

November 16, 2001

Mr. Timothy S. Lucas  
Chairman, Derivatives Implementation Group  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**Re: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets: October 2001 Tentative Guidance**

Dear Mr. Lucas:

The Bond Market Association (“TBMA”)<sup>1</sup> and the International Swaps and Derivatives Association (“ISDA”)<sup>2</sup> are pleased to offer the following comments in response to the above-referenced tentative guidance recently issued by the Derivatives Implementation Group (“DIG”) of the Financial Accounting Standards Board (“FASB”). The comments that follow were developed and are being presented jointly by a working group composed of representatives of the respective accounting policy committees of TBMA and ISDA. Collectively, the membership of those committees possess substantial professional expertise and practical experience in dealing with the accounting policy issues and questions raised by this tentative guidance, including with respect to both securitized and derivative financial instruments.

### **Interpretation of Creditworthiness**

Application of the tentative guidance contained in DIG Issues B-12, C-17 and D-2 to many beneficial interests (“BIs”) issued by securitization vehicles will rely on an

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<sup>1</sup> The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities, both in the United States and abroad. The Association’s members are active participants in the securitization market, collectively accounting for the vast majority of primary issuance and secondary market trading in U.S. mortgage-backed and other asset-backed securities. More information about The Bond Market Association may be obtained from its Internet website, located at [www.bondmarkets.com](http://www.bondmarkets.com).

<sup>2</sup> ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 540 member institutions from 41 countries on six continents. These members include most of the world’s major institutions that deal in privately negotiated derivatives, 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. Information about ISDA and its activities is available from its Internet web site, located at [www.isda.org](http://www.isda.org).

investor's interpretation of the term "issuer's credit risk," and whether such risk is clearly and closely related to the host contract. Based on the guidance presented in B-12, we believe that the determination of whether or not a credit risk is clearly and closely related to the host instrument would be established by looking at the explicit terms of the BI. If the BI is payable based on the performance of the issuer (i.e., the SPE), bifurcation is not required. This view is consistent with the approach established in B-12 whereby the investor looks to the terms of the instrument rather than the detailed holdings of the SPE to determine if the investor holds a derivative embedded in the BI.

We believe that an opposing view requiring bifurcation of an embedded derivative in certain synthetic instruments, in which the economics of the transaction and terms of the BI are identical, would result in different accounting for virtually identical instruments and produce misleading results. Moreover, we believe that an approach that looks only at the explicit terms of the BI is appropriate, because to require otherwise, i.e., to evaluate the holdings of the SPE, creates a model that is unworkable.

Following are two examples of how we would apply the B-12 model of reviewing explicit terms. Assume that an investor owns a \$1,000 BI in each of the following static, unleveraged securitization vehicles:

- **Cash Structure** : Vehicle 1 holds 5-year, fixed rate bonds issued by XYZ Corp and a pay fixed, receive LIBOR interest rate swap. Vehicle 1 issues BIs to investors, which pay a floating rate of interest.
- **Synthetic Structure** : Vehicle 2 owns 5-year, fixed rate U.S. Treasury Bonds; a pay fixed, receive LIBOR interest rate swap; and has written a credit default swap referenced to the same 5 year, fixed rate XYZ Corporate bonds held by Vehicle 1. The notional amount of the credit default swap equals the principal amount of Treasury bonds held. Periodic payments received by Vehicle 2 on the credit default swap equal the fixed spread between the Treasury Bonds and the reference XYZ obligations.

Based on this description of each vehicle's holdings, the investor will earn substantially the same return, and be exposed to the same economic risks, on each of the BIs.

In order to determine the terms and conditions of the BI it holds, in both the cash and synthetic structures the investor looks to the legal documents governing the transaction, which indicate that the investor will receive coupons equal to LIBOR plus a fixed spread, and a final distribution equal to the investor's pro-rata share of each vehicle's assets on the specified distribution date. Focusing on these terms, the investor applies the guidance in Example 24 (par. 190), which illustrates application of the "clearly and closely related" concept to credit-sensitive bonds. In this example, the FASB states:

"A credit-sensitive bond can be viewed as combining a fixed-rate bond with a conditional exchange contract (or an option) that entitles the investor to a higher rate of interest if the credit rating of the issuer declines. Because the **credit**

**worthiness of the debtor** and the interest rate on a debt instrument are clearly and closely related, the embedded derivative should *not* be separated from the host contract.”

The payment to be made by Vehicle 1 in settlement of its BIs is based on the performance of the vehicle. The payments to be made by Vehicle 2 in settlement of the BIs are similarly based on the performance of Vehicle 2, which is the issuer. We would therefore suggest that any variability in cash flows associated with the BIs of each vehicle is attributable to the credit risk of each vehicle and should be considered clearly and closely related to the debt host. EITF Issue 99-20 would be applied to effectively capture any variability. We believe this conclusion would be reached solely by focusing on the terms of each vehicle’s BIs, as the holdings of the SPE are not transparent to the BI holder from the terms of the legal documents (i.e., the BIs are not explicitly linked to a reference credit). Further, we believe that this analysis is consistent with the conclusions reached in the Response to DIG Issue B-19, which states, “The characteristics of a debt host contract generally should be based on the stated or implied substantive terms of the hybrid instrument”.

To summarize, under our interpretation of the guidance in B-12, the investment in each vehicle would receive similar accounting treatment because the terms of the BI are based solely upon the credit risk of the issuer (i.e., the vehicle). To reach an opposing conclusion in the second instance (i.e., Vehicle 2) would lead to the undesirable result whereby two virtually identical transactions would be accounted for differently.

In order to eliminate diversity in the application of Statement 133’s provisions to such transactions, we encourage the FASB to clarify its definition of the term “credit worthiness of the debtor” as it relates to this issue and confirm our understanding of the application of B-12 as set forth above.

### **Interpretation and Amendment of Statement 140 Required**

We are concerned that an outcome of this proposal would be to disqualify certain SPEs as Qualifying Special Purpose Entities (QSPEs), as defined in Statement 140. Specifically, we question whether after identifying and bifurcating an embedded derivative from a BI, the existence of that derivative may, in certain circumstances, cause the QSPE to fail the requirement in paragraph 35(c)2 of Statement 140, which requires that a QSPE may only enter into “Passive derivative financial instruments that pertain to BIs (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40).”

We believe that the FASB’s intent in writing paragraph 35(c)2 was to allow a QSPE to hold derivative financial instruments that pertain to the economic characteristics of BIs held by parties other than the transferor, its affiliates, or its agents. As a result, the creation of a “synthetic” or “accounting” derivative through application of the embedded derivative model should not cause a formerly qualifying QSPE to fail its qualifying status. Accordingly, we recommend that the FASB provide an interpretation of

paragraph 35(c)2 clarifying that a QSPE may hold “passive derivative financial instruments that pertain to BIs (other than another *freestanding* derivative financial instrument). . . .” The term *freestanding*, as used in this context, is intended to include items that are legally documented as separate instruments and are explicitly transferable independent of another financial instrument, which is consistent with the principles contained in DIG Issue K-2. As the framework included in DIG Issues B-12, C-17 and D-2 is directed at the accounting by holders of BIs, the interpretation we have suggested should preserve the transferor’s current accounting, which is appropriate given that there have been no legal or economic changes to the original structure created by the transferor.

Furthermore, we believe that the requirements in Statement 140 that a derivative entered into by a QSPE must: 1) have a notional amount that does not exceed the amount of the BIs and 2) partly or fully but not excessively counteract some risk associated with those BIs or the related transferred assets, were originally established to curb a perceived abuse whereby the investor would be investing in a synthetic derivative that would be exempt from the Statement 133 bifurcation rules. As the staff has now fully addressed the potential for abuse by requiring BI holders to bifurcate explicitly referenced credit, equity, commodity and other non-clearly and closely related risks, we believe that this QSPE guidance is unnecessary. Accordingly, we recommend amending Statement 140 so that only derivatives that require a QSPE to make a decision (e.g., purchased call and put options) would be prohibited.

### **Transition**

Statement 140 currently requires that the transferor reassess consolidation of an SPE if the entity loses its qualifying status. In certain instances, the proposed amendment to Statement 133, if adopted as proposed, may result in an SPE losing its qualifying status (for instance, if our proposed amendment to Statement 140 is not adopted, many SPEs with BIs requiring bifurcation of embedded derivatives would lose their qualifying status).

Although DIG Issue D-1 mentioned the FASB’s intent to interpret the interaction between Statements 133 and 140, in the absence of cleared guidance, many BIs issued during the period following D-1’s release included terms that may both (a) jeopardize qualifying status under the proposed framework and (b) be difficult, if not impossible, to change now that the BIs have been issued. Thus, if our proposal is not adopted, we request that the FASB grandfather the qualifying status of SPEs existing prior to the issuance of any amendment to Statement 133.

### **Other Matters**

We believe that the staff intended the guidance in DIG Issue B-12 to apply to all BIs rather than solely those issued by a QSPE. If this is the case, we suggest that B-12 be revised to reflect this. We would support this editorial change, as it would prevent requiring investors to determine whether or not the BIs they hold were issued by QPSEs.

## **Conclusion**

Again, TBMA and ISDA appreciate the opportunity to provide the foregoing comments in response to the tentative guidance. We would also expect to comment on these matters to the extent that they are addressed in connection with the forthcoming exposure draft to amend Statement 133. In that context, we believe that a public comment period of at least 60 days be allowed, given the significance and complexity of the issues that will be addressed therein.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact either of the undersigned at the telephone numbers provided, or George Miller, Senior Vice President and Deputy General Counsel of TBMA at 212.440.9403, or Stacy Carey, Policy Director of ISDA at 212.332.1202.

Sincerely,

**/s/ Esther Mills**

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