



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

October 10, 2005

Mr. Lawrence Smith
Director – Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: File Reference No. 1210-001, Proposed Statements of Financial Accounting Standards, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140*

Dear Mr. Smith:

The International Swaps and Derivatives Association (“ISDA”) is pleased to offer the following comments in response to the Financial Accounting Standards Board’s (“FASB” or the “Board”) above referenced Exposure Draft (the “Exposure Draft”), *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140*. In addition, while we are not submitting detailed comments herein on the FASB’s proposed amendment to Statement 140 relating to Accounting for Transfers of Financial Assets, we endorse the comments in the October 10, 2005 comment letter submitted by the American Securitization Forum.

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.

General Comments

We support the Board’s decision to permit fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require

bifurcation. We recognize the Board's efforts to increase the simplicity and consistency in the accounting for hybrid financial instruments.

We do have concerns regarding the operationality of certain impacts of the Exposure Draft; however, we believe that these concerns can be addressed within the final Statement without having to include implementation guidance on how to evaluate whether an instrument contains an embedded derivative that would require bifurcation. Note that while we support the Board's fair value decisions in the Exposure Draft and believe they are an improvement in financial reporting, the most effective advance in accounting guidance would be a timely issuance of the Fair Value Option Standard.

Amendment to Statement 133, paragraph 16

We believe that the Board's decision to amend paragraph 16 of Statement 133 to permit fair value remeasurement for any hybrid instrument that contains an embedded derivative that otherwise would require bifurcation is a significant improvement in the operationality of Statement 133.

However, the Board removed the sentence "If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires to be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement" from paragraph 16 of Statement 133. Although in the past it has been our experience that this provision has not been utilized by members, ISDA believes the provision should be retained because of its added importance due to the repeal of Derivative Implementation Group Issue No. D1 ("DIG Issue D1"), "Recognition and Measurement of Derivatives: Application of Statement 133 of Beneficial Interests in Securitized Financial Assets." As DIG Issue D1 will be deleted in its entirety, many more hybrid financial instruments will be subject to the requirements of Statement 133, and many of these derivatives will be more complex than the population currently subject to paragraphs 12 and 13 of Statement 133.

In short, it may be difficult to reliably identify whether an embedded derivative requiring bifurcation is present in certain hybrid instruments, especially beneficial interests,¹ thus impeding the goal of operational simplicity intended by the Board.

As ISDA members have expressed in past meetings with FASB staff, the existence of an embedded derivative requiring bifurcation in a hybrid financial instrument, particularly in residual interests and subordinated classes of securitizations, may be intuitive. However, clearly articulating the specific derivative may be difficult due to the complexity of the cash flow allocations and interdependencies of the assets and other arrangements within a securitization vehicle. Given the provisions of paragraphs 3(b) (paragraph 14A of Statement 133) and A16-A17 of the Exposure Draft which require the acquisition of sufficient detailed information and

¹ The term "beneficial interest(s)" as used in this comment letter is intended to retain the same meaning it contains under current accounting principles and not the meaning under the revised definition in the "Accounting for Transfers of Financial Assets" Exposure Draft. See comments in the "Use of the Term 'Beneficial Interest'" section of this letter.

significant investigation for the evaluation of the terms of interests, we are concerned that the election to remeasure a hybrid instrument in its entirety may be operationally precluded due to the complexity of identifying the specific terms of the embedded derivative unless the practicability exception is maintained.

Measuring such instruments that are unable to be practicably evaluated under paragraphs 12 and 13 of Statement 133 at fair value is consistent with the Board's view that the most relevant measure for financial instruments is fair value, and will further the Board's goal of measuring financial instruments at fair value. Additionally, similar provisions are found in the International Accounting Standards Board's ("IASB") amendment to International Accounting Standard No. 39, *Financial Instruments: Recognition and Measurement* ("IAS 39"). IAS 39 as amended by the Fair Value Option amendment requires in paragraph 11A that:

“Notwithstanding paragraph 11, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:

- (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
- (b) *it is clear with little or no analysis* when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.” [emphasis added]

Maintaining the existing guidance in paragraph 16 would also allow entities to measure the entire hybrid instrument at fair value when the separate derivative identified may not be reliably measured. Again, IAS 39 contains this similar concept in paragraph 12:

“If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall designate the entire hybrid (combined) contract at fair value through profit or loss.”

Therefore, for purposes of convergence and to make the proposed amendment to paragraph 16 of Statement 133 operational the Board should maintain the guidance in paragraph 16 and also consider including a similar concept to that of IAS 39. This would allow the entire hybrid instrument to be measured at fair value if it is qualitatively clear with little or no analysis that the hybrid instrument contains a derivative that requires bifurcation and would provide a similar election for hybrid instruments with embedded derivatives that cannot be reliably measured.

We reemphasize our previous comment that we support expeditious completion of the Fair Value Option project; but in the interim, we believe that retaining the phrase proposed to be deleted from paragraph 16 is necessary as a result of the repeal of DIG Issue D1.

Amendment to Statement 140

1. Deletion of the phrase “other than another derivative financial instrument”

We agree with the proposed deletion of the phrase “other than another derivative financial instrument” from paragraph 35(c)(2) and paragraph 40 of Statement 140. This amendment will substantially simplify accounting for transfers of financial assets and we believe that the resulting accounting analysis will be more consistent with the market’s evaluation of such transactions. However, this amendment alone is not sufficient to address the practice issues that will result from rescinding DIG Issue D1.

As a result of the requirement to evaluate all beneficial interests for bifurcation under paragraph 12 of Statement 133 and our understanding that the Board intends that the significant majority of beneficial interests will be considered as debt hosts, many additional “accounting derivatives” will be required to be bifurcated from beneficial interests, particularly residual interests. As currently drafted, it appears that qualifying special purpose entity (“QSPE”) beneficial interest holders and transferors will be required to evaluate these accounting derivatives under paragraphs 35 and 40 of Statement 140 similar to a freestanding derivative. We question the objective and necessity for a requirement to evaluate QSPE status with respect to bifurcatable derivatives embedded in beneficial interests. We see this as a significant operational challenge for the following reasons:

- The embedded derivatives in beneficial interests requiring evaluation under Statement 133 as a result of the rescission of DIG Issue D1 will, in many cases, be a constantly changing interest rate derivative as a result of prepayment or changes in the composition of the underlying assets. These derivatives do not exist on a freestanding basis, and thus there is no existing market practice regarding the determination of the embedded derivative terms. It is likely that different beneficial interest holders and transferors will identify the terms of the embedded derivative differently.
- The obligation to evaluate whether an embedded derivative exists is not limited to the residual interest holder and transferor. Transferors, residual interest holders and any other investor in a special purpose entity (“SPE”) must perform this evaluation to ensure that the entity should be considered to be a QSPE under Statement 140, and not as a VIE under FIN 46 (Revised).

2. Recommendation to Delete Paragraph 40 in its entirety

We recommend that paragraph 40 of Statement 140 be deleted in its entirety; although we agree that the key restriction that derivatives be passive in nature as provided for in paragraph 39 of Statement 140 should be retained.

While the burden of embedded derivative measurement under SFAS 133 is mitigated by the optional fair value election provided for in the amendment to paragraph 16, the burden of embedded derivative identification is shifted to and magnified within Statement 140 and the evaluation of QSPE status.

The Board’s original basis for including the restrictions in paragraphs 35 and 40 of Statement 140 (as noted in paragraphs 187 and 188 of the Basis for Conclusions) was to ensure (1) derivatives were passive in nature and (2) a reporting entity was not able to circumvent the fair value requirements for accounting for derivatives under Statement 133. As the second concern is addressed by the rescission of DIG Issue D1 and by the introduction of a fair value election in

this amendment, such restrictions need to be reconsidered. It is our understanding that some Board members have expressed concerns that derivatives may be used to introduce leverage in a securitization or that derivatives may become “off-balance sheet” without the provisions of paragraph 40 of Statement 140. We fail to appreciate these concerns because (1) the counterparty to any derivative executed with a QSPE would continue to account for its freestanding derivatives at fair value, and (2) the impact of any derivatives in a QSPE flow through to the beneficial interest holders and would cause the beneficial interest holders to account for the resulting derivative that is required to be bifurcated from the beneficial interest they hold at fair value with changes in fair value recognized in earnings.

At a minimum, if the Board does not agree with our recommendation, we suggest that the wording of paragraph 40(c) of Statement 140 be amended to read as follows:

“Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets, *or serve to allocate cash flows within the qualifying SPE in order to provide for risks and cash flows to the beneficial interest holders that are consistent with the substantive terms of the beneficial interests.*”

We believe that this phrase allows for passive derivatives to be held by an entity without jeopardizing it from QSPE status.

Evaluating the Contractual Terms of the Interest in a “Look Through” Model

Under the Exposure Draft, in order to determine if an instrument is a freestanding derivative or contains an embedded derivative otherwise required to be bifurcated, paragraph 3(b) requires an evaluation of the “contractual terms of the beneficial interest.” In addition, under paragraph A16, the Board explained that an understanding of “the payoff structure and the subordination status of the instrument will require an understanding of the nature and amount of assets and the nature and amount of liabilities and other beneficial interests comprising a transaction.” It is not clear when analyzing a structure for an embedded derivative how these provisions should be applied. For example, assume an entity is formed and acquires from the market or receives by transfer fixed-rate Japanese government bonds (“JGBs”) and issues \$100 of fixed-rate US dollar denominated debt to fund the asset purchase. In addition the entity enters into a foreign currency swap under which it makes fixed Yen payments and receives fixed USD payments. Based solely on the contractual terms of the interest it would appear that the instrument is a fixed-rate USD debt. However, if the holder were to analyze the underlying assets or liabilities of the entity, then the debt instrument could be interpreted to be a Japanese Yen denominated host contract and an embedded currency swap.

We believe that if the contractual terms of the interests are consistent with the economic risks of the interests, then no further investigation into the assets and liabilities of the vehicle should be necessary. We believe the results of this application leads to bifurcation results consistent with current application of Statement 133, notably paragraph 15. In the above example, the USD denominated debt would not include an embedded derivative. This result is consistent with the Board’s intent with respect to embedded derivative identification and we note that the same issue is present for interest rate as well as foreign exchange risk. We recommend that the Exposure Draft specify that the investigation of the assets and liabilities of an entity is required when the

existence of an embedded derivative cannot be determined by evaluating the contractual terms and economic risks of the interests.

Evaluating Beneficial Interests for Embedded Derivatives

As addressed in ISDA's May 17, 2004 comment letter, ISDA believes that distinguishing between a debt and equity host in a hybrid beneficial interest will require significant judgment. Any accounting model must provide transferors and 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 financial instrument. The accounting model should allow equity host classification when such classification is consistent with the economic nature of the beneficial interest. ISDA continues to believe that certain scenarios exist where the beneficial interest should be evaluated as an equity host, and request that the Board provide a similar acknowledgement of this in the final Statement as appears in paragraph 60 of Statement 133.

Use of the Term "Beneficial Interest"

The Exposure Draft, *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140*, defines beneficial interest as:

“A right to receive all or portions of specified cash inflows to a qualifying SPE, including senior and subordinated shares of interest, principal, or other cash inflows to be “passed-through,” or “paid-through” premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.”

This definition of a beneficial interest specifies that beneficial interests are issued only by QSPEs.

Paragraph 3(b) of the Hybrid Financial Instruments Exposure Draft notes that the “holder of a *beneficial interest* in securitized financial assets (other than those identified in paragraph 14) should determine whether the interest is a freestanding derivative or contains an embedded derivative...Credit risk in a beneficial interest...shall not be considered an embedded derivative under this Statement.” Paragraph A18 of the Hybrid Financial Instruments Exposure Draft uses the term *beneficial interest* in a similar manner. The use of the term beneficial interest in the Hybrid Financial Instruments Exposure Draft implies that the requirements listed above are applicable only to those securitization vehicles that are QSPEs. However, we believe this was not the Board's intent, and that the provisions of the Exposure Draft apply to interests issued by SPEs, qualifying or not, VIEs and other securitization vehicles. We recommend that the Board clarify that the provisions of the Hybrid Financial Instruments Exposure Draft are applicable to all interests issued by a special purpose entity, that is, not solely beneficial interests issued by QSPEs.

Consolidated Variable Interest Entities and Failed Sales

Paragraph 3(b) of the Exposure Draft states that “Credit risk in a beneficial interest resulting from financial instruments or other assets and liabilities (including derivative contracts) that are held by the issuing entity, shall not be considered an embedded derivative under this Statement.

The concentration of credit risk in the form of subordination of one interest to another shall not be considered an embedded derivative under this Statement.”

However, the Exposure Draft does not clarify for purposes of preparing **consolidated financial statements** whether preparers should look to the creditworthiness of the parent company or the consolidated variable interest entity (“VIE”) issuing credit-linked liabilities when determining the existence of a bifurcated embedded derivative in such liabilities. We believe there is precedent in Statement 150 to reevaluate a liability upon consolidation (footnote 13 in paragraph A5 regarding trust preferred securities that are mandatorily redeemable only upon liquidation or termination of the trust), and suggest a similar approach could be taken with respect to a parent’s creditworthiness in determining whether a liability of a consolidated VIE is a bifurcated hybrid instrument.

Furthermore, we are concerned that the Exposure Draft does not address the accounting asymmetry between liabilities associated with a transaction that does not meet the sale accounting provisions of Statement 140 and the assets related to those liabilities. For example, in a “failed” Statement 140 sale involving securitized loans, the assets could decline in value such that the investor in this pool of assets is subject to losses, yet under current guidance, the liability associated with the underlying securitized portfolio still remains at amortized cost.

While we recognize these issues could be viewed as more broad than the conceptual scope of the Exposure Draft, these matters have been of longstanding concern to ISDA. The Board also is aware of these concerns and recently acknowledged them in its Exposure Draft on noncontrolling interests, citing a “research project” to address these concerns. While our intent is not to delay final issuance of the Exposure Draft, this is a pressing practice issue and we urge the Board to distinguish between the general credit of a consolidated group’s financial statements and the credit of a nonrecourse entity for purposes of applying the concepts of clearly and closely related credit risk to hybrid financial instruments for consolidated VIEs and Statement 140 “failed sales.”

However, a timely issuance of the Fair Value Option Standard would also solve these disparities. We believe this is critical to resolve financial reporting issues that exist, such as the ones mentioned in this letter.

Effective Date and Transition

We agree with the Board’s decision to not require all instruments be re-evaluated for embedded derivative instruments (i.e., allow the repeal of DIG Issue D1 to be treated prospectively). Also, consistent with ISDA members’ long standing views on bifurcation of financial instruments, we fully support the Board’s decision to permit fair value measurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation. However, we also believe that the same election should be provided for existing instruments that have previously been bifurcated as of the effective date of the proposed guidance. We note that some hybrid financial instruments have long-term lives such that the operational burden and disparity in the accounting approach between similar instruments could continue for an extended period without this transition alternative.

If the Board is concerned with entities not consistently applying an instrument-by-instrument election at transition, we suggest that the Board allow an entity to elect fair value accounting for all hybrid instruments previously bifurcated that are not being used as hedging instruments under Statement 133 at transition date. The Board declined to allow for an all-or-none transition approach in the Exposure Draft as the Board concluded this would not be practical as some bifurcated hybrid financial instruments could be hedging instruments under Statement 133. In our members' broad experience, we have rarely encountered such situations. We believe the financial reporting and operational benefits of consistent accounting for the types of instruments (e.g., structured notes) that were bifurcated under current Statement 133 and will likely be measured at fair value under the proposed amendment outweigh the perceived costs or issues noted in paragraph A30. After adoption, the election would be made on an instrument by instrument basis consistent with paragraph 5.

In addition, we are unclear as to how to apply the transition provisions of the Exposure Draft to Master Trust, Multi-issuance and other vehicles that issue new beneficial interests. If the provisions of paragraphs 35 and 40 of Statement 140 are retained, we question whether bifurcated derivatives contained in beneficial interests issued by a QSPE after the transition date could potentially taint the qualifying status of the entire Master Trust or Multi-issuance vehicle. The impact on existing vehicles and transition provisions need to be fully considered. We believe that the provisions of this proposed amendment should not disqualify QSPE status for entities that are deemed to be QSPEs under existing guidance. We note that the Board set a precedent for transition relating to transfers involving Master Trusts in paragraph 8, footnote * of FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets* ("FTB 01-1"), when it allowed for a potential five year transition period (no later than June 30, 2006). This transition provision was provided because necessary changes to Master Trusts in order to conform with the new guidance could be made only with the approval of most outside beneficial interest holders, it was virtually impossible to obtain such agreement from a sufficient proportion of existing outside beneficial interest holders in a Master Trust and the direct and indirect costs of establishing new Master Trusts in a short period were very high. In view of those arguments, the Board did not object to additional transition time for such circumstances.

We believe the difficulties that Master Trusts and other Multi-issuance vehicles face to conform with the Exposure Draft will be similar to those faced to comply with FTB 01-1. Therefore, we recommend that the Board use the same additional transition period for Master Trusts provided in FTB 01-1 for purposes of the Exposure Draft. Alternatively, the Board may consider grandfathering all prior series issued from a Master Trust and allow application of the guidance on a prospective basis for any new series that are issued by a Master Trust after the effective date.

Conclusion

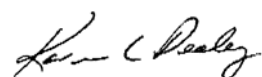
We support the Board's decision to permit fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation. Addressing the accounting for such instruments in this manner is consistent with the Board's convergence and fair value objectives, enables financial reporting that is more closely representative of the business evaluation of such transactions and represents a substantial reduction in the operational costs associated with applying Statement 133.

We do not believe that the final issuance of the Exposure Draft should be delayed in order to include implementation guidance on how to evaluate whether an instrument contains an embedded derivative that would require bifurcation. We believe that our recommendations regarding paragraph 16 of Statement 133 address this issue. Further, while we are concerned about certain provisions of this Exposure Draft as written and its interaction with Statement 140, we believe that our recommendations regarding paragraph 16 of Statement 133 and paragraph 40 of Statement 140 address these matters.

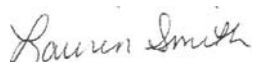
Sincerely,



Robert G. Pickel
Executive Director and CEO
International Swaps and Derivatives Association
212.901.6020



Karen L. Dealey
Morgan Stanley
Co-Chair, Accounting Policy Committee
International Swaps and Derivatives Association
212.276.2452



Laurin Smith
J.P. Morgan Chase & Co.
Co-Chair, Accounting Policy Committee
International Swaps and Derivatives Association
212.648.0909