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FASB Exposure Draft: Proposed Statement of Financial Accounting Standards, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*

We appreciate the opportunity to comment on the FASB's Proposed Statement of Financial Accounting Standards, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140* (the Exposure Draft or Proposed Amendment). We appreciate the Board's efforts to address the issues raised in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." While the proposed guidance in the Exposure Draft would sacrifice comparability in the near term, we believe that the election to remeasure certain hybrid financial instruments at fair value will, in due course, simplify the accounting for those instruments. However, we believe that certain provisions of the Exposure Draft require clarification or modification to ensure consistent application.

We recommend that the proposed amendment to paragraph 40 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), that is included in the FASB's Proposed Statement of Financial Accounting Standards, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (the QSPE Exposure Draft), be included in the final statement resulting from the Proposed Amendment to ensure that the applicability of that amendment coincides with the applicability of the interrelated amendment to paragraph 14 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133), in the event that the Proposed Amendment and the final statement for the QSPE Exposure Draft are not issued at the same time with the same effective date.



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As discussed in paragraphs 187 and 188 of Statement 140, the Board included the guidance in paragraphs 40(b) and 40(c) of Statement 140, in part, to address concerns about transferors using QSPEs to enter into derivative transactions to avoid the accounting requirements of Statement 133. It is our understanding that the Exposure Draft, which would eliminate the exemption from applying Statement 133 to beneficial interests in securitized financial assets, is intended to alleviate those concerns. However, it is not clear that the evaluation of whether an embedded derivative exists in a beneficial interest would be required to take into consideration the underlying contracts of the QSPE that issued the beneficial interests. Even if it does, a resulting embedded derivative in the beneficial interest(s) would not always be required to be accounted for separately from its host instrument under the requirements of Statement 133 and could, therefore, be accounted for differently from an equivalent freestanding derivative instrument held by the QSPE.

Paragraph 3(b) of the Exposure Draft states, in part:

The holder of a beneficial interest in securitized financial assets (other than those identified in paragraph 14) should determine whether the interest is a freestanding derivative or contains an embedded derivative that under paragraphs 12 and 13 would be required to be separated into a host contract and a derivative instrument. The determination should be based on the *contractual terms* of the beneficial interest. A holder of a beneficial interest or an issuer of an instrument is required to obtain sufficient information about the *payoff structure* and the *payment priority* of the instrument to determine whether an embedded derivative exists (italics added for emphasis).

Based on the language in that paragraph, it is unclear whether the Board intends for beneficial interest holders or issuers to “look through” the contractual terms of their beneficial interests to the underlying contracts of the QSPE when evaluating whether an interest is a freestanding derivative or contains an embedded derivative. The second sentence in paragraph 3(b) clearly states that the determination should be based on the *contractual terms* of the beneficial interest. However, the third sentence indicates that entities are required to obtain information about the *payoff structure* and *payment priority* of the instrument, which would suggest a need to consider the underlying contracts of the QSPE in determining whether the beneficial interest contains an embedded derivative that is required to be accounted for separately from its host under the requirements of Statement 133.

For example, assume that an entity transfers U.S. dollar-denominated fixed-rate AAA-rated bonds to a securitization trust, which concurrently enters into a foreign currency



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swap that converts the cash flows to be paid to beneficial interest holders to Japanese yen. Further assume that the beneficial interest holders are entitled to a pro-rata share of all of the cash flows. If a beneficial interest holder examined only the contractual terms of its interest, it would likely conclude that its interest is not a freestanding derivative and it does not contain an embedded derivative. However, if that same beneficial interest holder “looks through” the contractual terms of its interest to the underlying contracts of the securitization trust it may conclude that its interest contains an embedded foreign currency swap that is required to be accounted for separately from the debt host. As another example, assume that an entity transfers fixed-rate bonds to a securitization trust, which concurrently issues variable-rate beneficial interests to investors. The trust enters into an interest rate swap to convert the fixed-rate cash flows from the bonds into variable-rate cash flows to be paid to the beneficial interest holders. If a beneficial interest holder examined only the contractual terms of its interest, it would likely conclude that the interest is not a freestanding derivative and that it does not contain an embedded derivative. However, if that same beneficial interest holder “looks through” the contractual terms of its interest to the underlying cash flows of the securitization trust, it may (based upon an analysis of the impact of paragraph 13 of Statement 133 on the beneficial interest and the embedded derivative feature) conclude that its interest contains an embedded interest rate swap that is required to be accounted for separately from the debt host.

The Board should clarify whether it intends for beneficial interest holders or issuers to “look through” the contractual terms of their beneficial interests to the underlying contracts of the QSPE to determine whether an interest is a freestanding derivative or contains an embedded derivative. In a related matter, the Board should clarify why the guidance for identifying freestanding and embedded derivatives in the first subparagraph of paragraph 3(b) is provided specifically in the context of beneficial interests in securitized financial assets, while the guidance in the second subparagraph of paragraph 3(b) and paragraph 3(c) applies to all hybrid financial instruments. We recommend that the Board consider requiring, for all transferor’s beneficial interests, that the transferor either (a) “look through” the contractual terms of their beneficial interests to the underlying contracts of the QSPE to determine whether the interests are freestanding derivatives or contain an embedded derivative or (b) measure the beneficial interests at fair value with all changes in fair value recognized currently in earnings. As an integral aspect of that approach, we also recommend that the Board consider requiring transferors to consider freestanding derivatives held by a QSPE to represent an embedded derivative feature of the transferor’s beneficial interest that *requires* bifurcation even if the provisions of Statement 133 would not otherwise result in that conclusion.



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The second subparagraph of paragraph 3(b) of the Exposure Draft states:

Credit risk in a beneficial interest resulting from financial instruments or other assets and liabilities (including derivative contracts) that are held by the issuing entity, shall not be considered an embedded derivative under this Statement. The concentration of credit risk in the form of subordination of one interest to another shall not be considered an embedded derivative under this Statement.

The embedded derivative exclusion for certain forms of credit risk in paragraph 3(b), above, appears to be inconsistent with the analysis of other types of risks, such as interest rate and foreign currency risk. In addition, pursuant to paragraph A18 of the Exposure Draft, credit risk that has been synthetically introduced into an entity through a derivative instrument is afforded the same exclusion as credit risk arising from cash instruments. That is, the proposed guidance in the Exposure Draft does not appear to limit the embedded derivatives exclusion for credit risk to concentrations of credit risk (e.g., arising from subordination). As such, it appears that an entity could arbitrarily transfer or embed credit derivatives that otherwise would have been required to be marked-to-market under Statement 133 in a securitization transaction to avoid the earnings volatility associated with those instruments. If that is not the Board's intent, we suggest that the guidance be clarified.

As previously noted, paragraph 3(c) of the Exposure Draft allows entities to irrevocably elect fair value remeasurement of hybrid instruments that otherwise would have been required to be separated into a host contract and a derivative instrument pursuant to paragraph 12 of Statement 133. It is unclear whether the Board intended that guidance to apply to both issuers and holders of such instruments. If applicable to issuers, entities would effectively be able to carry their debt at fair value by embedding a derivative feature therein that would be required to be separated under the requirements of Statement 133, even if the embedded feature has little significance relative to the overall instrument. The Board should clarify whether this was its intent, including whether a significance test should be applied to the embedded feature to determine whether the issuer qualifies for the fair value measurement election with respect to the hybrid financial instrument.

Paragraph 3(a) of the Exposure Draft indicates that interest-only strips and principal-only strips are not subject to the requirements of the proposed Statement provided that they resulted from separating the *portions* of the contractual cash flows labeled interest and principal and do not incorporate any terms not present in the original financial



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instrument. We believe that the Board should include an example illustrating the application of this scope exception as it is unclear what the Board intended by including the phrase *portions of* in this paragraph. Is this meant to limit the application of the guidance to situations where all of the cash flows are separated into only principal and interest strips or is it meant to convey that a portion of contractual cash flows labeled interest and a portion of contractual cash flows labeled principal could be separated from other cash flows of the instrument and still qualify for the exception?

In addition to an example illustrating the application of the paragraph 3(a) scope exception, we believe the Board should provide examples illustrating other changes proposed in the Exposure Draft, such as identifying whether an instrument is a freestanding derivative or whether it contains an embedded derivative that otherwise would be required to be bifurcated. The analysis should consider the accounting by holders of beneficial interests and the issuer, which may be a QSPE. For that purpose, we have included several examples in the Appendix to this letter for the Board's consideration.

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If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact either Mark Bielstein at (212) 909-5419 or Kimber Bascom at (212) 909-5664.

Sincerely,

KPMG LLP



Appendix

Example 1: Asset-Backed Securitization Using a QSPE as Issuer (Residual Interest in Form of Preferred Stock)

Company A transfers fixed-rate loans to a bankruptcy-remote entity, which concurrently issues a 100% undivided interest to a QSPE. The advance rate is 90% on the assets sold. The QSPE issues variable-rate, investment grade senior and mezzanine bonds to third party investors and a beneficial interest representing the residual interest in the entity to Company A. The residual interest is in the form of preferred stock. The QSPE enters into an interest rate swap paying fixed returns from the loan portfolio to the counterparty and receiving LIBOR plus a spread.

Example 2: Asset-Backed Securitization Using a QSPE as Issuer (Residual Interest in Form of Subordinated Debt)

Assume the same facts as Example 1 above, except that the residual interest held by Company A is in the form of subordinated debt.

Example 3: CDO Issuance

Company B, acting as asset manager, purchases fixed- and variable-rate debt securities in the open market on behalf of CDO Issuer LLC. CDO Issuer LLC issues variable-rate, investment grade senior and mezzanine bonds and a residual interest in the form of an LLC membership interest to third party investors. CDO Issuer LLC enters into an interest rate swap paying fixed rate returns from the fixed-rate securities purchased to the counterparty and receiving LIBOR plus a spread. The notional amount of the swap matches the amount of fixed-rate debt securities purchased. Company B trades debt securities for the account of CDO Issuer LLC.

Example 4: Synthetic CDO Issuance

Assume the same facts as Example 3, except that rather than purchasing fixed- and variable-rate debt securities in the open market, CDO Issuer LLC enters into a credit default swap with Investment Bank that references those same securities.

Example 5: Credit Linked Note

Investment Bank X issues notes to third party investors in which repayment of principal is contingent on credit events of a reference portfolio of securities unrelated to Investment Bank.