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Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116 11 November 2009

Re: Proposed Accounting Standards Update, "Derivatives and Hedging (Topic 815) - Scope Exception Related to Embedded Credit Derivatives" (File Reference No. 1740-100)

Dear Mr. Golden:

We appreciate the opportunity to comment on the Financial Accounting Standards Board (FASB or Board) Proposed Accounting Standards Update, "Derivatives and Hedging (Topic 815) - Scope Exception Related to Embedded Credit Derivatives" (the Exposure Draft). We recognize that credit derivatives, particularly credit default swaps (CDS), have attracted growing public scrutiny and have become the focus of attention for both market participants and regulators because of recent turmoil in the current credit markets. We understand the Board's concerns about the lack of transparency of entities' involvement with certain embedded credit derivatives and support its efforts to cause more frequent bifurcation of these features from beneficial interests to increase the transparency of those derivatives and to achieve greater convergence with International Financial Reporting Standards (IFRS). We believe this project will help the Board to achieve these objectives.

We supported the initial version of this Exposure Draft in our letter dated 13 February 2009. This revised Exposure Draft would result in a significantly greater number of credit derivatives being bifurcated than under the previous Exposure Draft. While we support the objective of the Exposure Draft, we do not believe that this revision articulates a principle that is sufficiently operational and understandable. Constituents will have difficulties in understanding the principle the Board used in reaching its conclusions in the examples illustrated in the Exposure Draft with respect to analyses of embedded derivatives, including credit features, in securitized hybrid financial instruments. We are concerned that, without a clear and operational principle, diversity may arise in practice with respect to the application of paragraphs 815-15-25-11 through 25-13 and 815-15-15-9.

Furthermore, we question whether the "clearly and closely related" model used by the Board in the examples is a principles-based approach that would give consistent and rational bifurcation results for all types of derivative features embedded in beneficial interests of a securitization structure, including credit derivatives, interest rate derivatives, currency derivatives, or other derivatives. Although it appears to us that the Board intends to establish a principle for bifurcation of credit derivative features, we do not believe the Exposure Draft achieves that objective. The examples provide for bifurcation of credit-risk related embedded derivatives while preserving a non-bifurcation result for most common interest-risk and currency-risk related embedded derivatives, but it is not clear how



there is a consistent principle at work outside the simple examples in the Exposure Draft. It appears that the examples articulate a new concept for what constitutes the "host instrument" that has never been articulated before (including during the extensive due process that led to Statement 155) in order to achieve the desired result when applying the "clearly and closely related" concept. If the intention of the Board is to create a different governing principle for embedded credit features, we urge the Board to consider a rule that the existence of any credit-risk related embedded features is by definition not "clearly and closely related" to the host contract and therefore would require bifurcation of such a credit derivative (similar to the IFRS approach). We believe that such an approach would better achieve the Board's objective with respect to credit derivatives (vs. other types of derivatives), and we believe there are strong public policy sentiments that would justify the Board adopting a rule for this issue.

We also encourage the Board to consider other approaches that would provide greater benefit to constituents before it finalizes the proposed guidance. The International Accounting Standards Board (IASB)'s exposure draft on the classification and measurement of financial instruments proposes to eliminate bifurcation of embedded derivatives from a financial host and require all financial instruments, including hybrid instruments with a financial host, to be measured at fair value or amortized cost. The Board may consider whether this somewhat narrow issue mainly applicable to synthetic CDOs must be addressed in the near term or could instead be addressed as part of the broader financial instruments project, which is expected to result in a final standard before the end of 2010.

The revised "clearly and closely related" principle

We observe that the current scope exception in paragraphs 815-15-15-8 and 15-9 is well-understood and consistently applied in practice. Said simply, an investor in a beneficial interest with exposure to the credit risk of Company XYZ looks to the assets and liabilities of the SPE to see if the SPE either holds Company XYZ assets or a derivative tied to the default risk of Company XYZ assets. If either exists and the cash flows attributable to the beneficial interest are provided by the assets and liabilities of the SPE (without leverage), the investor does not bifurcate a credit derivative. If instead the cash flows of the beneficial interests are not supported by the assets and liabilities of the SPE (including derivative assets or liabilities), the investor presumes that another tranche holder is providing the exposure to Company XYZ and bifurcates the credit derivative feature in accordance with paragraph 815-15-55-226 (which this Exposure Draft would remove). Bifurcation is required because the credit risk in the beneficial interest is not clearly and closely related to assets or liabilities of the SPE (including derivative assets or liabilities).

The Exposure Draft proposes to change this result such that when investors' beneficial interests are supported by a *credit derivative tied to the default risk of Company XYZ assets* instead of *actual Company XYZ assets*, bifurcation of a credit derivative should result even though the beneficial interest is fully supported by the assets and liabilities of the SPE (including derivative assets or liabilities). We do not object to this outcome, but we would prefer that the Board not change practice as to how a host contract is defined and then how the "clearly and closely related" principle is applied in order to achieve this result. It is apparently not the Board's intention that an embedded derivative be bifurcated out of every beneficial interest because the SPE's assets and liabilities include a freestanding derivative. The Board appears to seek "automatic" bifurcation only when freestanding written *credit* derivatives are observed.



The new and revised examples in the proposed guidance introduce the new approach in applying the guidance in paragraphs 815-15-25-11 through 25-13 with respect to the identification and analysis of embedded derivative features for potential bifurcation in hybrid beneficial interests of a securitization structure. The revised "clearly and closely related" principle now requires beneficial interest holders to look inside the issuing SPE to determine whether instruments inside the entity (one of which will be deemed to be "the host") are "clearly and closely related" to each other. However, the new approach does not provide any guidance regarding how to determine when an embedded derivative exists in a beneficial interest and thus requires further bifurcation analysis. We are not certain whether the Board's intent is to modify the model based on which embedded derivatives (including credit-risk related derivative features) are identified, but we believe the new principle evidenced in the examples undermines what otherwise has been a well-understood principle in paragraphs 815-15-25-11 through 25-13. Constituents have been able to apply this principle consistently for all types of embedded derivative features, including credit, interest rate and currency related features. In addition, constituents have also applied the exception for embedded credit derivative features related to the concentration of credit risk in the form of subordination of one financial instrument to another and applied the scope exception in the manner consistent with the examples illustrated in the Exposure Draft. We have not seen diversity in practice with respect to the application of the guidance in paragraphs 815-15-25-11 through 25-13.

We believe the Exposure Draft does not adequately articulate a new principle and does not explain why credit derivatives should be subject to a different bifurcation result than other commonly seen derivatives (interest rate, currency, etc.) when paragraphs 815-15-25-11 through 25-13, which are not being amended, are applied. As such, we recommend the FASB better articulate why credit derivatives are different from other types of derivatives or, better yet, adopt a rule that provides that embedded credit derivatives should achieve a different result.

Determination of the host contract

The proposed new model focuses on the nature of the assets held by the issuing entity in determining the host contract to be used in the "clearly and closely related" analysis rather than the longstanding approach of looking to the terms of the beneficial interest to determine the host. It effectively requires the beneficial interest holders to identify the host contract "inside an SPE." This approach is new and we are concerned about unintended consequences of changing the approach to determining the host. The Exposure Draft does not provide the basis for the new model or explain why the Board proposes this new model. In the absence of the Board's basis for conclusions, we are concerned that users would not be able to apply this approach consistently to facts and circumstances other than those illustrated in the examples.

The current practice of identifying the host contract by analyzing the terms of the beneficial interests issued by the SPE, rather than by examining the contents of the SPE, is supported by the guidance in paragraphs 815-10-15-11, 815-15-25-24 and 25-25. Paragraph 815-15-25-24 provides:

"The characteristics of a debt host contract generally should be based on **the stated or implied substantive terms of the hybrid instrument**. Those terms may include a fixed-rate, floating-rate, zero-coupon, discount or premium, or some combination thereof."



Paragraph 815-15-25-25 further indicates that "it would be inappropriate to do either of the following:

- Identify a floating-rate host contract and an interest rate swap component that has a comparable floating-rate leg in an embedded compound derivative, in lieu of identifying a fixed-rate host contract
- Identify a fixed-rate host contract and a fixed-to-floating interest rate swap component in an embedded compound derivative in lieu of identifying a floating-rate host contract."

The current practice has been well-understood by constituents and has resulted in little to no diversity in practice since Statement 155 was issued several years ago. Constituents have been evaluating the terms of a beneficial interest to identify the host contract and potential embedded derivative features, bifurcating any immediately obvious features that are not clearly and closely related (such as an equity-indexed feature in a debt host). Furthermore, as discussed above, if the assets and liabilities of the SPE (including freestanding derivatives) are not capable of providing the necessary cash flows for the beneficial interest tranche, other tranche holders are viewed as providing those cash flows and that feature is then bifurcated (unless it is the "subordination"-type of credit feature addressed in paragraph 815-15-15-9).

The new proposed approach seems inconsistent with the existing guidance. Therefore, it is unclear to us how to operationalize a model for identifying the host contract by evaluating the assets within an SPE while simultaneously analyzing the beneficial interest issued by the SPE for potential bifurcation. This lack of clarity creates challenges for constituents in applying the proposed approach. For example:

- A trust may hold a portfolio of corporate bonds with different issuers. This is most common in a cash collateral debt obligation (CDO) structure.
 - Under the proposed approach, it is unclear to us whether one bond or all bonds in the portfolio as a group would be considered the host contract. If one bond is determinative of the host contract, which one of the bonds inside the SPE should be defined as the host contract?
- Case W in the Exposure Draft involves fixed-rate bonds held by the SPE and a matching interest rate swap structure under which the SPE issues variable-rate beneficial interests. The example concludes that the investment in fixed-rate bonds is the host contract.
 - ▶ If the SPE in the example holds an equal mix of fixed- and floating-rate bonds, it is unclear whether the fixed-rate bonds or the floating-rate bonds comprise the host contract.
 - ▶ If the mix of fixed- and floating-rate bonds changes over time, which often occurs in a managed CDO structure, would the host contract change, thus resulting in a different conclusion as to whether the economic characteristics and risk of the embedded interest rate swap would still be considered "clearly and closely related" to the host contract?



- Case Z in the Exposure Draft illustrates the application of the new approach which results in identifying the U.S. Treasury securities held by the SPE to be the host contract.
 - The beneficial interest holders must compare the economic characteristics and risks of the freestanding credit derivatives inside the SPE to the U.S. Treasury securities to determine whether the embedded credit derivatives are "clearly and closely related" to the U.S. Treasury securities, which are deemed to be the "host."
 - ▶ We find it precedent-setting to say that the host contract of a beneficial interest issued by an SPE is a U.S. Treasury security. We do not believe it is plausible for any issuing entity, other than perhaps the U.S. government itself, to be capable of issuing a hybrid instrument for which the host contract would be deemed to be risk free.¹ Paragraph 815-15-25-24 requires the identification of host contract to be based on the substantive terms of the entire beneficial interest. We believe the host contract in Case Z is a debt instrument for a term equal to that stated by the beneficial interest itself that carries a *non*-risk-free coupon rate appropriate to the expected term of the beneficial interest and to the creditworthiness overall of the issuing SPE.
 - Given the above-described determination of the host contract, it is unclear how the economic characteristics and risks of the embedded written credit default swap on a referenced credit are not "clearly and closely related" to this host contract, which itself contemplates the economic characteristics and risks of everything the issuer owns or to which it is a contractual party.

Credit-risk versus interest rate or currency embedded features

Assume that in Case Z above there was no credit derivative inside the SPE but, rather, a LIBOR-based interest rate swap that permitted the beneficial interest to pay a floating rate of interest rather than the fixed rate provided by the U.S. Treasury securities. If the "host" is deemed to be risk-free U.S. Treasury securities, how does one conclude that the non-risk-free LIBOR-based interest rate swap is "clearly and closely related" to a fixed-rate risk-free U.S. Treasury security? There are other permutations of this example for which the change in guidance on identifying the host contract could lead to unintended consequences.

The Board has attempted to draw a distinction between credit-risk related embedded features and other features, and the drafted examples appear designed to demonstrate that the application of the new "clearly and closely related" principle would result in different bifurcation results for interest rate and foreign currency related embedded derivatives versus embedded credit derivatives. However, the Exposure Draft does not clearly describe how the Board concludes the host contract (the assets of the SPE) and the cross-currency swap and interest rate swap in Case V and Case W, respectively, would be considered "clearly and closely related." While we are inclined to support the results of Case V and Case W, we find that analysis to be unclear, which is why we advocate a rule for embedded credit derivatives.

As expressed in the Basis for Conclusions of FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, an amendment of FASB Statement No. 133 (Statement 138)



There are unique features of credit derivatives that could be cited to justify an inherently different approach when they are encountered as terms embedded in beneficial interests. For example, credit derivatives generally contain *entity-specific* underlyings, while foreign currency derivatives and interest rate derivatives are characterized by underlyings referencing broad, overall market indices that are applicable universally to a broad category of host instruments. We believe it is reasonable to develop a different approach for embedded credit derivatives.

Impacts for issuers of beneficial interests

The Exposure Draft does not address whether the requirements for holders of beneficial interests in a securitization to identify embedded derivatives for bifurcation analysis also apply to the issuers of these interests. We understand that historically the issuer's accounting has not been a focus of attention, because in most cases those SPE structures are not consolidated by any entity, nor are financial statements typically prepared for non-consolidated SPE structures. However, this practice may change given the issuance of Statement No. 167, Amendments to FASB Interpretation No. 46(R) (Statement 167). Although we cannot envision why the accounting would be different for issuers and holders of the same hybrid instrument (the beneficial interests issued by an SPE) that both parties are evaluating, we are not certain whether the Board believes the guidance in paragraphs 815-15-25-11 through 25-13 and 815-15-15-9, including the embedded credit derivative scope exception, would also apply to the issuing entity, and if it does, would apply in the same manner.

We are of the view that the proposed guidance should be applied equally to the holders and issuers of the same beneficial interests. This view can be supported by the credit-linked note example illustrated in paragraph 815-15-55-103. The example provides the accounting analysis for the credit-linked note from the issuer's perspective and concludes that the credit-linked note issued by Entity A contains an embedded credit derivative requiring bifurcation, because "the credit risk exposure of the reference security (Entity X) and the risk exposure arising from the creditworthiness of the obligor (Entity A) are not clearly and closely related." The credit-linked note structure is similar to the fully funded synthetic CDO structure with a single-tranche structure illustrated in Case AA, except that the issuer in paragraph 815-15-55-103 is a corporation, whereas the issuing entity in Case AA is an SPE. In the synthetic CDO structure in Case AA, the SPE has issued a single-tranche beneficial interest that passes through to the holder of the beneficial interest the economics of the U.S. Treasury securities and the freestanding written CDS. The sole tranche holder receives a premium in the form of higher interest from the SPE for agreeing to assume the default risk associated with the referenced credit to a third party and to make potential future payments related to defaults on the CDS. If the SPE is consolidated by a corporation, the corporation's balance sheet would show the U.S. Treasury securities as an asset, a freestanding written CDS with a third party bank, and a hybrid instrument liability (the single-tranche beneficial interest). By analogy to the credit-linked note example in paragraph 815-15-55-103, the SPE (or the consolidating corporate entity) would be expected to bifurcate an embedded credit derivative from the single-tranche beneficial interest it issued, even though that embedded credit derivative is a purchased credit derivative from the issuer's perspective. We anticipate issuers (or the consolidating corporate entity) would desire to bifurcate the purchased credit derivative, because it provides a natural offset in the statement of earnings to the freestanding CDS written by the SPE (or the consolidating corporate entity).



However, it is unclear to us whether the Board believes the guidance illustrated for the credit-linked note in paragraphs 815-15-55-103 through 55-104 would be relevant for the issuer (or the consolidating corporate entity) if it is an SPE instead of a general corporation and whether it intends to create an accounting distinction between purchased versus written credit derivatives. We recommend the Board address the effect of the proposed guidance for issuers of beneficial interests (or the entities that consolidate the issuing entities) and further clarify whether the proposed guidance only requires evaluation of beneficial interests issued by an SPE. In addition, we believe a clear articulation of the Board's view with respect to how the guidance in paragraphs 815-15-25-11 through 25-13 and 815-15-15-9 interacts with that in paragraph 815-15-55-104 would be beneficial to constituents.

Effective date

The effective date proposed in the Exposure Draft is the first day of a reporting entity's first fiscal quarter beginning after 15 December 2009 (1 January 2010 for calendar year-end companies). As currently drafted, we do not believe that the proposed effective date will give preparers sufficient time to evaluate the effect of the proposed guidance, particularly if there is lack of clarity on the implications of the new guidance on the accounting by the issuer, and particularly for those issuers that will be consolidated under Statement 167. Furthermore, it is unclear whether a nonpublic company with a fiscal year-end is supposed to adopt the proposed guidance in the middle of a reporting year. We suggest the Board consider adding specific transition guidance for nonpublic entities.

Other comments

In addition, we have the following additional comments regarding the draft language of the Exposure Draft (where applicable, suggested added text is underlined and suggested deleted text is struck out):

Case X, paragraphs 815-15-55-224 and 55-225: the example states that "the embedded credit derivative feature related to the credit loss allocation among tranches is subject to the application of paragraph 815-10-15-11 and Section 815-15-25 because the related transfer of credit risk is not created only by the subordination of one financial instrument to another, as discussed in paragraph 815-15-9, but also includes the introduction of variable-rate-based payments, which enables the senior, floating-rate financial instrument to receive amounts in excess of the fixed rate on the special-purpose entity's bonds."

While we do not disagree with the final conclusion reached in this example, it is unclear to us how the presence of variable-rate-based payments in the beneficial interests is related to the transfer of credit risk (it appears to represent a transfer of interest-rate risk). The purpose of this example originally was to illustrate when an embedded interest rate derivative is not considered "clearly and closely related" to the host. In the new version, the explanation as to why the paragraph 815-15-15-9 exception is not applicable to the subordination in the structure is unclear and, in any event, appears to be irrelevant as the example does not conclude that a "credit derivative" must be bifurcated. Therefore, we suggest the Board consider eliminating the references in the example related to the application of paragraph 815-15-15-9 and allow the example to serve as it once did in illustrating the bifurcation of an interest rate derivative.



Case Z, paragraph 815-15-55-226D: the example explains that the structure does not expose the investor to potential future payments; rather, the investor is merely exposed to a potential reduction in its future cash inflows. We believe it would be helpful to users to add the following:

"Rather, the investor is exposed to a potential reduction in future inflows <u>and is compensated for this by a higher interest rate than a U.S. Treasury security would pay."</u>

Paragraph 815-10-65-xx (c)(2): it states "if the fair value option is not elected for a hybrid contact that is required...the carrying amount of the host contract at adoption of this paragraph shall be based upon a pro forma bifurcation as of the inception of the hybrid contract and ..."

It appears the Board intended for the carrying amount of the host contract at adoption to be based upon a pro forma bifurcation of the hybrid instrument. While the guidance suggests that this bifurcation be performed at the inception of the contract because the current owner of the interest may not have been the owner at inception, or other remeasurement events may have occurred, we suggest the language be changed to require pro forma bifurcation "as of the inception of the hybrid contract and the date the hybrid contract was acquired, issued or subject to a remeasurement (new basis) event."

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

Very truly yours,

