition of a derivative has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider the terms of the beneficial interest itself. That evaluation generally should be based on the stated or implied substantive terms of the instrument.

This language is taken from in Statement 133 Implementation Issue No. B19, *Identifying the Characteristics of a Debt Host Contract*. We believe that this guidance is both sufficient to address the Board's concerns and is consistent with existing guidance in the area.

Implications for Qualifying Status under Statement 140
We believe the Board should further consider the interrelationship between Statement 140 and this proposed guidance as it relates to a QSPE's ability to hold derivatives. Despite the limited examples in the proposed Statement 140 *Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity* ("Q&A"), constituents are still grappling with the application of this guidance to very complex QSPE structures.

We are troubled by the notion that bifurcation under the proposed guidance of a derivative from a beneficial interest may result in loss of qualifying status for an SPE. Paragraph 40(c) of Statement 140 requires that a derivative relate at least partly to a risk of either the beneficial interests or the related transferred assets. Situations exist where a derivative in a structure relates to a risk in the beneficial interests or the related transferred assets that must now be bifurcated, leading to a "derivative on derivative" problem that disqualifies the SPE. We are troubled by this outcome.

We will briefly relate a example illustrating our concern that arises in a real securitization we have recently analyzed. In this securitization, there are two derivatives (one bifurcated, one with an independent third party) that serve, in combination, to convert the cash flows from a QSPE's assets to the cash flows of the beneficial interests. In this case, prime-based assets are hedged within a QSPE using a pay LIBOR, receive fixed interest rate swap entered into with a third party.[1] Application of the proposed guidance in Implementation Issue D2 would further require the bifurcation of a basis swap (pay prime, receive LIBOR). We believe that the staff's proposed guidance on interpreting Statement 140 should permit two derivatives to be evaluated in combination (in this case, the result is a pay prime, receive fixed interest rate swap). We note that this outcome is the same as if the QSPE had not entered a third-party swap. In that case, we believe the bifurcated swap would have been pay prime, receive fixed. This seems consistent to us with both paragraph 18 of Statement 133, which permits the designation of multiple derivative instruments *in combination*, and the provisions of paragraph 40(c) of Statement 140, which does not appear to require that a hedging derivative use *the same index*. Instead, it requires that a derivative instrument "partly or fully but not excessively counteract, some risk associated with those beneficial interest or the related transferred assets."

Synthetic Credit Exposures
In evaluating the proposed guidance, we have struggled in the attempt to apply the guidance proposed in Implementation Issue No. B36, *Bifurcation of Embedded Credit Derivatives*; indeed our most difficult implementation challenges and questions have

[1] This is a very common practice because the LIBOR-based swap market is quite liquid but the prime-based swap market is not.

arisen as a result of attempt to identify and bifurcate "synthetic" credit. We strongly recommend the Board modify its response in proposed Implementation Issue No. B36 for the following reasons:

- ✓ We are unsure how significant the benefits would be to users of observing bifurcated credit derivatives with regard to beneficial interests in securitizations, partially because Implementation Issue B36 fails (even though it attempts to do so) to distinguish between so-called "synthetic" credit risk and "real" credit risk (see Example 1).
- ✓ To apply this guidance, one needs to understand the specific assets in a securitization vehicle – a concept that is totally inconsistent with the guidance in Implementation Issues B12 and D2 (see Example 2). For many beneficial interest holders, especially those that hold a minor interest, this process is not operational or nor is it cost-beneficial.

The two examples that follow illustrate our points.

Example 1

Beneficial interests in a securitization reflect the blended credit risk of the (generally numerous) assets transferred to the securitization vehicle. In addition it is quite common to use some of the assets' cash flows to purchase third-party credit guarantees. Loan payments (although not their timing) are frequently guaranteed by a highly rated third party. In those circumstances, an investor's (including the transferor's) interest reflects the credit risk of both the assets in the securitization vehicle and the credit risk of an entity external to the securitization vehicle. The value of such beneficial interests is quite likely to be "affected by an event of default or a change in creditworthiness of an entity that is not the issuing entity."

This situation is analogous to a government-sponsored agency's guarantee of a mortgage loan securitization; the beneficial interest trades based upon the implied credit risk afforded by the agency's guarantee and, theoretically, the U.S. Government. We do not believe that the Board is proposing that such interests contain "synthetic" credit risk and require bifurcation (at least we hope this is not the Board's intent). However, we find it difficult to distinguish this fact pattern from the fact pattern proposed in Example 2 of Implementation Issue B36[2]. Further, an event of default by a creditor referenced in a credit default swap, such as in Example 2 of Implementation Issue B36, typically requires the physical transfer (gross settlement) of the defaulted instrument to the beneficial interest holders, literally requiring an investor to take direct ownership of the underlying instruments.

Example 2

We have found other fact patterns where there are large static pools of securitized financial instruments containing both traditional debt instruments and credit derivatives (a synthetic investment in a debt instrument's credit risk). Each pool is

[2] The only distinction is that one credit instrument is scoped out of Statement 133 while the other is not.

generally widely diversified and the credit derivatives often comprise a relatively small percentage of the pool but tend to provide significant diversification benefits in that credit risks that are simply unavailable in the marketplace for traditional debt instruments can be acquired in this manner. To further the complexity, the beneficial interests in such pools generally have a seniority structure with respect to credit losses. Implementation issues that arise are:

- ✓ How should one determine what derivative instrument (a basket credit derivative?) should be bifurcated?
- ✓ How should the credit subordination structure of the beneficial interests impact the evaluation of the beneficial interests? For example, the senior beneficial interest has, in a practical sense, no significant credit risk. How should beneficial interest holders of that class evaluate their interests? Does the relative probability of defaults of the physical bonds and the credit default swaps impact this decision?

We urge the Board to reverse its view proposed in Implementation Issue B36 regarding synthetic credit structures. Instead, we recommend that a beneficial interest holder look at the substantive risks and terms of its beneficial interest. Generally, that process would not result in the bifurcation of an embedded credit derivative instrument.

We have arrived at our position because we have been unable to develop an operational distinction between synthetic and "real" credit risk. Although we understand the reasoning behind the Board's proposed solution to this issue, we recommend that the Board instead adopt a solution consistent with that in Implementation Issues B12 and D2. Although this arguably results in an inconsistency between Examples 1 and 2 of proposed Implementation Issue B36, that is only a different inconsistency than the one currently present in the Board's proposal.[3]

Implementation of the proposed guidance in this area will be exceedingly difficult because one needs to understand the specific assets and liabilities of a securitization structure to implement the proposal – a need that is inconsistent with the proposed guidance in Implementation Issues B12 and D2. In contrast, we do not anticipate significant implementation challenges with our alternative. We believe that our recommendation provides consistency with Implementation Issue D2 that is currently lacking and will be significantly less expensive for constituents to implement. Without this change, we fear that constituents will require further (and considerable) implementation guidance in this area before the Board's proposal can be realistically implemented.

[3] That is, the inconsistency between Example 1 with the third-party guarantee of a loan pool (a guarantee that could easily meet the definition of a derivative in some cases) and Example 2 of proposed Implementation Issue B36, since both contain the substantive credit risk of a third party whose assets are not physically present in the securitized vehicle.

Transition and Effective Date
Because of the complexities of applying the proposed guidance to a significant number of existing beneficial interests and QSPEs, we believe it is unrealistic to require the proposal to be applied to pre-existing structures or beneficial interests. Further, the expectation that this guidance be applied to non-grandfathered SPEs or the related beneficial interests at the *issuance date* of a final standard is not realistic given that the identification of potentially failed structures will be a laborious and costly exercise which cannot even begin until final guidance is issued.

We strongly believe that all existing QSPEs should be grandfathered since they were established in good faith in conformity with GAAP applicable at the time of their formation. If the board is concerned about the issuance of derivatives posing as beneficial interests after the issuance of a final Statement, consideration should be given to modifying paragraph 42 of the ED to allow a QSPE to issue additional beneficial interests after the issuance of a final standard *only* if they are not either derivatives in their entirety or contain embedded derivatives.

Similarly, we would recommend that all existing beneficial interests be grand fathered. As previously addressed, we do not believe a beneficial interest holder's accounting should vary depending upon the qualifying status of an SPE. We believe, therefore, that all beneficial interests should be treated similarly in the transition guidance.

Given the interrelationship with the SPE Consolidation project, consideration should also be given to delaying the issuance of this guidance until the mutual impact of the projects can be evaluated and understood. Failure to do so could result in a sort of "double jeopardy" for constituents – a prospect that strikes us as unreasonable. Finally, consideration of an appropriate effective date should consider that systems do not currently exist to perform and account for the level of bifurcation necessary under the proposed guidance.

Derivatives Embedded in Liability Host Contracts

We continue to believe that entities should be permitted to account for financial instruments that would otherwise require bifurcation at fair value with changes in fair value recognized currently in earnings. We observe that this alternative is already permitted for all instruments that are assets as long as a company is willing to account for the entire instrument at fair value under the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Further, carrying the entire contract at fair value is consistent with the proposed guidance contained in International Accounting Standards and would result in more financial instruments being accounted for at fair value than under the current literature.

In the case of broker-dealers, this prohibition results in few benefits and significant costs. The first significant cost arises in the attempt to separately track the historical cost of the host contracts for external reporting purposes.[4] The second significant cost results from

[4] Such contracts are marked to market for internal reporting purposes.

the fact that the vast majority of broker-dealers' assets are carried at fair value for financial reporting purposes. The prohibition on marking these liabilities to fair value results in what we believe is misleading income volatility (that is, reported income volatility differs from actual volatility) and information that is thus less useful to investors than it should be.

This is a very significant financial reporting issue to broker-dealers. We understand that some at the Board may view the *choice* of accounting for certain liabilities at fair value as subject to manipulation; however, we do not believe that concern outweighs the desirability of having more financial instruments carried at fair value. Indeed, we find it hard to believe this is a significant concern to the Board, given its clear intention of eventually requiring all financial instruments to be accounted for at fair value.

Should the Board choose not to address this issue at this time, we request that the Board clearly explain its reasons for not doing so in the Basis for Conclusions of any final Statement.

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We would be pleased to discuss our comments with you at your convenience.

Very truly yours,

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