



1120 Connecticut Avenue, NW
Washington, DC 20036

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Michael L. Gullette
VP – Accounting &
Financial Management

Phone: 202-663-4986
Fax: 202-663-5209
Email: mgullette@aba.com

November 12, 2009

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

Via email: director@fasb.org

File Reference: No. 1740-100 *Derivatives and Hedging (Topic 815) – Scope Exception Related to Embedded Credit Derivatives*

Dear Mr. Golden:

The American Bankers Association (ABA) appreciates the opportunity to comment on the exposure draft: *Derivatives and Hedging (Topic 815) – Scope Exception Related to Embedded Credit Derivatives* (ED). ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.3 trillion in assets and employ over 2 million men and women.

The ABA is very concerned that, while the apparent goal of the ED is solely to address accounting for some collateralized debt obligations (CDOs) and synthetic CDOs, the ED appears to redefine the nature of subordination, especially in context of a credit-tranched debt security. We believe that if the Board intends to change how such commonly-held instruments are defined from the perspective of whether or not they contain embedded derivatives, a separate project should be initiated to address this issue. As a result, we recommend that the related language, which is included in Accounting Standards Codification (ASC) Section 815-15-15-9, be retained. Prescriptive guidance addressing credit derivative holdings in CDOs or synthetic CDOs (such as credit default swaps) should be addressed in a separate ASC section or paragraph unrelated to 815-15-15-9.

Background: The ED Changes Credit-Tranching so that it is Now Considered a Derivative

The existing standard, as originated in paragraph 14b(2) of FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* (now ASC Section 815-15-15-

9), notes that a “*concentration* of credit risk in the form of subordination of one financial instrument to another shall *not* be considered an embedded derivative...” The ED, however, now defines such an arrangement as a “*transfer* of credit risk” that “redistributes credit risk” and “*is* an embedded derivative (emphasis added in italics)”.

“Transfer of Credit Risk” is Inconsistent with Current GAAP Language and Ignores the Substance of the Business Decision

We believe that such a redefinition, when applied to standard credit-tranched asset-backed securities, misrepresents their economic substance. The term “transfer”, as used in the ASC, is based on external transactions between entities. In credit-tranched securities, there is no external transaction that transfers credit risk between creditors. Indeed, during its “classification and measurement” phase of their financial instruments project, IASB staff almost exclusively referred only to concentration of credit risk.

The concentration of credit risk occurs as part of the master security. Emphasizing substance over the form of the security contract, the holders of individual tranches generally ignore any perceived “transfer” of credit risk and, instead, focus on the return, based on the credit risk maintained. Practically speaking, similar to the maintenance of collateral on the underlying assets, these security holders receive a specific yield based on the level of additional “collateral” included in *the structure* (“collateral” being the level of losses (if any) to be assumed by lower tranches, the effects of over-collateralization within the structure, and any other credit enhancements – all of these are in addition to the collateral underlying each loan within the security). Subordinate tranche holders thus require higher return for the concentration of credit risk resulting from reduced collateral. Senior tranche holders accept lower return resulting from the mitigation of credit risk by additional collateral.

More Discussion is Needed for Such a Change

In any event, we believe that the general response in this ED would be wider if it were known that such a change in definition could affect commonly-held financial instruments. For example, a transfer of credit risk in the form of a loan participation that has cash flow priority (and, thus, will not qualify for sale accounting under FASB Statement No. 166) is specifically treated as a secured borrowing without reference to any embedded derivative. By deleting paragraph 815-15-15-8 (formerly paragraph 14b(1) of FASB Statement No. 133, which specifically describes a credit-tranched security), one can conclude that paragraph 815-15-15-9 applies to these instruments, in addition to credit-tranched securities. Since the title of the ED indicates it applies only for embedded credit derivatives, and that these instruments are not currently thought of as having embedded credit derivatives, we do not believe that sufficient attention will be given to this issue. No mention of this change was made in the ED’s Basis for Conclusions.

We understand that the prescribed treatment for credit-tranched securities does not change as a result of the ED. However, as the Board continues its financial

instruments project, we believe that redefining the nature of credit tranching at this time may have unintended consequences in the future. Therefore, we recommend that the Board retain the current language that defines such subordination as not being an embedded derivative. We believe the Board should, thus, address embedded credit derivative holdings in CDOs and synthetic CDOs (such as credit default swaps) in a different or additional section of the ASC.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael L. Gullette". The signature is written in a cursive, flowing style.

Michael L. Gullette