

# ISDA

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May 17, 2004

Robert H. Herz  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856

Dear Mr. Herz:

In conjunction with the FASB's reconsideration of the interim guidance in Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*, and because of ISDA's extensive work on the FASB's previous projects regarding the accounting for beneficial interests in securitized financial assets, ISDA would like to take this opportunity to provide brief comments relating to the direction taken by the Board at its March 31, 2004 meeting.

At that meeting, the Board decided to consider two alternatives for accounting for beneficial interests in more detail. Those alternatives are to:

1. Require that beneficial interests be classified as a trading security under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and recorded at fair value and
2. Permit beneficial interests to either be classified as a trading security under Statement 115 and recorded at fair value or accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, with any identified derivatives accounted for as derivatives and the host contract being accounted for under Statement 115.

In addition, the Board decided to consider separate bifurcation of the credit support component of a retained beneficial interest.

We recognize that these comments on the Board's proposed direction are unsolicited; however, we believe the complexity of the issue and the magnitude of affected population merits consideration. ISDA is providing these comments in advance of further Board discussions in order to provide the Board with the information gained by ISDA in the course

of its participation in the FASB's previous efforts to address the accounting for beneficial interests.

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.

## **Comments**

ISDA does not support an approach that requires that beneficial interests be classified as trading securities, and has significant concerns that the application of Statement 133 to beneficial interests will further complicate the application of an already tremendously complex accounting standard. In addition, ISDA does not believe that separate bifurcation of the credit support component of retained beneficial interests will improve financial reporting. In fact, this would result in an entirely new concept of bifurcating non-derivatives out of financial instruments and would warrant an amendment to Statement 133.

### *Accounting for Beneficial Interests as Statement 115 "Trading" Securities*

While certain entities follow fair value accounting for all of its financial assets, a significant number of holders of beneficial interests in securitized financial assets are classifying these interests as available-for-sale securities. Some entities also have certain beneficial interests, such as senior interests that are not subject to prepayment, classified as held-to-maturity.

Requiring trading security classification for all beneficial interests (including beneficial interests that would not be required to be bifurcated under Statement 133) would represent a significant change in practice for many holders and would effectively represent an amendment to Statement 115. ISDA does not believe that an amendment to Statement 115 should be driven by a project that is narrowly focused on a single asset class. In addition to representing a significant change in practice, requiring beneficial interests to be accounted for as trading securities would not result in increased transparency of financial statements since the funding of these interests would not be marked to fair value through earnings. Without a full reconsideration of the effects of this change on both the asset and related liability side of the balance sheet, a change of this nature would not improve financial reporting or readers' understanding of the economics of holding these investments.

As the Board has yet to deal with the issue of subsequent measurement of liabilities, a change of this nature cannot be justified at this time, outside of the context of a broader reconsideration of accounting for liabilities.

### *Accounting for Beneficial Interests under Statement 133*

The Board is also considering an approach that would permit beneficial interests to be accounted for either as trading securities or under a combined Statement 133/115 approach. While ISDA members support optional classification of beneficial interests as trading securities, members have significant concerns regarding the accounting for beneficial interests under Statement 133 because of the numerous implementation issues identified herein and in previous ISDA comment letters (attached) primarily related to issues of bifurcation. Over the past few years, ISDA members have invested hundreds of hours testing different methods of applying Statement 133 to common marketplace transactions and proposing alternative models for the Board to consider. As a result of these efforts, ISDA is particularly concerned that the current Board not underestimate the scope and complexity of the implementation issues involved with applying Statement 133 to beneficial interests.

If the Board pursues this alternative, then fundamental implementation issues such as identification, bifurcation, and valuation of embedded derivatives and host contracts must be thoroughly addressed before proceeding further. ISDA believes it is critical that implementation guidance address the most significant implementation questions for constituents, including:

- Evaluation of a beneficial interest as a debt or equity host, specifically, the required attributes for a beneficial interest to be considered an equity host. ISDA believes that distinguishing between a debt and equity host will require significant judgment. Any accounting model must provide holders of beneficial interests with the flexibility to apply judgment in defining the host contract in order to ensure that the host contract reflects the true economic nature of the hybrid instrument. The accounting model should allow equity host classification when such classification is consistent with the economic nature of the beneficial interest.
- Consideration of the extent to which the holder of beneficial interests should look through the issuer to the underlying assets to identify embedded derivatives. Looking through to the underlying assets in a vehicle to determine whether a beneficial interest contains an implicit derivative is extremely complicated and will result in a myriad of implementation issues and inconsistent application. In the case of beneficial interests issued by an entity with actively managed assets, this means providing guidance on bifurcating embedded derivatives when the underlying assets may change on a daily basis. In addition, requiring two different approaches for analyzing beneficial interests, depending on whether the transferor or third party holds the beneficial interests, will result in a lack of comparability.
- Determination of whether the economic characteristics and risks of the embedded derivative instrument are clearly and closely related to the host contract. Further guidance would be needed to determine when credit risk is clearly and closely related to the host instrument.

- The appropriate application of EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, to the derived debt host. Analysis of the debt host under EITF 99-20 would require further guidance regarding the allocation of cash flows of the beneficial interests to the debt host and the embedded derivative. The interdependency of the components of beneficial interests and the fact that the bifurcated derivatives are not recognized in the marketplace creates complexity with respect to separation of the cash flows.

ISDA is concerned that the application of Statement 133 may require an investor to artificially create, bifurcate and value an embedded derivative that is not meaningful to the investor and does not represent a standalone contract that trades in the market. There may be circumstances where it is difficult, if not impossible, to accurately identify the terms of the artificially created derivatives. Further, the interdependency of the components of beneficial interests and the fact that the bifurcated derivatives are not recognized in the marketplace creates complexity with respect to valuation. The difficulty in attempting to identify and value a component of an instrument that does not trade in the marketplace has been highlighted in the Liabilities and Equity Project. ISDA also believes that users of financial statements will have difficulty comparing financial information amongst companies if varying interpretations of this guidance exist or inconsistent application of the guidance occurs.

One of the key reasons given by the Board for allowing the Statement 133 approach was that it would allow entities to use any bifurcated embedded derivatives as hedging instruments. However, in practice, few, if any, companies utilize bifurcated derivatives as hedging instruments because the artificially created derivatives have unconventional characteristics and unique interactions with the host contracts that make the derivatives unsuitable hedges under the strict requirements of Statement 133.

#### *Effect of Embedded Derivatives on QSPEs*

Accounting for beneficial interests under Statement 133 will also require analyzing the effect of bifurcated embedded derivatives on the status of QSPEs. Without a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, bifurcation of an embedded derivative from beneficial interests may result in SPEs losing their qualified status. The idea that an accounting derivative could cause an SPE to lose its qualifying status is troublesome. We believe that the intent of paragraph 35.c(2) of Statement 140 was to allow a QSPE to hold derivative financial instruments that pertain to the economic characteristics of beneficial interests held by parties other than the transferor, its affiliates or its agents and revisions to Statement 140 will be required to preserve this objective.

#### *Separate Bifurcation of the Credit Support Component of a Retained Beneficial Interest*

The Board is also exploring the idea of separate accounting for an embedded credit liability in a retained interest. The rationale provided for requiring bifurcation of the credit component was that the credit support component is systematically undervalued and,

therefore, the residual interest itself is overvalued. However, we believe bifurcation of the credit support component will not improve the accuracy of the valuation of the retained interest. In fact, creating an additional artificial instrument may serve to complicate the valuation process, given the interdependency of the components of the retained interest.

Further, requiring these credit guarantees to be subsequently marked-to-market will also necessitate a change to FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Any change to subsequent accounting for guarantees under FIN 45 would have broad ramifications and far reaching consequences. Such a change should be thoroughly researched and addressed as part of a broad project on guarantees, as it would represent a significant change from the FASB's previous position that subsequent measurement guidance for guarantees should be determined on a case-by-case basis.

Finally, a requirement to separately record and account for the credit support component of a retained interest on the balance sheet would appear to contradict existing SEC and FASB guidance. Separately recording the credit support component in conjunction with accounting for beneficial interests under Statement 133 appears inconsistent with paragraphs 18 and 361 of Statement 133 that generally prohibit separating compound derivatives. In addition, SEC comments made in late 2000 indicate that a net balance sheet presentation of the components of bifurcated structured notes provides the most meaningful presentation of the cash flows of the respective instrument.

## **Conclusion**

ISDA continues to support accounting for beneficial interests as trading or available-for-sale securities under Statement 115 with income and impairment recognition in accordance with EITF Issue Nos. 99-20 and 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. For the reasons outlined above, ISDA is not persuaded that a new accounting model will more effectively address the accounting for beneficial interests and the related implementation issues than ISDA's current recommendation. During the holding period of beneficial interests, the guidance in EITF 99-20 and 03-1 provides appropriately restrictive guidance on income and impairment recognition. ISDA believes its recommended accounting model provides the flexibility necessary to properly reflect the economics of the transactions while simultaneously providing the rigor necessary to ensure that relevant and reliable information is reported to users of financial statements.

Consistent with our recent comment letter regarding structured notes, ISDA continues to support an optional fair value measurement process for certain liabilities (ISDA's March 11, 2004 comment letter is attached for your reference). Optional fair value measurement is appropriate in order to better reflect the business purpose and intent of certain transactions and to prevent the distortion of the financial statements when liabilities are recorded at amortized cost and assets are recorded at fair value.

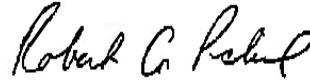
We are providing a copy of a previous comment letter that we believe is relevant to the issues currently being addressed by the FASB. ISDA would welcome the opportunity to discuss any these issues with Board members and the staff. Should you have any questions or desire

any clarification concerning the matters discussed in this letter, please do not hesitate to contact any of the undersigned at the telephone numbers provided.

Sincerely,



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