

July 1, 2002

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1100-163: Proposed Statement of Financial Accounting Standards, Amendment of Statement 133 on Derivative Instruments and Hedging Activities.

Dear Ms. Bielstein:

The Bond Market Association (“TBMA”), the International Swaps and Derivatives Association (“ISDA”) and the Securities Industry Association (“SIA”) are pleased to offer the following comments in response to the Financial Accounting Standards Board’s (“FASB”) above-referenced Exposure Draft (the “Exposure Draft”), the guidance in tentative Statement 133 Implementation Issues Nos. A20, B12, B36, C17 and D2, and Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (“SPE”) (the “Statement 140 Q&As”). For purposes of this comment letter, the Exposure Draft as it pertains to beneficial interests in securitized financial assets, the reference Statement 133 Implementation Issues, and the Statement 140 Q&As may also be collectively referred to as the “D2 model.”

The comments that follow were developed and are being presented jointly by a working group (the “Joint Industry Working Group”) composed of representatives of the respective accounting policy committees of TBMA, ISDA and SIA. Collectively, the membership of these committees have substantial professional expertise and practical experience addressing the accounting policy issues and questions raised by this tentative guidance with respect to both securitized and derivative financial instruments. A description of our organizations is contained in Attachment II.

In summary, the Joint Industry Working Group believes the proposed amendment to Statement 133 and the proposed D2 model for applying Statement 133 to beneficial interests will add another significant layer of complexity to an already complex standard without readily apparent improvements to current financial reporting. Even with the level of detailed guidance provided, we were not able to apply the concepts to common market transactions (for example, multi-tranche managed collateralized debt obligations (CDOs).) We urge the Board to seek a simpler solution that can accommodate the wide range of beneficial interests being created and issued today. Financial statement preparers and users have already reached the point of complexity overload. Thus, implementing the D2 model as written will make it difficult for a financial statement user to understand and analyze the investments held by a company as a result of the different accounting methodologies applied to the theoretical accounting components of an investment and the recording of these components potentially in different line items on the balance sheet.

At the March 19, 2002 meeting with certain FASB Board Members and staff, the Joint Industry Working Group relayed significant issues and concerns with the D2 model and presented actual marketplace examples where the model raises many questions that remain unanswered. As of the issue date of the Exposure Draft, those issues and concerns have not been fully addressed or resolved by the FASB staff. The examples provided in the implementation guidance are overly simplified and do not reflect the appropriate economics of instruments that would actually be executed in the market. Further, the examples are deceptive in that they fit neatly into the proposed D2 model but when remolded into economically viable transactions, the model breaks down. To remedy these concerns, we proposed that the Board consider a broad application of EITF Issue No. 99-20 to all beneficial interests and not proceed with the D2 model. Based on our subsequent conversations with FASB staff, we understand that the Board would not consider the recommendation and prefers a broad application of Statement 133.

Accordingly, to address our concerns with the D2 model and other provisions in the Exposure Draft, we have developed several recommendations that are discussed at length in the body of this letter. Our primary recommendations include the simplification of and the reduction in the amount of guidance that addresses the accounting for both beneficial interests and derivatives. Our comments cover the following key areas:

- The proposed D2 model
- Statement 133 implications for qualifying Special Purpose Entity (“QSPE”) status
- The proposed amendment of the definition of a derivative
- For hybrid instruments with embedded derivatives that are not clearly and closely related, permitting these instruments to be accounted for at fair value in their entirety
- The effective date
- Rationalization of Statement 133 changes and pending consolidation guidance

Each of these topics is discussed in more detail below.

THE PROPOSED D2 MODEL

As previously noted, the Joint Industry Working Group has spent a considerable amount of time assessing the impacts of applying the proposed D2 model to common beneficial interests and continues to believe that the tentative guidance will be extremely difficult, if not impossible, for constituents to apply in practice. If the FASB moves forward with its proposed D2 model for beneficial interests in securitized financial assets, we strongly support the following revisions and clarifications of the proposed D2 model:

- An investor should focus on the substantive terms and economics of the beneficial interest and not the detailed holdings of the vehicle to determine if the instrument contains an embedded derivative.

- The nature of the host contract for a respective beneficial interest should be determined based on the characteristics of the beneficial interest and the definitions of debt and equity hosts outlined in Statement 133.
- The determination of whether or not credit risk is clearly and closely related to the host instrument should also be established by looking at the substantive terms of the beneficial interest. If the beneficial interest has terms that are based on the creditworthiness of the issuer (i.e., the SPE), bifurcation should not be required. The conclusion in Statement 133 Implementation Issue No. B36, *Embedded Derivatives: Bifurcation of Embedded Credit Derivatives* that broadly differentiates between cash and synthetic credit risk will result in different accounting for virtually identical instruments, and therefore should be deleted.
- Statement 133 Implementation Issue No. B12, *Embedded Derivatives: Beneficial Interests Issued by Qualifying Special Purpose Entities*, including the aforementioned changes, should be broadly applied to all SPEs, not just QSPEs.
- The Board should clarify in paragraph 301 of Statement 133 that, with respect to the application of paragraph 16, the term “unusual” was not intended to mean “never.”
- All beneficial interests in securitized assets, whether securitized using QSPEs or non-QSPEs, issued prior to the effective date should be exempted from the application of Statement 133, similar to the grandfathering of embedded derivatives in other cash instruments as of a certain date that the Board permitted in the initial adoption of Statement 133.

A detailed discussion of each recommendation follows.

An investor should focus on the substantive terms and economics of the beneficial interest and not the detailed holdings of the vehicle to determine if the instrument contains an embedded derivative.

Rather than attempt to develop a separate model for analyzing beneficial interests, we believe that existing implementation guidance provides a sufficient basis for the evaluation of beneficial interests under Statement 133. Specifically, we believe that the holder of a beneficial interest should look at the explicit characteristics and implied substantive terms of the beneficial interest it holds in order to determine whether the interest is a hybrid instrument that requires bifurcation. We believe that in most instances a focus on explicit terms will prove operational because the underlying positions in the SPE will be consistent with the substantive terms of the beneficial interest (for example, debt instruments and fixed income derivatives in an SPE which issues debt beneficial interests). However, we share the Board’s concerns that if the explicit terms are not valid or substantive, then the holder must look to the substance of the arrangement to determine the characteristics of the beneficial interest. For example, a qualifying SPE holds equity securities and issues a senior beneficial interest with a stated fixed rate and the transferor retains an equity interest that absorbs first loss. If the terms of the senior interest do not explicitly reference the underlying equity risk that the senior investor’s interest is subject to, then the holder

should consider the underlying equity risk of the investment in determining the implied substantive terms of its investment.

This approach was taken by the Board and successfully used in practice in Statement 133 Implementation Issue Nos. B19, *Embedded Derivatives: Identifying the Characteristics of a Debt Host Contract* and B20, *Embedded Derivatives: Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?* This approach is clearly delineated in the response to Statement 133 Implementation Issue No. B20 which states, “[S]ince a loan and a derivative can be bundled in a structured note that could have almost an infinite variety of stated terms, it is inappropriate to necessarily attribute significance to every one of the note’s stated terms in determining the terms of the non-option embedded derivative.”

Reliance on the substance and economics of a beneficial interest (rather than the underlying assets held by the entity) should be the basis for determining the accounting for beneficial interests issued by both QSPEs as well as other SPEs. The concepts of clearly and closely related are well articulated in paragraphs 12-15 of Statement 133 as interpreted by numerous Statement 133 Implementation Issues and thus using the substantive terms of the beneficial interest should enable holders to appropriately apply that guidance to all other hybrid instruments. If the Board has concerns that focusing on substantive terms will enable certain derivatives to “escape” bifurcation, we believe this concern is mitigated by existing accounting guidance. Other guidance such as EITF Issue Nos. 99-20 and 96-12 and the rules on recognizing other-than-temporary impairment will ensure that variability in returns for beneficial interests are recognized in the income statement even if the beneficial interest has not been bifurcated.

The nature of the host contract for a respective beneficial interest should be determined based on the characteristics of the beneficial interest and the definitions of debt and equity hosts outlined in Statement 133.

The presumption that all beneficial interests in QSPEs are debt hosts and that non-QSPEs’ beneficial interests are debt hosts if the beneficial interest is legally debt (although the beneficial interest economically acts like equity) will artificially create more hybrid instruments that require bifurcation and pose serious practical problems for holders. In the examples we provided to the FASB in March, it was clear that many beneficial interests, while issued in legal form as debt hosts, behave like residual equity. Determining the embedded “derivative” in an equity instrument that receives all residual cash flows is a futile exercise. An analogy can be made to an investor trying to determine the embedded derivative in a share of a company’s publicly traded stock that has the right to all the residual cash flows in the company.

In Statement 133 Implementation Issue No. B19, the staff indicated that “[t]he characteristics of a debt host contract generally should be based on the stated or implied substantive terms of the hybrid instrument....In the absence of stated or implied terms, an entity may make its own determination of whether to account for the debt host as a fixed rate, floating-rate or zero coupon bond. That determination requires the application of judgment, which is appropriate because the circumstances surrounding each hybrid instrument containing an embedded derivative may be different. That is, in the absence of stated or implied terms, it is appropriate to consider the

features of the hybrid instrument, the issuer, and the market in which the instrument is issued, as well as other factors, in order to determine the characteristics of the debt host contract.”

We believe that distinguishing between a debt host and an equity host also requires judgment. A blanket decision that all QSPE beneficial interests or all beneficial interests that are labeled “debt” actually act like debt makes bifurcation meaningless when the economics are at odds with the artificial classification. Investors should have the flexibility to apply judgment in the accounting model to be used based on the true economic nature of the host contract and should account for the “hybrid” in the most appropriate manner, which, we suggest, may involve no bifurcation. In cases where the host contract is deemed to be an equity instrument, we would expect that the beneficial interest would fall under paragraph 14 of Statement 140 and be treated in the same manner as an available-for-sale or trading security. However, if this were not the case, we believe that paragraph 14 of Statement 140 should be amended to cover these instruments. Thus, the instrument in its entirety will be carried on the balance sheet of the holder at fair value and total stockholders’ equity will properly reflect the change in value. If classified as available-for-sale, then the instrument will also be subject to various impairment tests.

The guidance in Statement 133 on distinguishing a debt host from an equity host contained in paragraph 60 provides a reasonable basis for that distinction. Equity treatment should be based on residual economic rights and should not be limited to items that are equity in form and have substantive governance rights. A beneficial interest in an SPE can contain all of the economic characteristics of an equity instrument without substantive voting or governance rights, which has been duly noted in the FASB’s current SPE consolidation project. Recognizing the equity-like nature of some of these beneficial interests may best portray the unique characteristics and economic behavior of a beneficial interest in securitized financial assets. Our experience has been that many of the difficulties in bifurcating beneficial interests are created when trying to analyze a residual interest under a debt host model.

The determination of whether or not credit risk is clearly and closely related to the host instrument should also be established by looking at the substantive terms of the beneficial interest. If the beneficial interest has terms that are based on the creditworthiness of the issuer (i.e., the SPE), bifurcation should not be required. The conclusion in Statement 133 Implementation Issue No. B36 that broadly differentiates between cash and synthetic credit risk will result in different accounting for virtually identical instruments, and therefore should be deleted.

We strongly believe that beneficial interests that are economically substantially the same should be accounted for in the same manner. We do not agree with the distinctions for holders between the credit of the SPE and the credit of the underlying instruments in the SPE. An SPE’s credit is dependent upon the instruments in it, which are the sole determinant of whether or not beneficial interests in these entities will be paid or be in default. We do not see the benefit of distinguishing between a “synthetic credit” SPE and one that directly holds the asset upon whose credit the beneficial interest is based. For example, when TBMA and ISDA responded to the October 2001 Tentative DIG Guidance, the group put forth our view that the definition of credit risk, whether it comes from holding a third party’s debt or a credit default swap (referenced to such third party)

supported by treasuries, produces substantially the same credit profile for the beneficial interest holders and thus the accounting for each beneficial interest should be the same. This is particularly true in view of the fact that in many cases, the SPE with the synthetic credit risk (a credit default swap and other assets) will ultimately hold the defaulted asset if a default occurs and the liquidation amount to be paid to the beneficial interest holders will depend on the credit performance of the underlying credit in the same way as if the underlying reference asset had been held by the SPE from inception. If the concern is recognizing the fair value of the instrument, that is accomplished by permitting the security to be accounted for in its entirety as a Statement 115 trading or available-for-sale security.

In addition, the application of Statement 133 Implementation Issue No. B36 to managed transactions that contain a combination of cash assets and credit derivatives (e.g., managed CDOs) pose significant bifurcation challenges for investors. Since the proportions of each type of instrument and the actual risk taken on (by changing the composition of the portfolio by underlying creditor) changes often, it would be difficult to allocate the potentially changing implicit derivatives to the different tranches of beneficial interests. The cash flows from the credit derivatives are not allocated to the holders of the beneficial interests in a unique manner. Thus, investors would be forced to artificially attribute a portion of their investment return to these implicit derivatives in order to apply Statement 133.

We would therefore recommend that Statement 133 Implementation Issue No. B36 be deleted in its entirety as current implementation guidance in Statement 133 Implementation Issues Nos. B19 and B20 also applies to credit risk.

Statement 133 Implementation Issue No. B12 with the aforementioned changes should be broadly applied to all SPEs, not just QSPEs.

We believe that the staff intended the guidance in Statement 133 Implementation Issue No. B12 to apply to all beneficial interests rather than solely to those issued by a QSPE. If this is the case, we suggest that Statement 133 Implementation Issue No. B12 be revised to reflect this. The examples in Statement 133 Implementation Issue No. D2 focus on QSPEs; however, often other SPEs are similar in nature to QSPEs. A non-QSPE may have failed some requirement in Statement 140 for QSPE status; for example, because there is no transferor. Thus, the assets in the SPE are similar in nature to the type of assets found in QSPEs and the portfolio is a fixed pool where there is no active management. We see no compelling reason why a beneficial interest in a QSPE should be treated differently from a beneficial interest in a non-QSPE that has similar economic characteristics and a similar mode of operation as an SPE. The focus in both cases should be on the characteristics of the beneficial interest and not the classification of its entity.

The application of paragraph 12 of Statement 133 should be applied consistently to all hybrid instruments and no distinction should be drawn in applying Statement 133 to an instrument based solely on the nature of the issuer of an instrument. Further, we do not believe that the distinctions drawn in the Exposure Draft between instruments issued by QSPEs and non-QSPEs are operational, particularly for investors in beneficial interests, as we do not believe investors will always have sufficient information to distinguish investments in QSPEs from investments in non-

QSPEs. In fact, investors will generally be provided information based on the substantive economic characteristics of their investment, not based on accounting characteristics, further supporting the position that bifurcation of embedded derivatives be based on the substantive terms of a beneficial interest. We would also note that the Board has developed the concept of a financial SPE (FSPE) as part of the SPE consolidation project, and as such, these SPEs will be treated in a manner similar to QSPEs, thus further eroding the need for a different accounting treatment for beneficial interests in non-QSPEs.

As part of FASB's efforts toward stream-lining accounting standards, we would further note that Statement 133 Implementation Issues Nos. B12, B36 and D2 could be eliminated in their entirety as sufficient guidance already exists, which requires embedded derivatives to be evaluated under a contract's substantive terms (i.e., Implementation Issues B19 and B20 as noted above). We do not believe there is a need for separate bifurcation guidance for embedded derivatives in beneficial interests, as this leads only to confusion when clarification is only needed to reiterate that Statement 133 paragraph 12 should be applied to any and all contracts.

The Board should clarify in paragraph 301 of Statement 133 that, with respect to the application of paragraph 16, the term "unusual" was not intended to mean "never."

Paragraph 16 of Statement 133 indicates that "If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings..." The Board provided its basis for conclusion on this paragraph in paragraph 301. In practice, the Board's comment in paragraph 301 of Statement 133, that the circumstances where an entity would not be able to reliably identify and measure an embedded derivative should be "unusual" has been interpreted to mean that there are no situations where this should occur. This situation is analogous to the interpretation in practice with respect to the transfer of available-for-sale securities to trading in which the FASB indicated the circumstances supporting a transfer should be rare and in practice "rare" has been redefined as "never." We believe there are instances where it is difficult, if not impossible to accurately identify the terms of the artificially created embedded derivatives identified solely for accounting purposes, and thus, there should be no stigma or restrictions to utilizing the provisions of paragraph 16. Indeed, greater use of this provision is consistent with the Board's express preference for carrying financial instruments at fair value with changes in fair value recorded in earnings each period and would ease the financial reporting burden for many financial statement preparers. Thus, we recommend the discussion in paragraph 301 regarding "unusual" be deleted.

All beneficial interests in securitized assets, whether securitized using QSPEs or non-QSPEs, issued prior to the effective date should be exempted from the application of Statement 133, similar to the grandfathering of embedded derivatives in other cash instruments as of a certain date that the Board permitted in the initial adoption of Statement 133.

Consistent with our previous comments regarding unnecessary distinctions between QSPEs and non-QSPEs, we strongly recommend that the Board grandfather all beneficial interests in securitized financial assets issued prior to the effective date of this proposed amendment that

were accounted for under Statement 133 Implementation Issue No. D1. We see no compelling reason to limit grandfathering to QSPEs which meet the requirements of paragraph 42 of Statement 133 and suggest the Board provide a dispensation similar to the one for embedded derivatives contained in paragraph 50 of Statement 133 so that these beneficial interests continue to be accounted for as available-for-sale or trading securities in their entirety. Any new implementation guidance provided in this area should be applied on a prospective basis to new transactions occurring after the effective date. We have recommended, as discussed in a following section of our letter, an effective date of a minimum of one year from the issuance of a final standard. As such, we propose that the provisions of a final standard be applied on a prospective basis to new beneficial interests issued after the effective date and new SPE structures created subsequent to the effective date.

Requiring the application of Statement 133 to existing beneficial interests places a significant burden on financial statement preparers given the amount of information necessary to properly value the embedded derivative since inception of the hybrid instrument in order to record the cumulative-effect-adjustment. The beneficial interests accounting used to date was done in good faith in the absence of the FASB staff providing other accounting guidance, is operational, and continues to produce reasonable, understandable results. We see no benefit to forcing an extremely time-intensive exercise on the holders or issuers of these interests. The FASB has already accepted prospective treatment for other aspects of the amendments and should therefore make this practical change to reduce the burden on financial statement preparers.

STATEMENT 133 IMPLICATIONS FOR QSPE STATUS

The Statement 140 Q&A interpretations further constrain certain SPEs from meeting the criteria for qualifying SPE status. Question 3, as drafted, states, “[A] derivative financial instrument that pertains to a beneficial interest that is also a derivative financial instrument does not meet the limits of paragraph 40 of Statement 140.” We understand that the Board has raised concerns regarding derivatives within QSPEs so that opportunities are not created to circumvent the provisions of Statement 133 and so that QSPEs are not engaged in transactions that give it discretion. Under our proposal above, these concerns would no longer be valid because:

- Many investors will be required to reflect on the balance sheet beneficial interests at fair value as hybrid instruments consisting of derivatives and available-for-sale hosts or in their entirety as trading securities. Fair value will encompass the value of the entire beneficial interest, which includes the total price risk of any derivatives within the SPE.
- The counterparty to all derivatives executed by an SPE is required to apply the full mark-to-market provisions for derivatives.
- Except for option-based derivatives, derivatives by their construct are passive in nature. In addition, many option-based derivatives can even be considered to be passive in nature. For example, an interest rate cap, while an option contract, generally involves no decision-making activities. The cap merely requires that interest be paid or received upon observing a specified interest rate strike occurring in the market.

In addition, we point out that derivatives are often included within SPEs to serve as risk-transformation vehicles that provide investors with a desired risk profile. For example, in Questions 3 and 4, Example 1, of the Statement 140 Q&As, an entity transfers treasury securities into an SPE and the SPE executes a long forward contract indexed to the S&P 500. The structure was executed in this manner as investors desired to obtain exposure to the S&P 500 and entering into a forward contract indexed to the S&P 500 was more efficient than actually holding all of the equity securities that comprise the S&P 500 index in their relative market-value weightings. Investors will reflect the beneficial interest or components thereof at fair value on their balance sheet, with the appropriate adjustment to consolidated equity, through earnings or other comprehensive income.. The counterparty that executed the long S&P 500 forward contract with the SPE would reflect the forward derivative contract on its balance sheet at fair value. Also, note that the long forward derivative contract is passive in nature. Again, we fail to see how the Board's concerns with respect to derivative contracts in SPE vehicles remain valid or how the Board's proposal, which would cause consolidation to the transferor, would result in more transparent reporting when components owned by each party are already reflected on the balance sheet at fair value.

We propose that all of the new Statement 140 Q&As be deleted and Statement 140, paragraph 40.c. 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.”

Without this revision, in certain instances, the proposed amendment to Statement 133, if adopted as proposed, may result in an SPE losing its qualifying status. 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 beneficial interests held by parties other than the transferor, its affiliates or its agents. **We strongly object to the notion that the creation of a “synthetic” or “accounting” derivative through application of the D2 model should cause a QSPE to lose its qualifying status.**

We strongly believe that all existing QSPEs should be grandfathered under Statement 140, regardless of the Board's decision on grandfathering beneficial interests under Statement 133 so that they do not lose their qualifying status. We see no benefit and significant cost to requiring the transferor to go back and undo QSPE accounting for those SPEs that no longer qualify under the revised guidance and are not grandfathered in accordance with paragraph 42. By requiring these vehicles to be consolidated because they lack sufficient outside equity and do not qualify as FSPEs, the accounting challenge for the transferor changes from accounting for his retained interest to accounting for the assets and liabilities of the SPE and evaluating the beneficial interest liabilities for embedded derivatives. Since there are often more tranches of beneficial interests sold than retained, which would now be treated as liabilities of the transferor, the accounting task will be multiplied, often by a significant factor. In addition to restating financial statements for

non-qualifying SPEs, there is the additional burden of trying to explain the change in financial statement presentation and the resulting effect on reported earnings.

We have also identified what we believe are some unintended consequences of applying the D2 model with respect to QSPEs. Assume that a transferor retains a small amount of a senior tranche in a QSPE and the residual class. By applying the D2 model, the transferor finds that he must bifurcate a passive derivative from the residual class. Since the transferor owns a small part of a senior tranche, it is possible that the notional of the bifurcated derivative will pertain to some portion of that tranche. In that case, the SPE will fail paragraph 35.c.(2) since the bifurcated derivative from the residual class will relate to a beneficial interest not held by a third party. Previously, this had not been problematic since the residual class was not subject to bifurcation.

We have also prepared a more extensive analysis of the consequences of applying the D2 model for a typical resecuritization transaction that would have negative market consequences if the proposed guidance were adopted in its current form. Please refer to Attachment I of this letter.

We do not believe that the Board intended to disqualify common securitization structures from being QSPEs solely due to the presence of “derivatives” that are created by the D2 model. Thus, it is critical that the Board revise Statement 140, paragraphs 35.c.(2), 40.b. and 40.c. (as previously recommended) prior to the adoption of any amendment of Statement 133 in this area.

Disclosure of Assets and Liabilities of Grandfathered QSPEs

While we support grandfathering of all QSPEs, we do not believe that the disclosure of the assets and liabilities in grandfathered securitization vehicles will provide meaningful information to financial statement users and should be eliminated. We must question how providing disclosure of the SPE’s assets and liabilities would provide more useful information on the transferor’s risks associated with the retained beneficial interest, which is a net risk position, than fair value information regarding the beneficial interest. This same issue has been raised in the context of the current SPE consolidation project where the SPE’s gross assets and liabilities, which are consolidated on the balance sheet, obscure the nature of the retained interest that is eliminated in consolidation.

PROPOSED AMENDMENT OF THE DEFINITION OF A DERIVATIVE

Statement 133 Implementation Issue No. A20 will require an increased amount of bifurcation when derivatives contain an off-market element. While we agree that certain derivatives do contain financing or investing elements and we support the Board’s basic objective in this area, we do not support introducing a “bright line” at which the holder/writer must bifurcate a compound instrument into its derivative and financing/investing components and providing for a choice below that bright line. For many of our constituents, 5% does not provide significant leeway for off-market transactions that have a large bid-asked spread. We do not support a threshold but rather believe that contracts should be accounted for based on their substance, which requires an element of judgment.

In its deliberations on the Statement 133 amendment, the FASB staff recommended that the definition of a derivative be clarified so that any initial net investment made should be considered “small” in comparison to the amount of investment that would result in the contract becoming fully prepaid. Under Statement 133 Implementation Issue No. A1, *Definition of a Derivative: Initial Net Investment*, a party is required to assess whether an upfront payment resulted in a hybrid instrument containing a debt host and an embedded derivative. We find this framework more meaningful as it allows for the spectrum of instruments and market situations that can exist.

Consistent with our comments on accounting for beneficial interests, we believe that contracts should be accounted for and reported based on economic substance. If an upfront payment for a derivative contract is made solely due to the off-market rate of the contract, the substance of the contract has not changed and a party to that contract should reflect its substance. For example, two parties (Party A and Party B) enter into a forward contract that at its inception has a fair market value of zero and includes no initial net investment. Subsequently, Party A sells its forward contract (an asset) to Party C. As market rates would most likely have moved in the interim period, Party C will be required to make an upfront payment to Party A to obtain the contract with its existing terms. It is quite possible that Party C’s payment may represent more than 5% of the fully prepaid amount of the forward contract. However, the substance of the contract has not changed; it remains a derivative contract and any payment made by Party C is not reflective of any substantive financing but merely part of engaging in derivative inventory trading. Again, this matter is reflective of our overall comments requesting simplification of already complex accounting guidance and a move toward a more principles-based approach, which will result in bifurcating financing elements when appropriate.

With respect to options that have a financing element included, we do not understand how a zero strike call option which has a premium equal to the strike price (notional of underlying) and its fair value does not have to be bifurcated, but a prepaid forward requires bifurcation. We understand that interpreting when the terms of an option are so off-market that the instrument acts like a forward is difficult. However, there may be cases where this distinction is easy to draw and bifurcation should potentially be considered so as to promote consistent accounting for items that have the same economics but are in form different.

We also believe clarification is necessary in the application of Statement 133 Implementation Issue No. A20 to swaps with embedded options. Again, we recognize the FASB’s objective to separately account for financing elements of certain derivative contracts. However, we fail to see the improvement in financial reporting that results from separating a swap with an embedded option where the premium is not exchanged at inception of the contract into a financing element and an on-market swap with an embedded option.

In summary, we support requiring that the financial statement preparers use judgment with respect to bifurcating “hybrid” instruments. We also support providing financial statement preparers with the right to treat the hybrid as a derivative in its entirety. We support this choice because for corporate derivatives users, bifurcation may have certain benefits such as being able to use the short cut method for the bifurcated, at-market derivative. It also supports the

accounting outlined in Statement 133 Implementation Issue E21, *Embedded Derivatives: Continuing the Shortcut Method after a Purchase Business Combination*. However, from a practical point of view, preparers should retain the right to treat these instruments as derivatives in their entirety. This is particularly important for financial institutions whose daily volume in derivatives transactions is high and the operational challenges this bifurcation would impose are enormous. Financial institutions carry their derivatives portfolios at fair value with changes recorded in earnings. Therefore, we do not see how bifurcation enhances the presentation of these transactions nor does it accurately reflect the underlying business model. In addition, it is a step back from reporting financial instruments at full fair value. We believe in this case, permitting a choice of treatment, used consistently, is the only practical alternative, which the Board has accepted in other compelling circumstances.

It is also important to note that current Statement 133-compliant systems have been designed to comply with guidance that has been in existence for several years. Companies would be forced to incur significant costs to yet again change systems in order to comply with the proposed guidance. Any change in accounting methodology would be costly and create a drain on resources in order to make changes to systems and processes. Given the noted difficulties expressed above, we must question the advisability of proceeding with a more complicated application.

Paragraph 68

Further, we suggest that the revisions to paragraph 68.b. be amended as follows:

“The fair value of the swap at the inception of the hedging relationship is zero except for an interest rate swap containing an embedded mirror-image call or put option as discussed in paragraph 68.d., in which case the fair value of the interest rate swap containing an embedded mirror-image call or put at the inception of the hedging relationship is equal to zero or the time value of the embedded call or put option.

We recommend this change because currently, to comply with the previous version of this paragraph, cancelable swaps used to hedge callable debt had to have a net present value of zero, with the option premium received over the life of the swaps through the net swap payments. Now, it seems from the wording of the amendment to this paragraph, that to qualify for the short-cut method, there must be an upfront premium received equal to the time value of the option. We think that either approach should be acceptable since the current practice of receiving the option premium over the life of the swap achieves better symmetry with the cash flows of the option embedded in the callable debt. The option embedded in the debt is also paid for over time through an adjustment to the stated coupon rate from an observed market interest rate for noncallable debt.

FOR HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT ARE NOT CLEARLY AND CLOSELY RELATED, PERMIT THESE INSTRUMENTS TO BE ACCOUNTED FOR AT FAIR VALUE IN THEIR ENTIRETY

We strongly support providing the option in Statement 133 for the holders and issuers of hybrid instruments with embedded derivatives not considered clearly and closely related to either bifurcate the hybrid instrument or to account for the hybrid instrument at fair value in its entirety with changes in fair value recorded in earnings. We believe that permitting this choice is particularly justified based on the additional costs being introduced both by the D2 model and more broadly by the revised definition of a derivative. As we have previously indicated, the level of complexity introduced by this amendment is significant and will require substantial system and operational changes to comply with its provisions. Providing the alternative mark-to-market treatment will alleviate some of these operational burdens while achieving fair value for certain financial instruments.

While providing a choice, application of this treatment would at least apply the same bifurcation or mark to fair value rules to all hybrid instruments, not just to assets. This flexibility is already provided to holders through the choice of trading versus available -for-sale treatment under Statement 115. We see no reason why the issuer of a hybrid instrument should not have the same flexibility at the inception of the contract.

If the FASB does not allow for this choice of accounting for hybrid instruments that are either assets or liabilities, we would appreciate the Board explaining why this should not be permitted. The discussions to date have not provided adequate explanation of the Board's position. Indeed, permitting this choice would reduce the burden on some financial statement preparers who would prefer to treat the liability as a derivative in its entirety because its fair value as a unitary instrument is readily determinable, whereas the value of the parts, which are based on accounting definitions not recognized in the market, are less so and therefore subject to significant estimation.

Further, the IASB has included this approach in its recently issued Exposure Draft to amend IAS Statement 39. In approving this change, the IASB indicated it supported this change by stating that "...to reduce the burden of separating embedded derivatives, an entity should have the option, rather than be required, to measure a hybrid instrument containing an embedded derivative that is not closely related to the host contract at fair value with changes in fair value reported in the net profit or loss." International harmonization would be enhanced if the FASB adopted a similar approach. In fact, the IASB proposal is even broader and permits a financial statement preparer to designate any financial asset or financial liability as an instrument to be carried at fair value through earnings. The change we are recommending, which is more limited in scope, would further the FASB's purported goal of carrying all financial instruments at fair value.

THE EFFECTIVE DATE

The Effective Date of the Exposure Draft

A critical issue, particularly for financial institutions, is the effective date of the Exposure Draft. An effective date for fiscal quarters beginning after November 15, 2002 is not sufficient time for entities to modify systems for new transactions (new beneficial interests and Statement 133 Implementation Issue No. A20 bifurcation situations) and apply new bifurcation rules to previously issued hybrid beneficial interests even if the FASB were to finish its deliberations and issue a new standard by September 30, 2002. An effective date of at least one year following issuance of final guidance should be permitted so that companies can interpret and apply the new rules and make systems changes that will take effect after the year-end reporting period. The FASB should not underestimate the significance of the changes proposed in the Exposure Draft and the implementation guidance and the effort that will be required by constituents to adapt current operations and systems to the new guidance. An extended implementation period is also appropriate considering the other FASB projects that are planned for the same timeframe (Guarantee Exposure Draft and SPE consolidation project). In addition, we believe that if the Board goes forward with the D2 model, substantial implementation guidance will be necessary.

Permit a One-Time Transfer from Available-For-Sale to Trading

We recommend that the FASB again permit a holder of a beneficial interest to transfer that interest from available-for-sale securities to trading, or from held-to-maturity to available-for-sale or trading in conjunction with the adoption of any amendment that affects beneficial interests. This would reduce the reporting burden for some holders of beneficial interests in securitized assets who will be required to bifurcate these instruments under the proposed guidance.

RATIONALIZATION OF STATEMENT 133 CHANGES AND PENDING CONSOLIDATION GUIDANCE

Finally, we strongly recommend that the models proposed for D2 and SPE consolidation be considered jointly and rationalized to a much greater degree than is currently the case. For example, SPE consolidation guidance regarding derivative restrictions for FSPEs should not be provided without resolving the issues raised in the D2 model. We would ask the Board to allow us to provide further recommendations on this guidance once the proposed Interpretation on SPE consolidation is released. The Board should not consider finalizing the Statement 133 amendment as it pertains to beneficial interests until the guidance on SPE consolidation is complete. These proposed standards are significantly interrelated and additional issues may become apparent as the SPE consolidation guidance becomes fully developed and constituents provide comments.

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
July 1, 2002
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CONCLUSION

Again, the Joint Industry Working Group appreciates the opportunity to provide the foregoing comments in response to the Exposure Draft and appreciates the opportunity the FASB staff has given it to work directly with them on these issues. We continue to be available for further discussions and assistance in identifying real-life examples for the Board to use as a “field test” of its conclusions.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact any of the undersigned at the telephone numbers provided, or George Miller, Senior Vice President and Deputy General Counsel of TBMA at 212.440.9403, Stacy Carey, Policy Director of ISDA at 212.901.6011 or Jerry Quinn, Vice President and Associate General Counsel of SIA at 212.618.0507.

Sincerely,

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Example - Consequences of Applying the D2 Model with Respect to Resecuritizations

A popular mortgage resecuritization transaction is known as a NIM or net interest margin securitization. The residual interest(s) from a REMIC* mortgage loan securitization structured as a QSPE or from several such mortgage securitizations are deposited into a second QSPE that typically issues one bond class (the NIM bond) backed by the residual interest(s). Often, the interest rate on the mortgage loans in the first QSPE (the REMIC) are fixed for some specified period such as two years and then convert to an adjustable rate for the remainder of the mortgage term. The REMIC issues one or more classes whose interest rate is tied to LIBOR. Accordingly, the cash flows to be paid to the residual interest in the REMIC (principally the interest rate spread between the fixed rate mortgage loans and the LIBOR-based beneficial interests) will be increased or decreased depending on changes in LIBOR. Sometimes, there may also be a QSPE-permitted passive interest rate cap derivative instrument in the first QSPE to mitigate the risk of interest shortfalls to the LIBOR-based beneficial interests. The NIM bond is issued out of the second trust with a principal amount and interest rate (fixed or floating) that the rating agencies believe can be supported by projected cash flows on the residual interests collateral, given certain loss, prepayment and interest rate assumptions. All of the cash flow received from the residual interests are first used to pay interest on the NIM bond with all of the remaining cash flows used to pay principal on the NIM bond until its principal balance is reduced to zero. The transferor retains the residual interest in the NIM trust and is entitled to all cash flow after the NIM bond is retired. Often, there is also a QSPE-permitted passive LIBOR interest rate cap derivative instrument in the NIM Trust.

The first QSPE continues to be a QSPE under the proposed guidance since its assets do not contain an embedded derivative that must be bifurcated. The beneficial interests sold to third parties are capped LIBOR floaters that according to the D2 model do not have to be bifurcated. Under the proposed guidance, the residual interest would be considered an inverse floater with a bifurcatable derivative that relates to the beneficial interests sold to third parties.

However, our concern is with the second QSPE (the NIM Trust). The assets of the NIM Trust (the residual interests from the first QSPE) contain embedded derivatives relating to the inverse floater element described above. The NIM Bond issued to third parties is either a fixed rate bond or a capped floater (similar to the capped floating beneficial interests in the first QSPE.) We are concerned that the bifurcated inverse floaters arising from the REMIC residuals deposited into the NIM Trust will be deemed to relate to the residual interest issued by the NIM Trust and that is retained by the transferor. Under the proposed guidance, the NIM Trust would therefore not qualify as a QSPE because it would have a derivative that does not solely relate to third party beneficial interests.

We do not believe that the Statement 133 bifurcation requirements should cause this vehicle (the NIM Trust) to be consolidated. The NIM transaction described above and the consequences of applying the proposed guidance in the proposed Exposure Draft and Statement 140 Q&As is just one of many market transactions involving resecuritizations that will be affected by the proposed guidance. Since the NIM Trust is totally passive, involves no discretion on the part of any parties to the transaction, we do not understand why this resecuritization vehicle should not be treated as a QSPE when the interests were originated from a QSPE.

The original transfer meets the Statement 140 requirements for sale of the mortgage loans in the REMIC transaction and for sale of the residual interest in the NIM transaction other than the transferor's retained interest. The residual interest in the NIM Trust retained by the transferor must be accounted for as a security required to be carried at fair value classified either as trading or available-for-sale under paragraph 14 of Statement 140 and then subject to the bifurcation requirements under the proposed guidance.

The irony is that there would be no disqualification from QSPE status if the NIM bond were to be issued as an additional beneficial interest from the REMIC QSPE. However, there are tax and other valid business issues that would make a structure where the NIM bond was issued directly by the first QSPE impractical.

*The term "residual interest" is used here in its economic sense: not in the technical tax sense of the residual interest class in a REMIC.

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.

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