



LETTER OF COMMENT NO. 3

Mr. Russell G. Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

13 February 2009

**Re: Proposed Statement 133 Implementation Issue No. C22, Scope Exception:  
Exception Related to Embedded Credit Derivatives**

Dear Mr. Golden:

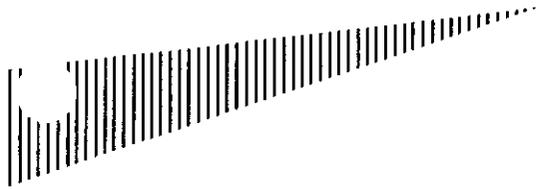
We appreciate the opportunity to comment on the aforementioned Proposed Statement 133 Implementation Issue ("Proposed Issue C22").

We concur with the Financial Accounting Standards Board's (the "Board") conclusion about the extent of the scope exception under paragraph 14B of Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("Statement 133") for embedded credit derivative features related to the concentration of credit risk in the form of subordination of one financial instrument to another. We also concur with how the Board has applied that exception to synthetic collateralized debt obligations ("CDOs") in the illustrations included in Proposed Issue C22. We are not aware of constituents that have interpreted the current paragraph 14B differently than the manner illustrated in Proposed Issue C22's new examples. Nevertheless, we support the Board's effort to clarify paragraph 14B of Statement 133 and believe Proposed Issue C22 and its new examples will be helpful to users.

We do believe, however, that the final Issue C22 should more clearly articulate the principle that is evident in the detailed analysis in Examples 35 through 40. It is apparent to us that the Board intends for the "clearly and closely related" concept, with respect to beneficial interest hybrid instruments, to be tied to the concept of the special purpose entity ("SPE") issuer being capable of providing the necessary cash flows to the beneficial interest holder. When a SPE is not capable of providing the necessary cash flows, different tranches of beneficial interests are essentially exchanging cash flows with each other, evidencing an embedded derivative that may need to be bifurcated. We suggest that the logical place to articulate this principle is in a new sentence added to the end of paragraph 14A:

"The financial instruments held by the issuing entity should be sufficient to provide the necessary cash flows to each holder of an interest in securitized financial assets."

We note that Proposed Issue C22 may not result in convergence with International Financial Reporting Standards ("IFRS") with respect to the accounting for synthetic CDOs, as we believe that IFRS does not necessarily look to the same principle articulated in the preceding paragraph. We support convergence as an overall objective, but we believe that convergence on this particular issue



will require a fundamental change to either US GAAP or IFRS that is more appropriately addressed in a broader project.

In addition, we have the following additional comments regarding the draft language of Proposed Issue C22:

The proposed issue seeks to amend paragraphs 14B and 200D - 200F such that reference is made to paragraphs 12, 13, and 14A of Statement 133. We understand that, collectively, these paragraphs constitute the bulk of Statement 133's embedded derivative and bifurcation guidance. However, we are concerned that because of this reference, constituents will mistakenly assume that paragraph 13 is intended to be applicable to embedded credit derivative features. Paragraph 13 states that "for purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index ...." Clearly, paragraph 13 is relevant to Examples 35 and 36 in paragraphs 200A and 200B, respectively, but it is not relevant to the credit risk examples (Nos. 38 through 40). Therefore, we suggest that the Board remove the references to paragraph 13 from the inapplicable examples in Proposed Issue C22 to avoid potential misunderstanding.

Implementation guidance provided by Example 39 (paragraph 200E) illustrates that a synthetic CDO structure containing an embedded credit derivative exposing investors to potential future payments ("partially funded synthetic CDO") is subject to analysis for bifurcation. While we agree with the conclusion reached in this example, it is unclear to us whether the requirement of further analysis for bifurcation is only applied to the interests in those tranches that expose the holders to potential future payments or to all tranches. We believe that if other tranches are the "beneficiaries" of the "excess" payments that another tranche must make to the SPE, such tranches are effectively the counterparty to that same embedded credit derivative and, therefore, should also be evaluated for bifurcation.

In addition, we ask the Board to clarify that the Example 39 embedded derivative being evaluated is the "excess" portion of the credit default swap that exposes the investor to potential payments beyond merely reduced cash flows. In reading Examples 39 and 40 together, that approach to bifurcation appears to be the Board's intent, but it would be helpful if the final Issue C22 clarified that point.

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We would be pleased to discuss our thoughts with the Board or its staff in further detail.

Very truly yours,

*Ernst + Young LLP*