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November 12, 2009

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File Reference: No. 1740-100 - Proposed ASU, Derivatives and Hedging, Scope Exception Related to Embedded Credit Derivatives

Dear Mr. Golden,

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the proposed Accounting Standards Update, *Scope Exception Related to Embedded Credit Derivatives* (the "proposed ASU").

The Board's stated objective in the proposed ASU is to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraphs 15-8 and 15-9 of Subtopic 815-15, *Embedded Derivatives*.

We do not believe the proposed ASU achieves its stated objective. Rather, we believe that the proposal establishes new exception rules for evaluating credit derivatives embedded in beneficial interests in securitized financial assets that focus on the form of the issuer and are not required for other financial instruments.

We believe that a single approach for evaluating embedded credit derivatives for all financial instruments is preferable and achieves a more consistent objective. For example, the recent efforts to align the credit impairment models for debt securities helped increase consistency amongst those models. Therefore, we encourage the Board to keep the assessments of embedded credit derivatives for all financial instruments aligned, regardless of the form of the issuer.

We also believe the recent changes made by the Board to the credit impairment model address most of the Board's concerns related to beneficial interests in securitized financial assets. As the Board is contemplating a project with the IASB to revise the accounting for financial instruments we recommend that the Board not address this narrow issue in isolation at this time. We believe this issue should be incorporated into the broader project on financial instruments.

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If the Board does decide to proceed with the proposed ASU, we do not believe that the amendments currently proposed by the Board provide an unambiguous model for evaluating credit derivatives embedded in beneficial interests in securitized financial assets. Specifically, we recommend that the Board address the issues and challenges that we summarize below, and that are further described in the Appendix to this letter. In part, we observe that the proposed ASU:

- provides new guidance for applying the clearly and closely related criterion which conflicts with the existing guidance for credit sensitive payments;
- does not provide sufficient guidance on the determination of the host contract and embedded derivatives, for example when multiple financial assets are securitized, or when securitized financial assets contain embedded derivatives;
- does not provide guidance on when the clearly and closely related criterion should be applied to embedded credit derivatives, or when derivatives held or issued by the securitized vehicle are not credit derivatives; and
- does not allow for sufficient time or transition relief to enable preparers and auditors to implement the new guidance.

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If you have any questions regarding our comments, please contact Russ Mallett (973-236-7115) or Francois Grunenwald (973-236-4315).

Sincerely,

Pricewaterhouse Coopers LLP

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Appendix

Issue 1: Do the amendments resolve the potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraphs 815-15-15-8 and 15-9?

The proposed amendments eliminate a scope exception for credit derivatives embedded in interests in securitized financial assets and introduce a new model for determining whether embedded derivatives are clearly and closely related to interests in securitized financial assets. We do not believe the amendments currently proposed by the Board provide an unambiguous model for evaluating credit derivatives embedded in beneficial interests in securitized financial assets. The proposed model is not sufficiently articulated and the illustrative examples appear ambiguous. Some additional observations for the Board's consideration follow.

1) Recently revised impairment model

The Board recently changed the recognition and measurement of impairment for certain debt securities, including the credit losses of beneficial interests in securitized financial assets, and enhanced disclosure requirements. The adoption of FSP FAS 115-2 and FSP EITF 99-20-1 considerably modified the accounting approach to credit risk, by requiring the credit loss to be immediately recognized in earnings. We also note the Board's guidance promoted an impairment model aligned for all financial debt instruments.

The proposed ASU would now modify this recently issued guidance and reinstate a difference for interests in securitized financial assets. We recognize that the proposed measurement of the credit risk would be based on fair value under the proposed ASU, as opposed to management's estimate of the credit loss. However, we believe the recent changes in the accounting guidance provide relevant information related to embedded credit features and therefore address most of the concerns of the Board.

2) New exceptions

The Board proposal provides a different accounting treatment based on whether the form of the financial instrument is a beneficial interest in securitized financial assets, and whether the securitization vehicle holds or issues derivatives. While we recognize that beneficial interests in securitized financial assets are complex and may differ from other financial instruments we do not believe such differences warrant exception treatment.

Bifurcating a hybrid instrument to separately account for an embedded credit derivative is required under Subtopic 815-15 when the credit risk of the embedded derivative is not clearly and closely related to the credit risk of the host. The credit risk of a financial instrument is generally the credit risk of the issuer, adjusted for the credit risk of any collateral pledged and/or any other credit enhancement for the benefit of the financial instrument holder, and further adjusted for any recourse provisions and/or any subordination of the financial instrument to other creditor's rights. Subordination may occur contractually, for example through tranching of interests, or legally, for example in the circumstances of bankruptcy.

Securitizations are generally non-recourse transactions and attempt to legally isolate financial assets for the benefit of the beneficial interest holders. Beneficial interest holders have recourse solely to the specified financial assets pledged as collateral (including derivatives) and do not bear the credit risk associated with the default or bankruptcy of any other party originating the transaction (for example the transferor or sponsor).

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Paragraph 815-15-15-8 recognized that the credit risk of beneficial interests in securitized financial assets is merely the credit risk of the assets and liabilities (including derivatives) that are held by the issuing entity, and pledged as collateral for the benefit of beneficial interest holders. In other words, there is minimal credit risk associated with a securitization vehicle *separate* from its assets and liabilities (including derivatives), unlike other issuers, such as corporations. This is further confirmed by the valuation of such financial instruments.

Accordingly, we do not object to the proposed elimination of the scope exception in paragraph 815-15-15-8, but we believe the Board's new model to require bifurcation of derivative instruments held or issued by securitization vehicles (including synthetic CDOs) is ambiguous as it is not justified by the clearly and closely related criterion.

3) Additional considerations related to subordination

We support the retention of a scope exception for subordination in paragraph 815-15-15-9, as we agree with the Board that the concentration of credit risk in the form only of subordination of one instrument to another should not be considered an embedded credit derivative that should be subject to bifurcation and separate accounting. However, we do not believe the amendments both to paragraph 815-15-15-9 and the examples will change current practice specifically with regard to the application of the subordination scope exception. We refer the Board to our previous letter dated February 16, 2009 in response to the Proposed Issue C22. Therefore, we recommend the Board not amend the existing guidance in that respect.

We have the following additional observations on the Board's proposed amendments to paragraph 815-15-15-9:

1. *Unfunded tranches* - We agree with the Board that the current scope exception in paragraphs 815-15-15-8 and 15-9 does not apply to interests in securitized financial instruments that expose the holder to potential future payments. Since paragraph 815-15-15-9 provides for an exception for subordination only, we believe that discussing unfunded tranches in the context of subordination is not necessary and creates confusion.

2. *Single tranche* - We do not object to the inclusion of the language in paragraph 815-15-15-9(b): "The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant." However, we believe the statement is not necessary in the context of subordination and creates confusion.

3. *Subordination outside securitizations* - We believe the scope exception should not be restricted to beneficial interests in securitized financial assets and be discussed in the context of all issuers, including corporate or other entities such as investment funds.

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Issue 2: Are the revisions to the existing examples and the new examples in paragraphs 815-15-55-226 through 55-226E effective in clarifying the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9?

The proposed revisions to the existing examples and the new examples clarify the breadth of the embedded credit derivative scope exception related to subordination in paragraph 815-15-15-9. However, as mentioned in Issue 1, we do not believe this specific amendment would change current practice as to the application of the subordination scope exception.

In addition, and most importantly, the ASU amendments propose a new clearly and closely related methodology applicable to beneficial interests in securitized financial assets. We do not believe the proposed ASU provide an unambiguous guidance for evaluating embedded credit derivatives. We are also concerned that unintended consequences may arise. Therefore we provide the following observations for the Board's consideration.

1) Model for evaluating embedded credit derivatives

The elimination of the scope exception in paragraph 815-15-15-8 will require preparers to determine whether embedded credit derivatives in interests in securitized financial assets need to be bifurcated in accordance with 815-15-25-1. The proposed ASU provides a few examples illustrating which feature is required to be bifurcated and which is not. However, the examples are simplistic and the implicit principles or guidance is not sufficiently articulated. In addition, the examples do not address, and potentially conflict with the guidance for credit sensitive payments stated in paragraph 815-15-25-47. We ask the Board to state the guidance for the identification and evaluation of embedded derivatives in beneficial interests in securitized financial assets in Section 815-15-25.

2) Determination of host contract and embedded derivative

The examples contemplate simplified securitization structures that hold a single financial asset and that are party to a single freestanding derivative. Insight is not provided as to how one would define the host contract and the embedded derivative in situations where there are multiple financial assets and multiple freestanding derivatives, or where the financial assets held contain embedded derivatives (e.g., re-securitizations). Absent clarification there will be diversity in application.

Some preparers may believe the host contract should be defined as a single financial asset selected from the pool of underlying assets, if the freestanding derivatives held or issued by the structure economically hedge the assets. This approach could apply where the financial assets held by the structure are partially invested in foreign currencies, or partially invested at fixed rate conditions while other financial assets and the beneficial interests are at floating rate. The host contract might also be defined as a hypothetical financial instrument representing the blended characteristics of all non-derivative financial instruments held by the structure. Alternatively, the host contract could be defined as a risk free non-derivative financial instrument.

Although not clearly indicated in the proposed ASU, we believe in the case of a re-securitization the analysis requires an understanding of each securitization making up the re-securitization transaction, consistent with the Board's view expressed in the FAS 155 basis for conclusions. Accordingly, we ask the Board to clarify that the proposed look-through rule applies regardless of whether the derivative instruments are freestanding or embedded in the financial assets.

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3) Timing of analysis for credit derivatives

The examples do not provide guidance on the timing of assessment of the clearly and closely related criterion for embedded credit derivatives. We recommend that the Board clarify whether the assessment is to be performed at a point in time (e.g., either at acquisition or issuance), or if changes in the assets and liabilities, including derivatives, would trigger a reevaluation. If it is to be performed only at a point in time, we ask that the Board further clarify whether the analysis is based solely on the existence of credit derivatives at that time, or based on the possibility, even remote, of the existence of credit derivatives.

4) Non-credit derivatives creating credit risk

The examples in the proposed ASU require the evaluation of any credit risk borne by beneficial interests that would be due to the presence of interest rate or foreign currency derivatives. The only criterion required to be met to be considered clearly and closely related is that the notional amounts of the derivatives, assets and beneficial interests match at inception. The examples do not address other differences between the various instruments, such as diverging notional amounts and the tenor of each. For example, a securitization vehicle holds contractually prepayable loans hedged with an amortizing interest rate swap. As the amortizing notional of the swap is based on estimated prepayments, actual prepayments on the loans may lead to the notional amount of the derivative exceeding the underlying loan balance.

Under the current guidance for interest rate risk, the evaluation of the clearly and closely related criterion is required at the date the beneficial interest is acquired (or incurred), or upon modification of the instrument. The current guidance also specifies that the evaluation needs to contemplate all possible future interest scenarios, even remote. In addition to the above observation regarding timing, we ask the Board to clarify whether the assessment is based solely on the assets and liabilities, including derivatives, at inception, based on expectations of future balances, or based on any possible interest rate or foreign currency scenario, even remote, and whether consideration of contractual terms protecting investors should be made (for example, prepayment of the beneficial interest contingent upon certain triggers).

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Issue 3: Is the proposed effective date operational and the transition provisions appropriate?

1) Effective Date

The proposed ASU requires preparers to assess all existing beneficial interests in securitized financial assets under the new model, except for those that were grandfathered under FAS 155. This assessment and the valuation of any derivatives requiring bifurcation will be onerous. We therefore recommend that the effective date be extended to allow for sufficient time for implementation.

In addition, clarification is needed to define "the first date of [the reporting entity's] first fiscal quarter beginning after December 15, 2009", for example as it applies to private companies or foreign private issuers. We note other recent FASB guidance refers to "interim periods" as opposed to "fiscal quarters."

2) Transition Provisions

The transition provisions in the proposed ASU do not contemplate situations where bifurcation would be required for certain beneficial interests as a result of the elimination of the scope exception in paragraph 815-15-15-8, as opposed to the amendments to 15-9. We ask that the Board revise the proposed ASU to extend the transition provisions to this circumstance.

Lastly, we recommend that the proposed guidance only be required to apply prospectively to beneficial interests acquired, issued or modified after a certain date, consistent with FAS 155. Alternatively, if the model is to be applied to all existing investments, we believe that a hybrid instrument should be assessed under the revised provisions at the date it is acquired, consistent with the Standard, as opposed to the date of adoption of the proposed issue. Applying the guidance on the date of adoption could lead to differing conclusions from those that would have been reached at the date of acquisition.