

October 19, 2006



LETTER OF COMMENT NO. 12

Mr. Lawrence Smith
Director of Technical Applications and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. 5116
Norwalk, Connecticut 06856-5116

Re: Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments"

Nationwide Mutual Insurance Company is comprised of three affiliated mutual insurance companies under common management, Nationwide Mutual Insurance Company, Nationwide Mutual Fire Insurance Company, and Farmland Mutual Insurance Company and the subsidiaries or affiliates controlled by those entities (collectively known as "Nationwide"). Nationwide supports the effort of the FASB in designing and implementing guidance to improve financial statement transparency. As part of its ongoing investment activities, Nationwide is a significant investor in asset-backed securities.

In evaluating the requirements of FAS 155, we initially concluded that prepayment risk associated with our asset backed securities (ABS), collateralized mortgage obligations (CMOs) and mortgage-backed securities (MBSs) (collectively, the "Securities") would be considered to be clearly and closely related based upon the guidance in Statement of Financial Accounting Standards No. 133 "Accounting for Derivative Instruments and Hedging Activities" (FAS 133), as amended by FAS 155.

However, we have recently learned that there has been significant discussion and differing views among practitioners and their independent accountants around the application of FAS 155 in concert with FAS 133 concerning the need to potentially bifurcate embedded derivatives relating to the prepayment risk associated with certain Securities that are purchased at a discount.

As a significant investor in these Securities, Nationwide is concerned about potential interpretations where prepayment risk relating to the Securities could trigger recognition of embedded derivatives to be bifurcated. The following are our comments relating to our understanding of the current issues that concern Nationwide:

Clear Understanding of FAS 133 Implementation Issue B39, Example 6

It is our understanding that much of the recent discussions and uncertainties have centered around the application of FAS 133 as amended by FAS 155 with a particular focus on various interpretations and potential impacts of Example 6 of FAS 133

Derivatives Implementation Group Issue B39 (“Issue B39”). Based on our interpretation of the facts and literature, we do not believe an embedded derivative should be bifurcated from these Securities.

Some of the ambiguities inherent in Example 6, Issue B39 include:

- It was our understanding that single class MBSs were exempt from the application of applying paragraph 13(b). However, there also has been a varying view that such single class securities almost universally include a guarantee or servicing fee giving rise to mortgage servicing rights (MSRs) potentially creating a disproportoinality in cash flows. Based on this varying view, such securities then would be subject to paragraph 13(b). We request clarification on this issue including variations of Example 6 including single class agency pass throughs with guarantees and servicing fees. It is not intuitive from Example 6, Issue B39 that this example results in the potential issue of disproportionate cash flows.
- In the case of a Securities purchased at a discount, **the investor does not have the unilateral ability to obtain the right to receive the doubled rate of return specified in paragraph 13 (b)**. Issue B39 states that the conditions in paragraph 13 (b) were intended to apply only to situations that meet the two conditions specified in paragraphs 13 (b)(1) and 13 (b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs. As a result of this apparent conflict, we request guidance and resolution as to the applicability of paragraph 13(b) with respect to concentrations of prepayment risk in securitized financial assets. Again, we do not understand this alternative view given the fact that the investor does not have the unilateral ability to obtain the right to receive the doubled rate of return specified in 13(b). In addition, the trust does not have the discretion to initiate prepayments, such rights are a characteristic of the underlying assets of the trust.
- Further clarification is needed as to the applicability of paragraph 13 to prepayment scenarios. It is not clear that paragraph 13 be applied to prepayment scenarios given the guidance that states that it should be applied to an embedded derivative instrument in which the underlying is **an interest rate or interest rate index that alters net interest payments that otherwise would be received on an interest bearing host contract**. The investor does not have the ability to leverage their return based upon changes in interest rates. While prepayment speed assumptions are highly correlated to interest rates, they are not driven exclusively by them.
- Finally, as previously indicated, it was Nationwide’s understanding that such instruments (CMOs and MBSs) were exempt from FAS133 (paragraph 293). In addition, paragraph 305 of FAS 133 indicates that embedded derivatives that bear a close economic relationship to the host contract were not intended to be

bifurcated. As a result, we believe there is a reasonable basis to conclude that paragraph 13 should not result in separate accounting for prepayment risk inherent in such Securities.

Accounting for Prepayment Risk in Applying the Provisions of FAS 133 as Amended by FAS 155

As previously indicated, our significant concern is the application of FAS 133 as amended by FAS 155 in respect to the Securities that are purchased at a discount. As an example, CMOs typically include agency mortgage-backed securities subject to prepayment risk whereby repayments of the underlying mortgage loans result in a return of principal to beneficial interest holders of the CMO. The prepayment risk is often disproportionately allocated between the classes of beneficial interest holders. Under paragraph 13(b) of FAS 133 an embedded derivative could result in the case of this CMO example because given a certain interest rate scenario, no matter how remote, the underlying loans prepay soon enough such that the investor's return could be doubled by receiving par value in a short timeframe after purchasing the security at a discount. We believe that identifying an embedded derivative that requires separate accounting in such common mortgage-backed (and asset backed) securities is a potential consequence of the guidance in FAS 133, as amended by FAS 155. Therefore, we are requesting clarification as to the FASB's intention on this issue.

The Board considered whether concentrations of credit risk in subordinated interests in securitized financial assets should be treated as bifurcated embedded derivatives. It concluded that such concentrations of credit risk should not be considered bifurcated embedded derivatives based on the facts that there was (1) no obligation on the part of the subordinated financial instrument holder to transfer cash or assets and (2) that such concentrations of credit risk are reflected in the fair value of the subordinated financial instrument and so there is no need for a separate recognition of credit concentrations.

We believe this is also true for concentrations of prepayment risk that are inherent in asset-backed securities based on the same rationale applied in the case of concentrations of credit risk, namely that there is no obligation on the part of the subordinated financial instrument holder to transfer cash or assets and that such concentrations of prepayment risk are reflected in the fair value of the subordinated financial instrument. While prepayment risk is a subset of interest rate risk, the Board has acknowledged in FAS 133 that prepayments occur for other reasons than for changes in interest rates.

In addition to the above reasons, we believe the existing accounting models (FAS 115, FAS 91, and EITF 99-20) adequately address measurement and income recognition for investments that incorporate prepayment risk as reflected in the investor's assessment of expected future cash flows. We believe this is a more appropriate approach than bifurcating an embedded derivative for prepayment risk and separately accounting for a non re-payable host.

Summary

In conclusion, it is critical that the FASB addresses the apparent varying views around the implementation of FAS 155 in conjunction with FAS 133 in respect to prepayment risk associated with certain Securities. Guidance is necessary to clarify interpretations that prepayment risk does not result in an embedded derivative. In addition, the current accounting literature appropriately addresses the accounting for Securities that have prepayment risk.

If the FASB concludes that prepayment risk requires bifurcation of an embedded derivative, we would also ask the FASB to provide a transitional approach to those who have already adopted SFAS#155. This guidance needs to be timely given the upcoming filing of third quarter financial statements. Alternatively, the guidance provided to early adopters could be to continue to follow their current approach until existing issues are fully vetted and resolved.

Thank you for your consideration of our comments and requests.

Steve Cross
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