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February 13, 2009

Mr. Russell Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference: Proposed Issue C22, Exception Related to Embedded Credit Derivatives

Dear Mr. Golden:

The International Swaps and Derivatives Association (ISDA)¹ appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board's ("FASB") proposed Statement 133 Implementation Issue No. C22, *Scope Exceptions: Exception Related to Embedded Credit Derivatives* (the "Proposed DIG Issue").

ISDA is not aware of significant diversity in how the scope exception and principles set forth in paragraphs 14A and 14B of SFAS 133 have been interpreted and applied by practitioners since the issuance of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140* ("SFAS 155").

ISDA believes that the principles expressed in SFAS 155 and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted* ("SFAS 133") would, under the current guidance, lead a reasonable practitioner to conclude that a derivative or embedded derivative exists in the (a) partially funded synthetic collateralized debt

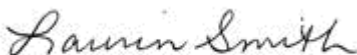
¹ ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the 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.

obligations (CDOs) and (b) fully funded synthetic CDOs examples presented in the Proposed DIG Issue (proposed SFAS 133 paragraphs 200D and 200E). Further, ISDA believes that there is also little or no diversity in practice in current application of the embedded credit derivative scope exception to the transactions described in proposed SFAS 133 paragraph 200F of the Proposed DIG Issue. Thus we do not believe there is a need to issue guidance on this perceived practice issue.

As the first sentence of paragraph 14B of SFAS 133 is the only location that reflects the FASB's original views as to whether a fully funded, single tranche² credit-linked note has a different bifurcation answer depending on whether the entity holds bonds issued by reference entity X or instead holds collateral such as U.S. Treasury obligations and sells a credit default swap on reference entity X, we strongly disagree with the proposal to eliminate the sentence. As previously expressed to the FASB, we agree with the Board's original decision that there should be no difference in the identification of embedded credit derivatives in fully funded single tranche transactions irrespective of whether the credit risk is obtained in funded or derivative form. As noted above, we do not believe that this sentence contributes in any reasonable way to diversity in practice regarding the application of SFAS 133 and SFAS 155 to securitizations that introduce new credit risk or to partially funded CDOs. ISDA strongly urges the FASB to retain this fundamental principle within SFAS 155 and believes that the removal of such a fundamental principle would warrant much greater due process than that required for a Statement 133 Implementation Issue.

More detailed comments on the specific provisions of the Proposed DIG Issue are included in Appendix A attached. We hope that you find our comments informative and useful. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned at 212-648-0909 or Hee Lee, Partner, Ernst & Young, ISDA's external accounting advisor, at 212-773-8605.

Sincerely,



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

² When the concept of subordination is described within this letter, including Appendix A, it is intended to describe the seniority of one class of beneficial interests in securitized financial assets over another in the payoff structure of an entity. If only one tranche is issued by the vehicle, no subordination exists.

1. Limited Diversity in Application of SFAS 155's Embedded Credit Derivative Scope Exception

The stated objective of the Proposed DIG Issue is “to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B” of SFAS 133. ISDA is not aware of significant diversity in how the aforementioned scope exception and the principles set forth in paragraph 14A and 14B of SFAS 133 have been interpreted and applied by practitioners since the issuance of SFAS 155, and thus questions the need for issuing guidance on this issue. Further, ISDA believes that the elimination of the first sentence of paragraph 14B is a significant amendment that would require further due process than that undertaken for the Proposed DIG Issue. As outlined below, we do not believe that this sentence contributes to diversity in practice, and we believe it is necessary guidance for determining the applicability of the bifurcation rules for certain very simple securitization structures. If this sentence were to be removed, thereby amending the fundamental principles for the treatment of fully funded synthetic credit-linked note securitizations, we do not believe that the proposed effective date is operational or that the proposed due process is sufficient as further discussed in Comment #5 below.

2. Application of SFAS 155 to a Securitization that Introduces New Credit Risk

ISDA agrees with the existing guidance in paragraph 200D of SFAS 133 related to the example illustrating application of SFAS 155's principles to a securitization transaction that introduces new credit risk not present within the financial instruments held by the SPE. ISDA emphasizes that practitioners applying SFAS 155's currently existing principles would reach the same conclusion on this securitization transaction in which a SPE holds a credit derivative referenced to Company A and high-quality bonds but issues beneficial interests explicitly referenced to Company B, and therefore do not believe additional guidance is warranted.

Evaluation of this securitization transaction would require application of the principles set forth in paragraph 14A of SFAS 133 to determine whether there is an embedded credit derivative. After analyzing the contractual terms of the beneficial interest in the SPE's financial assets, and understanding the payoff structure and the payment priority of the beneficial interests, ISDA believes that application of paragraph 14A would lead a reasonable practitioner to conclude that the beneficial interests in this example contain an embedded derivative requiring bifurcation because it is sufficiently clear from analyzing the contractual arrangements that govern the payoff structure that the SPE's financial assets may not provide the necessary cash flows to fund the contractual terms of its liabilities. Based on this analysis and application of paragraph 14A's principles, a reasonable practitioner would conclude that the beneficial interests are deemed to have an embedded credit derivative based on the structural mismatch in cash flows between the SPE's financial assets and its beneficial interests. We do not believe that the additional analysis of the exception in the first sentence

in paragraph 14B would change the conclusion reached by analyzing the transaction under paragraph 14A since credit risk to Company B is not present in the assets held by the issuing entity. We do not believe that there is any ambiguity in how to analyze this structure under 14B, especially given the benefit of the example currently in paragraph 200D of SFAS 133.

While the proposed elimination of the first sentence of paragraph 14B does not impact the conclusion on whether a credit derivative embedded within the SPE's beneficial interests in paragraph 200D must be bifurcated, such elimination would significantly impact the analysis of other common securitization transactions as discussed below in Comment # 4.

3. Application of SFAS 155 to a Partially Funded Synthetic CDO

ISDA also agrees with the conclusion in the proposed example paragraph 200E illustrating application of SFAS 155's principles to a securitization transaction that is only partially funded and thus may require a beneficial interest holder to lose more than its initial investment. We believe that under current guidance, depending on the structure of the tranches, either a derivative in its entirety or an embedded credit derivative would be present.

Under current guidance, evaluation of this securitization transaction would require analyzing the contractual terms of the beneficial interests in the SPE's financial assets (including the CDS), and understanding the payoff structure and the payment priority of the various tranches of beneficial interests on an individual tranche-by-tranche basis. ISDA believes that application of paragraph 14A's principles would lead a reasonable practitioner to conclude that the investors in unfunded or partially funded tranches are holding interests that meet the definition of a derivative because those tranches can lose more than their initial investment. An analysis of the contractual terms as required under paragraph 14A reveals that these tranches resemble a free-standing credit default swap more than they resemble a credit-sensitive bond. Based on the application of paragraph 14A, additional analysis of the transaction under the first sentence of paragraph 14B would not result in a different conclusion because the aforementioned tranches are deemed to meet the definition of a derivative instrument based on the structural mismatch in cash flows between the SPE's financial assets and its beneficial interests. The first sentence of paragraph 14B addresses the form of credit risk *in* the entity, not the form of the beneficial interest issued *by* the entity and would therefore not be applicable in this example.

Similar to the example discussed in Comment # 2 above, we must highlight that while the proposed elimination of the first sentence of paragraph 14B does not impact the conclusion on whether the investors in certain subordinated tranches issued by the SPE are holding credit derivatives or whether their interests contain embedded derivatives, it is expected to significantly impact the analysis of other types of securitization transactions as discussed below in Comment # 4.

In addition, we find that the proposed paragraph 200E introduces ambiguity regarding the embedded derivative analysis that is not currently present in SFAS 155. ISDA understands that it is well understood in practice that the analysis of whether a beneficial interest contains an embedded derivative is to be performed on an instrument-by-instrument basis. However, certain examples within the Proposed DIG Issue, such as the example within proposed SFAS 133 paragraph 200E as currently drafted, broadly conclude on the entire securitization transaction and all beneficial interests issued without differentiating between particular tranches or classes. Not all tranches in a partially funded securitization are themselves partially funded; some tranches may be fully funded. Therefore a broad conclusion about the entire structure versus conclusions specific to the contractual terms of each tranche would not be appropriate in practice. We recommend that the FASB modify the examples so that the analysis and conclusion is focused on a specific tranche of beneficial interests, rather than the entire securitization transaction.

Finally, we have included certain recommendations in Comment # 6 below for amplifying the clarity of this example and application of its conclusions in practice.

4. Application of SFAS 155 to a Fully Funded Synthetic CDO

Paragraphs 14A and 14B articulate clear and understandable principles for determining whether a beneficial interest contains an embedded credit derivative that must be bifurcated under SFAS 133. Taken together, the statements in these paragraphs cover the major types of securitization structures in place when SFAS 155 was drafted, and today. Deleting any of this guidance would leave a void in the guidance for significant portions of the securitization market.

To illustrate our concerns regarding the proposed amendment to paragraph 14B of SFAS 133 we will describe and analyze a common and a simple fully funded synthetic CDO transaction that involves the issuance of a single class/tranche of beneficial interests. Assume that a SPE that holds \$10.0 million of U.S. Treasury obligations and a credit default swap with a notional amount of \$10.0 million that references the credit of Company A, issues to investors \$10.0 million of a single class of notes referencing the credit of Company A. Each investor's interest in the notes is parri passu in terms of payoff priority. The investors are exposed to loss due to a credit event for Company A, but cannot lose more than their initial investment. Also assume that no investor consolidates the SPE and that no investor has a variable interest in specific assets.

Evaluation of this securitization transaction would require application of the principles set forth in paragraphs 14A and 14B of SFAS 133 to determine whether there is an embedded credit derivative. After analyzing the contractual terms of the beneficial interest in the SPE's financial assets, and understanding the payoff structure and the payment priority of the beneficial interests, ISDA believes that application of paragraph 14A does not require a

reasonable practitioner to immediately conclude that the notes contain an embedded derivative under SFAS 133 because the cash flows of the SPE are designed to be sufficient to meet its obligations. The practitioner would also need to consider the guidance in paragraph 14B. In applying the *proposed* paragraph 14B, a practitioner would note that the beneficial interests do not contain a concentration of credit risk in the form of subordination of one financial instrument to another (i.e., among different classes or tranches of notes). Currently, the practitioner evaluating a simple, fully funded credit-linked note structure would rely on the first sentence in paragraph 14B to conclude that the beneficial interest (which resembles a simple credit sensitive bond) does not have an embedded credit derivative as the variability in cash flows is attributable to the creditworthiness of the issuing entity. This conclusion is consistent with ISDA's understanding of the Board's views during the drafting of SFAS 155. We believe the FASB was correct to recognize that there is no economic difference between placing a bond issued by Company A into a SPE that issues a single class of beneficial interests versus placing full collateral and a credit default swap referenced to Company A into a SPE which issues such a beneficial interest, and that there should therefore be no accounting difference either.

ISDA interprets the proposed elimination of the first sentence in paragraph 14B as either seeking to simplify application of SFAS 155 in practice or addressing concerns regarding how the sentence may be applied in current practice to new credit risks or partially funded securitizations (which we have addressed in comments # 2 and 3 above). However, without the first sentence of paragraph 14B, ISDA believes that literal application of this paragraph, as currently drafted, to the most common and simple securitization transactions without structural subordination created through the issuance of multiple tranches of beneficial interests would require bifurcation even though there is no contractual or implied obligation for the investors to provide additional funds, and no economic difference between holding an investment in a fully funded synthetic CDO and holding a credit sensitive bond. Therefore ISDA strongly urges the FASB to retain this fundamental principle in the first sentence of 14B within SFAS 155.

If, however, the deletion reflects a fundamental change in the Board's views regarding whether securitization such as simple credit-linked note structures described in this section of our comment letter require bifurcation, we believe this view should be made apparent and subject to the due process required of such a fundamental amendment to a Statement of Financial Accounting Standards.

As previously expressed in this letter ISDA agrees with the FASB's conclusions in the current guidance for determining whether an embedded derivative exists within a beneficial interest in securitized financial assets and believe that this guidance is consistently applied in practice. Thus we do not believe there is a need to issue guidance and further do not support the issuance of the Proposed DIG Issue as currently drafted because it could increase complexity and impair consistency in application of SFAS 155. We would not, however, object to the issuance of guidance that does not alter the existing principles of SFAS 155,

including the first sentence of paragraph 14B, as it is not expected that the application guidance within proposed paragraphs 200E and 200F will lead to a significant change in practice. We would also not object to additional clarifying guidance to be added after the first sentence in paragraph 14B to state that credit risk in the entity that could cause the investor to lose more than its initial investment is an embedded credit derivative, or a derivative in its entirety.

If the FASB finds it necessary to issue guidance, we recommend the following changes to proposed paragraph 200F to amplify the clarity of how one must evaluate the credit risk associated with the assets of the issuer using a common, fully-funded synthetic CDO transaction rather than subordination, which is already illustrated in paragraph 200C [text added is underlined and text deleted is ~~struck~~]:

Paragraph 200F is added as follows:

Example 40: Fully Funded Synthetic CDO. An SPE that holds U.S. Treasury securities and that wrote a credit default swap on a referenced credit to a third party, with a ~~smaller~~ notional amount that matches ~~than~~ the U.S. Treasury securities, issues ~~various~~ a single tranches of credit-linked beneficial interests to investors that have the same ~~differ in terms of priority in~~ ~~for~~ the distribution of cash flows from the SPE. The assets in the SPE are sufficient to fund any losses on the credit default swap. Thus, none of the tranches expose the investor to potential future payments related to defaults on the written credit default swap; the investor cannot lose more than its original investment. Rather, the investor is exposed to a potential reduction in its future cash inflows, which is the effect of the credit related risk. That reduction in future cash flows is allocated equally among the beneficial interest holders ~~tranches by the subordination of one tranche to another~~. Under paragraph 14B ~~(as revised)~~, the investor's embedded credit derivative feature is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133 because its changes in cash flow are attributable to changes in the creditworthiness of securitized assets held by the issuer ~~relates only to the concentration of credit risk in the form of subordination of one tranche to another~~.

5. Effective Date and Transition

As stated above ISDA believes that if the FASB issues the Proposed DIG Issue with the amendments to paragraph 14B as currently drafted (with the intent to require bifurcation for fully funded securitizations of a single class of beneficial interests referenced to the specific assets of the SPE), the implementation of this guidance would not be operational within the proposed time frame given the pervasive and significant effect such a change of this magnitude would have in practice. The need to perform an instrument-by-instrument analysis from an entity's adoption of SFAS 155 would require significant resources and time to implement. The timing will coincide with companies preparing year-end financial reports and implementing significant financial reporting and disclosure projects.

If, however, the FASB agrees to modify its proposed guidance so that the first sentence of paragraph 14B of SFAS 133 and its principle are retained, ISDA does not believe that the Proposed DIG Issue will significantly change practice and therefore would not object to the proposed effective date and transition provisions. ISDA otherwise supports the instrument-by-instrument fair value election for contracts that require bifurcation on adoption of the Proposed DIG Issue. However, as noted above, we do not believe that additional guidance is necessary.

6. Bifurcation Criteria

The Proposed DIG Issue proposes to amend SFAS 133 paragraphs 14B, 200A, 200B, and 200D such that references are made paragraphs 12 and 13 of SFAS 133. Additionally, the proposed amendments may inject the phrase “clearly and closely related” into SFAS 133 paragraphs 200A and 200B. None of these proposed changes are relevant in determining whether an interest can qualify for the embedded credit derivative scope exception in existing paragraph 14B. Thus, the requirement to apply the clearly and closely related concepts, for example, to beneficial interests in securitized financial assets instead of the principle discussed in the first sentence of existing paragraph 14B will create confusion in practice and generally is not operational. The proposed amendments to SFAS 155 imply that that a holder of a beneficial interest in a credit-linked note must apply the recovery and leverage criteria in paragraphs 13(a) and 13(b) of SFAS 133 to a feature that is solely credit related. It is well understood in practice that interest rate features must be evaluated under paragraph 13 of SFAS 133 and that embedded interest rate-related derivatives must be identified. However, the introduction of interest rate-related thresholds into a discussion that is solely limited to credit risk is confusing and very likely to lead to disparity in practice.

Accordingly, ISDA strongly recommends that the FASB remove the proposed references to paragraphs 12 and 13 of SFAS 133 inserted within paragraphs 14B, 200A, 200B, 200D of SFAS 155 and within proposed paragraphs 200E and 200F. As paragraph 12 and 13 are referenced in paragraph 14A, their exclusion from purely credit-related examples do not detract from their application. We also recommend removal of the phrase “clearly and closely related” within paragraphs 200A and 200B of SFAS 155. Removal of these items preserves the clarity and usefulness of the aforementioned examples. Also, because existing paragraphs 200A, 200B and 200D are sufficiently clear in SFAS 155 we recommend the deletion of the additional proposed amendments to the aforementioned paragraphs.

7. Other

Proposed paragraph 200E illustrates application of the embedded credit derivative scope exception to a partially funded synthetic CDO transaction in which multiple tranches of beneficial interests with differing payoff priorities are issued, including tranches that expose investors to making additional payments to the issuer because those tranches are not fully

funded. While certain beneficial interests contain concentrations of credit risk created through tranching, the fundamental principle we believe is intended to be illustrated in this example is that certain CDO tranches have characteristics of embedded credit derivatives by virtue of their holders' potential obligation to remit additional funds to the issuer when defaults under the credit default swap occur. While we agree with this principle, the proposed example as written would likely create confusion on how SFAS 155, paragraph 14A, would be applied to the various tranches in a securitization structure that overall is only partially funded, as discussed in Comment # 2 above. Accordingly, we recommend that the FASB make the following modifications to proposed paragraph 200E [text added is underlined and text deleted is ~~struck~~]:

Paragraph 200E is added as follows:

Example 39: Partially Funded Synthetic CDO. An SPE that holds GICs and that wrote a credit default swap on a referenced credit to a third party, with a significantly larger notional amount than the GICs, issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority and in their potential obligation to fund any losses on the credit default swap. That is, if credit losses greater than the value of the GICs are incurred under the credit default swap, the investors in one or more tranches may be required to provide additional funds to the special purpose entity, which would then be passed on as payments to the holder of the credit default swap. ~~Under paragraph 14B (as revised), the investor's embedded credit derivative feature that relates only to the concentration of credit risk in the form of subordination of one tranche to another is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133. However, Thus the certain individual tranches that expose the investor to making potential payments related to defaults on the written credit default swap would contain an embedded derivative subject to the application of paragraphs 12, 13, and 14A (provided that the investor's overall contract is not a derivative in its entirety under paragraph 6 of Statement 133). While the risk in those tranches is credit-related, the investor can lose more than its original investment. Therefore, the credit risk is not related only to subordination and must be evaluated under paragraphs 12, 13 and 14A.~~ Because the credit default swap relates to a referenced credit and could expose the investor to potential future payments (not merely reduced cash inflows), the tranches' swap's credit risk of loss is not related solely to the credit risk of simply failing to receive cash inflows from the referenced credit but also to the leverage inherent in an unfunded or partially funded investment; ~~thus, the economic characteristics and risks of the credit default swap would not be clearly and closely related to the economic characteristics and risks of the host contract.~~