



International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

November 12, 2009

Mr. Russell Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1740-100: Scope Exception Related to Embedded Credit Derivatives

Dear Mr. Golden:

The International Swaps and Derivatives Association (ISDA)¹ appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board's ("FASB") Exposure Draft of proposed Accounting Standards Update ("ASU") to Topic 815, *Scope Exception Related to Embedded Credit Derivatives* (the "Proposed ASU").

ISDA continues to support the Board's original decision in ASU Topic 815 (paragraph 815-15-15-8) that the creditworthiness of an entity is determined by the assets that it holds and that the form of those assets (cash versus derivative) should not change the accounting. We refer the FASB to our previous letters dated February 13, 2009 and March 10, 2009 and the Board's previous decisions quoted therein.

While we note the Board's current desire to define credit-risky assets obtained in derivative form as creating embedded credit derivative risk in the related liabilities, we do not believe that the resulting changes to the clearly and closely related model as drafted in the Proposed ASU are

¹ ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

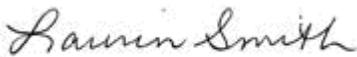
ISDA

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understandable or operational. We believe that preparers will not be able to apply the new model to the most common securitization structures:

- Cash CDOs – fully funded securitizations made up entirely of bonds or loans (all cash instruments and no derivatives).
 - It is unclear whether the Board intends for differing credit risks within an entity to require bifurcation even if no credit derivatives are present in the entity
- Synthetic CDOs – fully funded securitizations made up of multiple cash instruments and multiple derivatives
 - It is unclear whether the Board intends for all cash instruments collectively to be the host contract, or whether one cash instrument would be arbitrarily chosen amongst the entity's investments
- Actively managed CDOs – fully funded securitizations in which the investments of the entity change over time
 - It is unclear whether the Board intends for the host contract to change over time, and if so, what impact this has on the operation of the clearly and closely related model
- FX and Interest Rate securitizations – Case V and Case W
 - In the absence of full consideration of unintended consequences in the Proposed ASU, we do not believe that the change to the clearly and closely related model for FX and interest rate risks will in all cases come to the same conclusions as under the previous model
 - It is unclear how or why the cash instrument and derivative instrument can be considered to be clearly and closely related to each other based on existing literature

More detailed comments on the specific provisions of the Proposed ASU are included in Appendix A attached hereto. We hope that you find our comments informative and useful. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned at 212-648-0909 or Hee Lee, Partner, Ernst & Young, ISDA's external accounting advisor, at 212-773-8605.



Laurin Smith
J.P. Morgan Chase & Co.
Chair, Accounting Policy Committee
International Swaps and Derivatives Association

1. Clearly and Closely Related Model – Definition of Host Contract

The proposed changes to paragraph 815-15-15-9 (a) require an evaluation of whether the assets within the entity are clearly and closely related to each other rather than an evaluation of the contractual terms of the issued liability and an understanding of how the assets of the entity may impact the cash flows received pursuant to the contractual terms. This is a massive change to the clearly and closely related model for securitized instruments that requires a fulsome explanation and field testing of how the new model should be interpreted and applied to the most common instruments. In the absence of such articulation and field testing to actual instruments, we do not believe that the Proposed ASU is understandable or operational. The Proposed ASU states that derivatives investments held by a securitization entity that have credit risks that differ from those of a single cash instrument investment held by the entity require bifurcation. However, the Proposed ASU does not clearly articulate whether different credit risks of multiple cash instruments also require bifurcation, or whether it is only the presence of derivatives in the entity that result in bifurcation. This lack of clarity creates confusion and interpretive risk for securitized assets that do not involve derivatives, such as U.S. government agency mortgage backed securities. As a result, we are unclear how the new model should be applied to the following instruments, which are among the most common securitization structures:

- Cash CDOs – fully funded securitizations made up entirely of bonds or loans (all cash instruments and no derivatives).
 - It is unclear whether the Board intends for differing credit risks within an entity to require bifurcation even if no credit derivatives are present in the entity, which we believe should not be the case.
 - The Proposed ASU should clarify that Cash CDOs do not require bifurcation, as we do not believe that it is intended or useful to require bifurcation for instruments such as mortgage backed and asset backed securities whose credit risks are not derived from derivative instruments.
- Synthetic CDOs – fully funded securitizations made up of multiple cash instruments and multiple derivatives
 - Since the credit risk examples in the Proposed ASU only involve one cash investment in the securitization entity, it is unclear whether, for securitizations with multiple cash investments, the Board intends for all cash instruments collectively to represent the host contract, or whether one cash instrument would be arbitrarily chosen amongst the entity's investments to represent the host contract.
 - We believe that the Proposed ASU should clarify that the credit risk of the cash instruments collectively represent the credit risk of the host contract to be consistent with the recommendation for Cash CDOs above.

- Actively managed synthetic CDOs – fully funded securitizations in which the investments and credit derivatives held by the entity change over time
 - It is unclear whether the Board intends for the host contract to change over time, and if so, what impact this has on the operation of the clearly and closely related model.
 - The requirement to bifurcate credit derivatives will require massive changes to existing processes as investors would be required to identify and value a different embedded credit derivative each reporting period as the composition of credit derivatives change. These derivative identification and valuation processes will need to be created from scratch for many preparers. We therefore believe this aspect of the proposed ASU to such investments to be inoperational.

2. Clearly and Closely Related Model – Unintended Consequences

While we understand the Board’s intention in changing the clearly and closely related model for credit securitizations in order to achieve a bifurcation or full fair value result for credit derivatives, we do not understand the need to change the model for interest rate and FX risks. While we do not believe that the outcomes for Case V and Case W are different under the existing clearly and closely related model than is described in those cases, we are concerned that outcomes may be different in other examples. In the absence of a field test of the model, we do not believe that the existence or lack of unintended consequences can be determined.

Furthermore, we do not understand the basis for the FASB’s conclusion that the cash instruments and derivative instruments in Case V and Case W, respectively, are clearly and closely related to each other. We are unable to discern the basis for the conclusion using any existing literature, and therefore we question whether the conclusion can be useful for interpreting any cases with different facts.

We recommend the FASB delete these cases from the Proposed ASU and clarify that any changes to the clearly and closely related model apply to credit risk only. We believe that there is no need to incur the risk of unintended consequences with an unproven model change that is intended to address an unrelated risk.

3. Illustrative Examples: Interest Rate Risk

Case X, sections 815-15-55-224 and 815-15-55-225, illustrates application of the new clearly and closely related model for embedded credit derivatives to a securitization involving subordination, which also incorporates interest rate basis risk created through the terms of the interests issued by the special-purpose entity. The first sentence of the example states that transfer of credit risk among interest holders is not created only by subordination of one financial instrument to another and implies that such credit risk

transfer is created by the mismatch in interest payment terms between the different classes of liabilities. The example continues by stating that an embedded interest rate derivative exists in each tranche requiring analysis for bifurcation due to the mismatch between the assets of the entity and its liabilities.

While we do not disagree with the overall conclusion in this example, defining interest rate-related embedded derivatives as transferring credit risk creates confusion, as the model for evaluating interest rate derivatives is distinct from the model for evaluating embedded credit derivatives (i.e., the subordination exception is not applicable to embedded interest rate derivatives). A distinction between these two models already exists in Topic 815 and we believe such distinction continues to be necessary. Credit risk would always cause an embedded feature to fail the recovery test for interest rate derivatives in paragraph 815-25-26 of Topic 815, resulting in the identification of a bifurcatable embedded derivative.

We therefore recommend that the FASB remove all references in Case X to embedded interest rate derivatives creating a transfer of credit risk that is not created only by subordination.

4. Effective Date and Transition

The effective date for the provisions of the Exposure Draft are for interim periods beginning after December 15, 2009, which would be January 1, 2010 for calendar year-end companies. As currently drafted, we do not believe the proposed accounting standards update is operational within the time frame established by the proposed effective date, given the lack of understandability and operability of the new clearly and closely related model, as well as the requirement to include a potentially significant new population of affected instruments into the credit derivative disclosures. Preparers' resources are already strained in the implementation of other accounting standards effective either at year-end or in the first quarter of 2010, including the proposed ASU, *Improving Disclosures about Fair Value Measurements*, proposed SFAS, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, the recently issued SFAS 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and SFAS 167, *Amendments to FASB Interpretation No. 46(R)*.

Based on the above, we believe that it would take a minimum of six months to comply with the FASB's new clearly and closely related criteria and disclosures from the December 2009 issuance date. Therefore, we recommend an effective date that is no earlier than for periods beginning after June 15, 2010.

5. Other Clarifications

To enhance the understandability of the proposed changes to the embedded credit derivatives scope exception, we recommend that the FASB include the following additional criterion in paragraph 815-15-15-9 in the final ASU (text interest is underlined).

Consequently, the following circumstances (among others) would not qualify for the scope exception and are subject to the application of paragraph 815-10-15-11 and Section 815-15-25 for potential bifurcation:

- a. The holder of an interest in a tranche of that securitized financial instrument is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows); consequently, any transfer of credit risk for that tranche shall not be considered to be only in the form of subordination of one financial instrument to another because those future payments are considered to be related to credit risk outside that created by subordination. (Note, however, that the securitized financial instrument may involve other tranches that are not exposed to potential future payments, and thus, those other tranches may qualify for the scope exception).
- b. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.
- c. The holder owns an interest in a securitization vehicle that holds freestanding written credit derivatives (for example, credit default swaps pursuant to which the securitization vehicle sells protection to parties other than the holders of its beneficial interests).

Additionally, to enhance the understandability of the transition provisions related to the application of the fair value option, we recommend that the FASB incorporate the following changes to paragraph 815-10-65-XX (subsection c 2) in the final ASU (text deleted is ~~stricken~~ and text inserted is underlined).

1. If a contract (that is, hybrid instrument) would be required to be separated into a host contract and derivative instrument under paragraph 815-15-15-9 and if the contract is a hybrid financial instrument, the entity may elect the fair value option, that is, may irrevocably elect to measure that contract in its entirety at fair value (with changes in fair value recognized in earnings). The election of the fair value option shall be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption. If the fair value option is elected at adoption, any difference between the fair value of the hybrid instrument and the carrying amount shall be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption.

2. If the fair value option is not elected for a hybrid contract that is required to be separated into a host contract and a derivative instrument under paragraph 815-15-15-9, the carrying amount of the host contract at adoption of the content that links to this paragraph shall be based on a pro forma bifurcation as of the inception of the hybrid contract and the host contract's subsequent accounting to the date of adoption. At adoption, any difference between the total carrying amount of the individual components of the newly bifurcated hybrid instrument and the carrying amount of the hybrid instrument before bifurcation shall be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption. ~~If the fair value option is elected at adoption, any difference between the fair value of the hybrid instrument and the carrying amount shall be recognized as a cumulative effect adjustment to beginning retained earnings for the period of adoption.~~