



20 February 2009

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

cc Mr Bob Herz, FASB

Ref.: FRP/HvD/SS/SR

Dear Sir David,

Re: FEE Comments on Treatment of synthetic CDOs including embedded derivatives

- (1) FEE (the Federation of European Accountants) wishes to share with you some observations on the accounting treatment of synthetic CDOs and the embedded derivatives included therein. In our discussions with the European preparers in the banking industry, this issue was brought up again recently and it is for this reason that we write to you.
- (2) The issue of embedded derivatives had been identified by the European Commission in their consultation in October 2008 and brought to the attention of the IASB in a letter dated 27 October 2008. Subsequently, it was addressed also in the Roundtables organised by the IASB on the financial crisis, as one of the issues that required action of the IASB because of a difference in the treatment under IFRS and US GAAP. The IASB was asked to clarify whether under IAS 39 synthetic CDOs include derivatives that would need to be separated if the host instrument is not classified in the fair value through profit or loss category.
- (3) In its letter of 17 December, the IASB wrote back to the European Commission and indicated in relation to the clarification of the accounting treatment of embedded derivatives, that "Both Boards believe that the standards are consistent, and the FASB has now agreed to issue mandatory implementation guidance to ensure that US GAAP is applied in the same way as IFRS. The FASB will publish the draft statement shortly. This guidance will ensure that the US practice is in line with IFRS, providing a necessary level playing field".

- (4) On 14 January 2009 FASB issued Proposed Statement 133 Implementation Issue C22. The statement provides an interpretation of US GAAP as to when derivatives embedded in certain structures would not have to be separated. In particular, following the C22 interpretation, separate recognition would not be required for fully funded synthetic CDO structures and for fully funded tranches of synthetic CDO structures.
- (5) On the basis of discussions with financial instrument specialists in our working parties, we have come to the conclusion that the existing difference between IFRS and US GAAP would not be solved, in that C22 confirmed their understanding of US GAAP on the matter and IAS 39 AG 30 (h) would seem to require the separation of an embedded derivative in a synthetic CDO regardless whether it is fully funded or not. IAS 39 AG 39 (h) reads as follows: "Credit derivatives that are embedded in a host instrument and allow one party... to transfer the credit risk of a particular reference asset which it may not own, to another party... are not closely related to the host debt instrument."
- (6) The Information for observers for 20 February in relation to embedded derivatives (agenda paper 11) indicates in paragraph 11 that "The Board noted that there is no diversity in IFRS practice, and decided to retain the existing IFRS requirements. Indeed IFRS 39 AG 30 (h) as indicated above has consistently been interpreted as requiring separation of an embedded derivative in an investment in a synthetic CDO."
- (7) In paragraph 12 of the information for observers it is also stated that "In addition, the feedback from all of the IASB/FASB public roundtables (as well as the responses to the IASB ED Investments in Debt Instruments) clearly indicated that many constituents (including almost all users) believe that the IASB should not attempt to short-term patches that eliminate or reduce specific differences between US GAAP and IFRS, but rather should focus on the broader project to replace IAS 39." We agree with these observations and note that errors and/or unintended consequences can arise as a result of rushing through proposals and shortening the normal due process. As indicated in our letter of 17 December 2008 to yourself on the IASB work plan and our letter of 16 January 2009 on the Exposure Draft of proposed amendments to IFRS 7 "Investments in Debt Instruments": "Any further amendments to IFRS – resulting from the crisis or otherwise – such as to IAS 39 and IFRS 7 should be given full consideration as to their implications and potential unintended consequences and be subject to an appropriate due process that may be shortened if circumstances so require. Moreover, an appropriate due process would allow for more extensive consultation of all relevant stakeholders to discuss the practicability of the proposals."

- (8) We understand that FASB's objective in issuing C22 was to clarify their own literature rather than to ensure compliance with IFRS. The current discrepancy between the application of US GAAP and IFRS in the above mentioned particular situations may have the unintended consequence that some preparers nonetheless now expect the US GAAP guidance to be equally applicable to IFRS and consequently may lead to diverging interpretations. We therefore request that the IASB now clarify that C22 has not achieved the convergence anticipated in previous communications and that the resulting FASB guidance should not be interpreted as applying to IFRS. We cannot conclude differently than that the expectations included in the letter of IASB mentioned above and nearly identically included in the letter of 22 December 2008 to the European Banking Federation are not supported by the wording of the standards and thus their application in practice. Based on the discussion with the relevant accounting experts in our profession, FEE is of the opinion that separation of embedded derivatives in synthetic CDOs being fully funded structures would remain required under IAS 39 AG 30 (h).
- (9) In addition to the above, most banks and listed commercial companies with a calendar year-end will have already published their financial statements or are in the final stages of doing so and would not be able to implement any change to the standards which would be effective for 2008.
- (10) In the interest of the ongoing discussions of the IASB and European Commission, the IASB should as a matter of urgency clarify that a GAAP difference remains and consider, with FASB how best to address the difference with an appropriate due process in view of the discrepancy between IASB's earlier communications and FASB DIG C22.

We will publish this letter on the FEE website (www.fee.be).

For further information on this letter, please contact Ms Saskia Slomp from the FEE Secretariat.

Yours sincerely,



Hans van Damme
President