

ISDA

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

June 5, 2003

Mr. Larry Smith
Director of Technical Application
& Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
PO box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith:

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to comment on the proposed Statement 133 Implementation Issue No. A23 – *Definition of a Derivative: Prepaid Interest Rate Swaps (A23)*.

Need for Clarification

It is our understanding that A23 was developed to apply the guidance in paragraph 6 (b) and 8 of Statement 149 to prepaid derivatives that are based on a market rate or index, effectively rescinding A9 with respect to prepaid swaps. We believe that the changes in paragraph 8 made as part of Statement 149 were intended to be relevant both for derivatives where the underlying is a specific asset or liability and derivatives where the underlying is a market rate or index.

We understood that in applying these concepts to a derivative that is based on a market rate or index, one should determine the fully prepaid amount involved (the appropriate equivalent to the purchase price of the specific asset) by computing an amount that is equal to the notional amount times the market rate or index; in other words, the amount required to fully prepay one side of the swap. This amount would be compared to the actual initial net investment in the derivative (adjusted for the time value of money) to determine whether this initial net investment was less, by more than a nominal amount, than the fully prepaid amount and thus a derivative in its entirety. We believe that the notion of initial net investment being less, by more than a nominal

amount, than the fully prepaid amount was integral to both derivatives on specific assets or liabilities and derivatives based on market rates or indices.

As a result of our understanding of the application of paragraph 8 in Statement 149, we believe that the second paragraph of the response in A23 is unclear. This paragraph indicates

“The guidance in paragraph 8 about the initial net investment being determined by applying the notional amount to the underlying is particularly applicable to (but not limited to) contracts that involve an underlying that does not relate to a specific asset, such as those contracts for the structures described in the Background section. In contrast, contracts that involve an underlying that relates to a specific asset or liability is the focus of the remaining guidance in paragraphs 8 about the initial net investment of the contract (after adjustment for the time value of money) being less, by more than a nominal amount than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying....”

By the use of the term “In contrast” to start the second sentence, the staff seems to make a distinction in applying paragraph 8 to a contract that does not relate to a specific asset or liability, versus one that does. As such, this could be interpreted to mean that there is a different level of initial net investment is required for a derivative to be a “derivative in its entirety” for contracts that do not relate to a specific asset or liability. As noted above, we believe the Board intended the concept to be the same for both; however, the basis for determining the fully prepaid amount would be tailored to each specific instrument (e.g., a prepaid forward for delivery of an asset versus a prepaid interest rate swap). For both contracts, the initial net investment (after adjustment for the time value of money) should be less, by more than a nominal amount, than the initial net investment that would be required to either acquire the asset or incur the obligation related to the underlying, or if the underlying was an index or rate, the initial net investment to prepay one leg of the swap. The wording of this paragraph should clearly indicate that the approach in the second part of paragraph 8 of Statement 133 (as amended by Statement 149) should be used to determine whether the initial net investment in a notional contract meets the requirement to be treated as a derivative in its entirety or a hybrid instrument, regardless of whether the contract relates to an index or rate or a specific asset or liability.

Transition

ISDA believes that the guidance in this Implementation Issue should be applied to new transactions entered into or modified after June 30, 2003, consistent with the transition in Statement 149. Derivatives instruments that have been accounted for to date as derivatives in their entirety should continue to be treated in this manner and not retroactively bifurcated, essentially grandfathering these contracts in the same manner that was permitted for hybrid instruments under paragraph 50 at the initial adoption of Statement 133. However, we believe that any entity should be able to use this grandfathering provision, regardless of their original hybrid instrument grandfathering decision upon the adoption of Statement 133.

ISDA supports grandfathering the treatment of these instruments as derivatives in their entirety because we see no real cost/benefit in requiring reporting entities to search for these instruments and bifurcate them into mark-to-fair-value derivatives and amortized cost based hosts. Many of our member firms are derivatives dealers who enter into hundreds of derivative contracts per day. As such, these companies may have thousands of existing derivative contracts that must be analyzed to determine whether they must now be treated as hybrid instruments. Given these contracts have been recorded in the financial statements at fair value, we see little benefit in performing these exercise since the risks inherent in these contracts are transparent to readers of financial statements. In addition, we do not perceive any reporting benefit in disrupting hedge accounting if, despite the obstacles involved, the entity had been able to achieve hedge accounting with the original embedded financing element. Given that a new hedging designation is required upon transition, hedge accounting is unlikely to be available to the bifurcated derivative because it is unlikely that the derivative will have zero or little initial net investment at the time of the new designation and thus it is also unlikely that the derivative could qualify anew as an effective hedge.

Thank you for your consideration of these comments and we are available to discuss these issues with you further.

Sincerely,

Shannon Warren
Chair
ISDA North American Accounting Committee