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LETTER OF COMMENT NO. 7

February 13, 2009

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

RE: Proposed DIG Issue C22, "Scope Exceptions: Exception Related to Embedded Credit Derivatives" (File Reference: Proposed Issue C22)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed DIG Issue C22, "Scope Exceptions: Exception Related to Embedded Credit Derivatives" (the "proposed DIG Issue"). We support the Board's stated objective to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("Statement 133"), and agree with the conclusions in the proposed DIG Issue. The conclusions in the proposed DIG Issue generally are consistent with our interpretation of existing literature and current practice under US generally accepted accounting principles. However, we are concerned that the proposal does not clearly articulate the principles that the Board used in reaching its conclusions and, as a result, there may be inconsistent application of the proposed DIG Issue in fact patterns that differ from the examples provided. In addition, as discussed below, we note that if the DIG Issue is finalized as proposed, the existing difference in the conclusion reached under US GAAP and IFRS with respect to the need to bifurcate an embedded credit derivative feature in a fully funded synthetic CDO will remain.

The proposed DIG Issue includes Examples 38, 39, and 40 ("the Examples") to illustrate the application of paragraph 14B of Statement 133. These examples highlight when embedded credit derivative features are (1) not considered embedded derivatives or (2) are considered embedded derivatives that are subject to potential bifurcation and separate accounting under Statement 133 based on whether the economic characteristics and risks of the derivative and host contract are not clearly and closely related. Although the examples provide useful information about how to apply the guidance in paragraph 14B to specific fact patterns, we are concerned that the proposed DIG Issue does not provide the principles necessary for constituents to apply such guidance to facts and circumstances that do not clearly fit into those described in the Examples. The inclusion

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of the Board's principles is necessary to meet the objective to resolve potential ambiguities about the application of paragraph 14B.

Based on the conclusions reached in the Examples, we believe that the Board has implicitly considered certain principles that it believes should be used when analyzing instruments under paragraph 14B of Statement 133. Our understanding of these principles and how they could be articulated explicitly in the "Statement 133 Implementation Issue Guidance" section of the proposed DIG Issue is as follows:

- An embedded credit derivative feature that solely allocates the credit risk of the financial instruments held by the SPE among the beneficial interest holders (i.e., credit subordination) is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133. (Illustrated in Example 40)
- An embedded credit derivative feature with any other term is considered an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133. The economic characteristics and risks of an embedded credit derivative that must be analyzed under paragraph 12(a) of Statement 133 are not clearly and closely related to those of the host contract if:
  - The credit risk of the cash flows passed through to beneficial interest holders is not present in the financial instruments held by the SPE (Illustrated in Example 38) or
  - The credit risk of the cash flows passed through to beneficial interest holders is present in the financial instruments held by the SPE, but the credit risk is not fully funded or collateralized by the financial instruments held by the SPE (Illustrated in Example 39).

We believe that it is necessary for the proposed DIG Issue to include the Board's principles in order for constituents to understand and apply the guidance to facts and circumstances that do not clearly fit into the Examples.

Additionally, while we have outlined the principles on which the Board appears to have based its assessment of embedded credit derivatives in the Examples, we were unable to determine the basis on which these principles were developed or why they were chosen over others. Therefore, in addition to describing the principles of the guidance, we recommend that the Board also include a discussion of the basis on which the ultimate principles related to the separation of embedded credit derivatives in securitized financial assets were based. For example, it would be useful to understand why the obligation for an investor to provide additional funds would be an embedded credit derivative that is required to be bifurcated.

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Example 38 of the proposed DIG Issue does not state whether the economic characteristics and risks of the embedded credit derivative are clearly and closely related to those of the host contract. We believe they are not clearly and closely related because the credit risk of the cash flows passed through to beneficial interest holders is not present in the financial instruments held by the SPE. This should be stated in the example.

In addition, the proposed DIG Issue provides an opportunity to clarify the application of paragraph 14B to other scenarios that are similar to Example 38. Example 38 states that "the cash flows relating to changes in the credit risk of Company B are not present in the financial instruments held by the SPE." We suggest that the proposed DIG Issue clarify if the analysis or conclusion reached in Example 38 would change if the credit risk of the cash flows that is passed through to the beneficial interest holders (based on Company B) is not present in the financial instruments held by the SPE (credit derivative referenced to Company A), but the credit risk of Company B is highly correlated with the credit risk of Company A. Similarly, we suggest that the proposed DIG Issue clarify if the analysis or conclusion reached in Example 38 would change if the credit risk that is passed through to the beneficial interest holders and the credit risk of the financial instruments held by the SPE are based on the same entity, but reference different securities issued by the entity (e.g., a senior secured security (rated AAA) and a junior subordinated security (rated B).

Paragraph 14A

We understand that the proposed DIG Issue is intended to clarify the application of paragraph 14B of Statement 133. Therefore, we question whether the proposed DIG Issue is the appropriate mechanism to amend examples that illustrate the application of paragraph 14A of Statement 133 (Examples 35 and 36). In addition, the proposed amendments to Examples 35 and 36 delete the guidance that provides the Board's reasons why the embedded derivative would not have to be bifurcated and accounted for separately and replace that existing guidance with language that broadly states that the "...economic characteristics and risk of any perceived embedded derivative feature would be clearly and closely related to the economic characteristics and risks of the host contract." Based on the proposed amendments, it is not clear how these conclusions were reached. We believe these conclusions were reached because in both examples the terms of the beneficial interests do not indicate an embedded derivative and the financial instruments held by the SPE provide the necessary cash flows. We suggest that the proposed DIG Issue include a discussion that defines the embedded features and host contracts and explains how they are deemed to be clearly and closely related.

Similar to our earlier comment on the clarification of the application of paragraph 14B, if the proposed DIG Issue is finalized and includes amendments to Examples 35 and 36, we suggest that the "Statement 133 Implementation Issue Guidance" section of the proposed

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DIG Issue provide a discussion of the principles that should be used when analyzing instruments under paragraph 14A and the basis for their selection.

Transition

The transition guidance is written from the perspective of an entity that upon application of the guidance in the proposed DIG Issue must bifurcate an embedded derivative that previously was not bifurcated. While we understand that this may be the most common scenario, there may be entities that upon the finalization of the proposed DIG Issue will have to stop bifurcating an embedded credit derivative. Therefore, the proposed DIG Issue should provide clear transition guidance for entities that may have to start or stop bifurcating an embedded credit derivative upon the finalization of the proposed DIG Issue.

US GAAP/IFRS Difference

We believe that the proposed DIG Issue clarifies, but does not change, the application of the existing guidance related to embedded credit derivatives in paragraph 14B of Statement 133. It is our understanding that under IFRS a conclusion has been reached that a fully funded synthetic CDO (Example 40 in the proposed DIG Issue) contains an embedded credit derivative that is required to be bifurcated from its host contract and accounted for as a derivative. Therefore, a difference would continue to exist between US GAAP and IFRS related to the separation of embedded credit derivatives if the proposed DIG Issue is finalized. We note that neither the proposed DIG Issue nor the project summary indicate that convergence is an objective of this proposal. However, this may not be consistent with the expectation of some constituents.

Based on the Chairman of the IASB's response on December 17, 2008 to a letter from the Director-General of the European Commission dated October 27, 2008 (both available on the IASB's website), some constituents may believe that the issuance of the proposed DIG Issue was intended to eliminate the US GAAP/IFRS difference discussed above. In the section of the letter responding to the European Commission's request for clarification of the accounting treatment of embedded derivatives in investments in synthetic CDOs, the IASB Chairman states that "Your letter called for the need to clarify any possible difference in the accounting treatment between IFRSs and US GAAP. Both boards believe that the standards are consistent, and the FASB has now agreed to issue mandatory implementation guidance to ensure that US GAAP is applied in the same way as IFRS. The FASB will publish the draft statement shortly. This guidance will ensure that US practice is in line with IFRSs, providing a necessary level playing field." Since the Board has not identified convergence with IFRS as an objective of the issuance of the proposed DIG Issue, we believe that this point should be addressed in the basis for conclusions.

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We would be happy to further discuss these issues at the request of the Board or the staff. If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Enrique Tejerina at (212) 909-5530.

Sincerely,

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