October 10, 2005

Mr. Lawrence Smith
Director, TA&I
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: File Reference No. 1210-001, Proposed Statements of Financial Accounting Standards,
Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements
No. 133 and 140

Dear Mr. Smith:

Ernst & Young is pleased to offer the following comments on the above-mentioned Exposure
Draft (the "Exposure Draft"), Accounting for Certain Hybrid Financial Instruments, an
amendment of FASB Statements No. 133 and 140.

Overview

We support the issuance of this proposed Statement in concept, but we strongly believe that
clarifying language is needed. We are not certain that constituents who have not followed the
project from inception will be able to apply the Exposure Draft's bifurcation guidance. In that
light, at many points in this letter we will suggest what we believe to be the intent of the Board,
and we recommend that, if we are correct, the final Statement incorporate clarifying
interpretations.

We are afraid that readers who have not followed the project deliberations that led to the
Exposure Draft will believe that the presence of a freestanding derivative contract in an issuing
special purpose entity automatically means that a beneficial interest holder has an embedded
derivative it must evaluate for bifurcation. We believe that the answer depends on how that
derivative shifts risks present inside the issuing entity. Does the derivative shift risk back to the
derivative counterparty? Does the derivative shift risk among the beneficial interest holders such
that some tranches have embedded derivatives to evaluate and others do not?

Likewise, we believe that the Board does not intend to suggest that the absence of a freestanding
derivative contract in an issuing special purpose entity automatically means that a beneficial
interest holder does not have an embedded derivative it must evaluate for bifurcation. We
believe that the answer depends on how the cash waterfall structure and subordination arrangements have shifted risks among the beneficial interest holders.

A clarification as simple as what we have suggested above would improve a reader’s understanding of the Exposure Draft in an area of accounting that is already complex and intimidating. In our experience with FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, the guidance addressing bifurcation, particularly paragraphs 12 and 13, is among the most challenging in the entire Statement. Paragraph 13(b)’s “double/double” test, revised by FASB Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, continues to be subject to multiple interpretations, even, as we understand, among the FASB staff. Examples of how to apply paragraph 13(b) that were once posted on the FASB’s website were removed in 2003 due to numerous disagreements as to their correctness. (We believed the examples were incorrect.) The application of the rule in paragraph 13(b) is dependent on how the term “initial rate of return” is interpreted and how the host contract (if a debt host) is defined in light of Statement 133 Implementation Issue B19 (“Issue B19”), Identifying the Characteristics of a Host Contract. Issue B19 offers little substantive assistance in helping one define the host contract.

The Exposure Draft’s rescission of Implementation Issue D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets (“Issue D1”), would require bifurcation analysis to be performed on some of the most complex hybrid instruments created in the financial world, placing additional pressure on these inconsistently interpreted sections of Statement 133 (paragraphs 12 and 13 and Issue B19). While we appreciate the Board’s desire to create consistency in the literature by no longer exempting particular types of hybrid instruments from the bifurcation requirements of Statement 133, the Exposure Draft in its current form does not achieve the Board’s goal of decreasing complexity in the application of Statement 133.

**Fair Value Election**

We support the Board’s decision to permit fair value remeasurement for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation. However, this decision offers minimal assistance in reducing the complexity of the application of Statement 133 because the “election” is not available unless one has first been able to obtain and analyze all available information about the innerworkings of the securitization vehicle, define whether the host beneficial interest instrument is “debt” or “equity” and, if debt, determine the type of debt host in accordance with Issue B19, and, finally, perform the “clearly and closely related” analysis required by paragraphs 12 and 13.

We believe that the analysis to determine whether “bifurcation would otherwise be required” could prove immensely challenging, particularly in light of the Exposure Draft’s omission of even the most basic of examples. While the proposed Statement 133, paragraph 14B exclusion
of credit risk from the analysis is helpful to constituents, there remain many other fundamental challenges for which the Exposure Draft offers little insight. Specifically, the Exposure Draft does not:

- Acknowledge that certain “lower” tranches of beneficial interests might contain equity hosts. Short of instituting a “rule” that eliminates that possibility, it is difficult to imagine how the Board might draft guidance that reliably identifies whether a particular host is debt or equity, given the difficulties associated with the 2002 Exposure Draft that led to Statement 149 and caused the Board to abandon “Implementation Issue D2.”
- Clarify the breadth of the “credit risk exemption” (discussed in next section).
- Address how to apply its provisions if the assets in the securitization vehicle are actively managed. All of Statement 133’s bifurcation guidance in paragraphs 12 and 13 presume that the evaluation is made at the time the hybrid instrument is acquired or incurred. Does the Exposure Draft require the investor in a beneficial interest in securitized financial assets to make a continuous assessment of the ever-changing securitized assets? And, if the Exposure Draft would require such a continuous assessment, it is unclear how the accounting for the fair value of a bifurcated derivative and the host instrument would work, since all the Implementation Issue literature presumes an evaluation at inception only.

In light of the operational difficulties we foresee, we strongly recommend that the Board reinstate the deleted sentence of paragraph 16 of Statement 133: “If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.” Although this sentence has been rarely used in current practice, one explanation for its rare applicability is the fact that Issue D1 exempted so many instruments that otherwise may have been included in this sentence’s scope. Reinstating this sentence would truly decrease the burden associated with applying Statement 133 to the instruments covered by this Exposure Draft, and would be consistent with the Board’s stated goals of simplification and increased relevance through expanded use of fair value measurement.

The Breadth of the Credit Risk Exemption and its Peripheral Impact

We support the “credit risk exemption” that is proposed to be added to Statement 133 in new paragraph 14B, but we believe the Exposure Draft needs to clarify several matters.

**Interaction with Statement 133 Implementation Issue B36.** We agree with the statement in paragraph A18 that “the creditworthiness of an issuer is determined by the assets it holds” and the focus on the securitization vehicle as the “issuing entity.” We believe that whether or not generally accepting accounting principles require the “issuing entity” to be consolidated into
another entity is not relevant to this principle or to whether the “credit risk exemption” is granted, but we believe the final Statement needs to clarify whether or not our belief is correct. In particular, the Board should indicate the impact of the final Statement on Example 1 in Statement 133 Implementation Issue No. B36, Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments” (“Issue B36”). Specifically, the Board needs to indicate whether bifurcation is required for a credit-linked note issued by a special purpose entity or variable interest entity that is required to be consolidated into another entity. Is such a note considered to be issued by that consolidating entity and, therefore, subject to bifurcation under Issue B36, Example 1, or is it considered to be issued by the special purpose entity or variable interest entity and not subject to bifurcation under the principles of this Exposure Draft?

Commodity Risk. A special purpose vehicle might be populated with commodity-based derivatives, such as gold or oil futures contracts. Depending on the contractual terms of the beneficial interests issued by the vehicle, a holder might be exposed to gold and oil price risks that place the receipt of future cash flows from the beneficial interest at risk. We do not believe that the exception from bifurcation for credit risk applies to the possibility of defaulted beneficial interest payments attributable to commodity price movements, because we believe that commodity price risk is distinct from credit risk and because credit risk should be evaluated from the perspective of the issuing entity’s assets. In principle, commodity price risk would not be considered to be clearly and closely related to a debt host (or equity host) instrument under paragraph 12 of Statement 133. However, if the commodity-based derivatives lose fair value due to the decline in creditworthiness of the derivative counterparty, we believe that that risk is intended to be exempted by the Exposure Draft.

Also unclear is how the Exposure Draft would address a special purpose vehicle populated with actual commodities such as gold (that is, a non-financial asset) rather than commodity derivatives, which are considered financial assets. The wording of the Proposed Statement does not distinguish between financial assets and liabilities and non-financial assets and liabilities when it discusses the credit risk exemption. Commodities cannot “default,” but their values can decline and impact the ability of the securitization vehicle to honor its obligations under the beneficial interests it has issued. Accordingly, the final Statement should clarify whether price risk declines in actual commodities held by a securitization vehicle could be considered “credit risks” that are intended to be exempted. We suggest that such price risk declines are not intended to be exempted, and that intention can be made clearer by revising proposed Statement 133 paragraph 14B to read as follows:

“Credit risk in a beneficial interest in securitized financial assets or other financial assets and financial liabilities (including derivative contracts) that are held by the issuing entity shall not be considered an embedded derivative under the Statement.”
Prepayment Risk and Peripheral Impact of the Rescission of Issue D1. The Exposure Draft also does not directly address “prepayment risk.” In Statement 133, prepayment risk is considered a subset of “interest rate risk,” and interest rate risk is considered a separate risk from “credit risk.” It is logical to infer that the prepayment risk of assets in an issuing special purpose entity is not part of the credit risk exemption granted by the Proposed Statement. However, faster than anticipated prepayments of assets on the “left side” of the issuing entity’s balance sheet can create default risks on the “right side” of the entity’s balance sheet, especially if the entity reinvests in new assets that pay a reduced amount of interest. Presumably, this possibility is among those that holders of beneficial interests must assess in determining whether their interest contains an embedded derivative that under Statement 133, paragraphs 12 and 13 (particularly 13(a)) would be required to be bifurcated. The final Statement should clarify whether or not our understanding is correct.

Issuing entities could enter into financial guarantee contracts that protect their ability to honor the contractual terms of certain beneficial interests in the event that the entity’s assets default or prepay. The presence of such a contract may enable certain beneficial interest holders to determine that they have no risk of not recovering substantially all of their initial recorded investment, when considering paragraph 13(a) of Statement 133. We believe that those beneficial interest holders have no embedded derivative requiring bifurcation because they have been immunized from default risk on their holding by the presence of the financial guarantee contract in the issuing entity. The final Statement should clarify whether our understanding of how a beneficial interest holder should interpret the presence of these contracts is correct.

The potential rescission of Issue D1 may have a peripheral impact on the writers of the financial guarantee contracts. From the perspective of the beneficial interest holder, the contracts help to guarantee the promised cash flow of the instrument. But from the perspective of the issuing special purpose entity, many guarantees fulfill whatever shortfall may ultimately emerge between the actual cash flows of the entity’s assets and the cash flows promised to the beneficial interest holder, including shortfalls caused by earlier-than-anticipated prepayments of the assets and/or reinvestment in lower yielding new assets. Many writers of such contracts have been interpreting the financial guarantee contract requirements of Statement 149 by looking past the perspective of the issuing special purpose entity to the perspective of the beneficial interest holder, who sees the guarantee as the contract that will reimburse the holder for “failure to pay” by the issuing special purpose entity, without regard to the root cause of that “failure to pay.” From which perspective does the Board believe this evaluation should be made? While there are varying viewpoints as to what the current literature requires, we believe that the rescission of Issue D1 would require that this evaluation effectively be made from the perspective of the issuing special purpose entity, because the rescission of Issue D1 appears to put forth the principle that all affected parties should have the same perspective. No one would be able to assert that there is a separate perspective of standing outside the special purpose entity and just
evaluating the “contractual terms” of the beneficial interest. Accordingly, we believe that writers of financial guarantee contracts may need to re-evaluate their application of Statement 149 to their own accounting for these contracts in light of this Exposure Draft. Many writers may note that from the perspective of the issuing special purpose entity, there are other risk factors such as prepayment and reinvestment risk that trigger guaranty payments under the contract that would render the contract ineligible for the exemption from derivative accounting. We suggest that the Board consider the impact of this Exposure Draft on the accounting for these commonly used contracts, both for the beneficial interest holder and for the writer of the contract, and provide clarifying guidance.

Evaluating the “Contractual Terms of the Beneficial Interest” and the Exception for Interest-Only Strips and Principal-Only Strips

The Proposed Statement needs to provide implementation guidance on how to evaluate whether an instrument contains an embedded derivative that would require bifurcation. Even the simplest illustration of a special purpose entity populated with plain vanilla fixed-rate assets that has issued floating-rate beneficial interests, with a residual absorbing the interest rate risk, would establish a base model to explain how senior beneficial interest holders and “residual” beneficial interest holders would approach the bifurcation guidance. From that base model, the Proposed Statement could then illustrate how the introduction of derivatives into the special purpose entity serves to eliminate risk for certain beneficial interest holders under paragraphs 12 and 13 of Statement 133, while shifting that same risk to other beneficial interest holders. A simple example of how the issuing entity directs cash waterfalls to different tranches could illustrate how some tranches may have no interests requiring bifurcation, while other tranches do.

We believe the Board could provide this guidance and still achieve its goal of issuing clarifying principles rather than writing rules. In addition to providing base case examples, we believe the following clarifications should be made:

- We understand the Exposure Draft’s use of the term “beneficial interest” is intended in its generic sense and was not meant to apply only to beneficial interests issued by qualified special purpose entities. If we are correct, this intention should be expressly stated.

- We question whether paragraph 3(b) of the Exposure Draft should state that “the determination (of whether an embedded derivative would be required to be separated) should be based on the contractual terms of the beneficial interest,” when the very next sentence strongly implies that evidence of the presence of an embedded derivative requiring bifurcation might lie outside the formal contractual terms. We believe the Board intended for all beneficial interest holders to understand all the cash flows and risks present in the securitization vehicle and to gather whatever information necessary to determine which cash flows and which risks pass through or, equally important, do not pass through, to them.
With respect to the exception for principal-only and interest-only strips, it is unclear what the Board means when it describes the “portions” of the contractual cash flows that must be separated. Consider a securitization vehicle populated with $10,000,000 in consumer mortgages that pay a 6% fixed rate and follow a monthly principal amortization schedule. It is unclear how the Exposure Draft would answer the following:

1. Can the interest-only strips issued by the securitization vehicle pay, for example, 5%? Is that considered a “portion” of 6%? Or must the interest-only strips pay 6%, just as the source assets pay?

2. Can the principal amount of the interest-only strips and principal-only strips be based on a notional amount less than $10,000,000, allowing a creation of a residual tranche? Would this be an acceptable interpretation of the word “portion”? Or must the interest-only and principal-only beneficial interests be created as a straight passthrough with no omissions or carveouts of any of the source cash flows? Some changes to the cash flows are likely to be fundamental to the structure to provide for the entity issuing the strips to pay its expenses, such as servicing or guarantee fees. However, the Exposure Draft could be read to not permit such revisions within the exclusion as the “servicing fee” or “guarantee fee” would not be “a term present in the original financial instrument.”

We also note that the proposed new paragraph 14 of Statement 133 addresses an exemption for interest-only strips and principal-only strips resulting from separating portions of the contractual cash flows “labeled” interest and principal. Consider the placement into a securitization vehicle of an equity-indexed debt instrument with coupons adjusted for S&P 500 fluctuations “labeled” as interest. We do not believe that the Board intended to permit an “interest-only” strip to be created from these coupons as a beneficial interest that enjoys the new paragraph 14 exception, but the choice of words in the drafting seems to leave that possibility open.

Effective Date and Transition

We support the planned timing of the effective date for this Proposed Statement if the Board decides to reinstate the fair value option for hybrid instruments for which the embedded derivative cannot be “reliably identified and measured” (the final sentence of paragraph 16 from the current Statement 133), which we think will be necessary for many of the more complex hybrid beneficial interests. The reinstatement of the full paragraph 16, coupled with base case implementation examples, would make the Statement sufficiently workable to adopt on the planned timetable.
We also agree with the transition guidance that allows the rescission of Issue D1 to be treated prospectively for new hybrid instruments. However, we agree with the minority of Board members who suggested that constituents be permitted to apply the fair value election to existing hybrid financial instruments that are currently being bifurcated to ease the application of Statement 133, as long as that election were made on an all-or-nothing basis. The majority of Board members' concern that such an election would eliminate the opportunity to use the embedded derivative as a hedging instrument is somewhat misplaced, because the constituent could always choose not to make this election if it had this concern and because, in our observation, we have rarely seen such bifurcated derivatives successfully placed in hedge relationships.

If the Board does not agree with our recommendation in the paragraph above, we recommend that the final sentence of paragraph 5 be re-written to clarify that “the provisions of the Statement shall not be applied to instruments that an entity holds or has issued at the effective date.”

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We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst & Young LLP