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RE: EITF 13-G

Dear EITF Committee,

ASC 815-15-25-1(a) provides one of the necessary criteria for bifurcation: “The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.” The discussion in EITF 13-G focuses on the economic characteristics of hybrids and their embedded derivatives, i.e. debt vs. equity, but not on the risks, per se. For example, ASC 815-20-25-12[f] provides four categories of (hedged) risk: market price, market interest rate, foreign exchange rate, credit.

The Whole approach has an advantage over the Chameleon approach because the Chameleon approach may result in an accounting anomaly. The anomaly is that embedded derivatives in the same risk category could have different determinations in terms of being closely and clearly related to the risks of their hosts.

Consider the following scenario:

A redeemable preferred stock is issued with three embedded derivatives in the same risk category; for example, derivatives A, B, C each have the issuer’s credit rating as the underlying. The redemption option of the preferred stock is tied to the embedded derivatives as follows: 60% of the total redemption amount is tied to derivative A, 5% is tied to derivative B, 5% is tied to derivative C, with 30% fixed and guaranteed.

Whole approach: derivatives A, B, C all will be clearly and closely related to the risk of the hybrid’s redemption option since credit risk derivatives are the source for the majority (70%) of the redemption option. No anomaly exists.

Chameleon approach: the nature of the redemption option without derivative A is dominated by the guaranteed 30% of redemption amount vis-à-vis the 10% tied to derivatives B and C. Therefore, derivative A will not be clearly and closely related to the risk of the hybrid’s redemption option. However, for derivatives B and C, the risk of the hybrid’s redemption option is dominated by the 60% tied to derivative A. Therefore, both derivatives B and C will be clearly and closely related to the risk of the hybrid’s redemption option. An anomaly exists because embedded derivative A will not be clearly and closely related to the risk of the redemption option of the host but B and C will be.

Solution:

One way to avoid this anomaly in the Chameleon approach is if we borrow another idea from hedging and instead of separating out and comparing each embedded derivative individually, that we view all embedded derivatives of the same risk category as one group to be separated out in its entirety and then compared to the host, similar to FAS 133, Paragraph 414:

414. Measuring the effectiveness of a fair value hedge requires determining whether a gain or loss on a hedging derivative offsets the loss or gain in the value of the hedged item that is attributable to the risk being hedged. Once the change in the value of a hedged item attributable to a particular risk has been offset by the change in value of a hedging derivative, a second, identical derivative cannot also be an effective hedge of that same risk. Similarly, an embedded derivative in a hedged item will modify the nature of the risk to which that item is exposed. **Thus, all embedded derivatives relating to the same risk class (that is, market prices, market interest rates, foreign exchange rates, or credit) in a hedged item must be considered together in assessing the effectiveness of an additional (freestanding) derivative as the hedging instrument.**

Sincerely,

Allen Schulman