

December 8, 2006

Mr. Lawrence W. Smith  
Director of Technical Application & Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 10

**Re: File Reference: Proposed Issue B40**

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the Financial Accounting Standards Board's ("FASB" or the "Board") proposed Statement 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets* ("B40").

We commend the Board for clarifying the circumstances in which a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). However, while we agree that B40 would be responsive to the concerns of market participants, we believe that the criteria proposed in B40 can be improved upon to provide consistency with Statement 133 Implementation Issue No. B39, *Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor* (B39), as explained further below.

FAS 155, *Accounting for Certain Hybrid Financial Instruments, an Amendment of FASB Statements No. 133 and 140* (FAS 155), establishes a requirement to evaluate interests in securitized financial assets to identify if they meet the definition of a freestanding derivative or a hybrid financial instrument that contains an embedded derivative requiring bifurcation. B40 would provide a narrow scope exception from paragraph 13(b) of FAS 133 for securitized interests that contain only an embedded derivative that is tied to prepayment risk of the underlying prepayable financial assets, subject to three criteria. However, we believe that criterion b. and c. of B40 add criteria that do not apply to other hybrid financial instruments that contain a debt host contract and an embedded call option as outlined in B39 and therefore creates an inconsistency in the treatment of similar instruments.

B39 states that "The conditions in paragraph 13(b) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (issuer/borrower)."

On the other hand, B40 has the following criteria for determining whether securitized interests in prepayable financial assets would not be subject to paragraph 13(b):

- a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor
- b. The underlying financial assets do not contain an embedded derivative that requires bifurcation
- c. The securitized interest itself does not contain an embedded derivative (including an interest rate related derivative) for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets.

We believe that the existence of another embedded derivative should not create an additional separable embedded derivative for prepayment risk that would not otherwise have existed if the first embedded derivative was not present. Whether a prepayment embedded derivative needs to be assessed under paragraph 13(b) should not depend on whether a second embedded derivative exists. This would appear counterintuitive to us. Under the proposed guidance, the existence of a second embedded derivative, including one that is non-substantive or insignificant, would require that the prepayment embedded derivative will have to be assessed under paragraph 13(b).

It also appears inconsistent that the presence of a freestanding derivative in a securitization vehicle would not result in the need for an evaluation of the embedded prepayment feature in a securitized interest under paragraph 13(b), but the presence of an embedded derivative in the underlying financial assets, as noted in criterion b. of B40, would.

Further, we question whether the presence of an embedded derivative feature in a beneficial interest that would require separation because it meets the criteria in paragraph 12 should be a determinant of whether the effects of prepayments on the underlying assets should be evaluated under paragraph 13(b). In our view, features that divide the interests in the underlying assets are not relevant to the determination of whether the prepayment features of the underlying assets are clearly and closely related to those interests. Here, too, we believe it is counterintuitive to conclude that the existence of a second embedded derivative, including one that is non-substantive or insignificant, would require that the prepayment embedded derivative be assessed under paragraph 13(b).

In addition, we believe that the interaction of the proposed guidance and the provisions of paragraph 14A of FAS 133, as added by FAS 155, is unclear. We interpret paragraph 14A to require a "look through" to the underlying assets of a securitization to ensure that the substantive cash flows are evaluated. To the extent that the expected cash flows do not support the contractual terms of the arrangement, one would evaluate the presence of the embedded derivative based on the substantive arrangement. The inclusion of criterion c. seems to conflict with this notion.

To address these inconsistencies, we recommend that criterion b. and c. be deleted and additional clarification be added in the response section of B40 to explain that where the underlying financial assets contain an embedded derivative, that embedded derivative should be considered, as with freestanding derivatives in the securitization structure, in evaluating whether an embedded derivative exists in the securitized interests. It should also be clarified that if the securitized beneficial interest contains another embedded derivative other than prepayment, then only that embedded derivative would need to be evaluated under paragraph 13(b) of FAS 133. We believe this will result in a consistent treatment of prepayment risk while still requiring the need to evaluate non-prepayment related embedded derivatives against the conditions in paragraph 13(b) or otherwise reduce the likelihood that such embedded derivatives would require bifurcation under paragraph 13(b).

Should the Board choose to continue with the three criterion model in B40, we have described in the attachment to this letter our views on the guidance as requested in the "Notice for Recipients of This Proposed Statement 133 Implementation Issue."



We recommend that B40 be issued in time for early January 2007 earnings releases in order to minimize potential differences between information in earnings releases and information in the financial statements. If B40 is not issued well enough in advance of when earnings are released, entities that had early adopted the provisions of FAS 155 could be affected.

If you have any questions about our comments, please contact John Lawton (973-236-7449), Tom Barbieri (973-236-7227) or Gerard O'Callaghan (973-236-7817).

Sincerely,

PricewaterhouseCoopers LLP

**PricewaterhouseCoopers LLP's Specific Comments to B40 Described in  
the "Notice for Recipients of This Proposed Statement 133 Implementation Issue"**

**Comments on the Response**

**1. Freestanding derivatives within securitization vehicle**

Although the examples indicate the intended conclusion that it is possible for a securitization vehicle to contain freestanding derivatives and still meet the exemption criteria under B40, we believe this should be made clearer in the response. We suggest that this be addressed by indicating in the paragraph below the three criteria that the inclusion of freestanding derivatives does not impact the scope exception, except in those cases where such derivatives result in the securitized interests having an embedded derivative that requires bifurcation.

**2. Applicability to resecuritizations**

In the first paragraph of the response section the intent of the term "securitized interest in prepayable financial asset" is not entirely clear to us. Similarly, the second paragraph includes a statement that the objective is to "provide a narrow scope exception . . . for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets. . . ." From the examples provided, it is apparent that the scope exception also applies to securitized interests in financial assets that are not themselves prepayable, but were formed from other securitization interests that were prepayable. We believe that the intent is to scope out embedded options in underlying financial assets, including those that are directly underlying the securitized interest and those that are ultimately the securitized interests that have been resecuritized in a subsequent transaction. We recommend that this concept be clarified in the response section.

**Comments on the Examples**

**3. Example #2 (Securitization Trust Includes a Freestanding Derivative)**

We believe that this example may be misleading because it does not address whether the notional amount of the interest rate swap and the underlying financial assets match, and therefore whether it is consistent with Example 36 in paragraph 200B of FAS 155. The guidance in B39 should also be emphasized to clarify that if the notional amounts of the loans and the notional amount of the interest rate swap do not match, the interest rate embedded derivative would need to be evaluated under paragraph 13 because the financial instruments may not provide the necessary cash flows.

We recommend that this example be amended (or the response clarified) to include guidance to deal with the following scenarios: (i) where the terms of the derivative perfectly match the underlying financial assets and together they provide sufficient cash flows to support the contractual terms of the arrangement, (ii) where the terms of the derivative do not perfectly match the underlying financial assets but together they provide sufficient cash flows to support the contractual terms of the arrangement, and (iii) where the terms of the derivative do not match those of the underlying financial assets and do not provide sufficient cash flows to support the contractual terms of the arrangement.

**4. Example #3 (Sequential-Pay Collateralized Mortgage Obligation (CMO))**

The response to Example 3 states that "...the investor would have to analyze the financial assets and liabilities that provide cash flows to each of the securitized guaranteed single-class mortgage pass-

through securities.” It is unclear what is meant by analyzing the liabilities, although we suspect it was meant to address derivatives in liability positions. We recommend that “liabilities” be replaced by “derivatives” in this context since consideration needs to be given to whether the cash flows provided by the financial assets and derivatives will provide the necessary cash flows to the pass-through securities.

**Comments on the Effective Date and Transition**

**5. Transition Provisions**

We do not believe that the transition provisions address all possible scenarios for companies that early adopted FAS 155. The transition provision provides guidance for early adopters of FAS 155 that identified embedded derivatives that would meet the scope exception under B40 and either bifurcated that embedded derivative or elected the fair value option under FAS 155.

However, there may be entities that early adopted FAS 155 and either did not bifurcate an embedded derivative and would now be required to do so under B40, or bifurcated an embedded derivative from a securitized interest but did not consider the effect of prepayments in the bifurcated derivative as would now be required. For example, an entity may not have considered the effects of prepayment risk in concluding that an embedded derivative does not need to be bifurcated when it would now require bifurcation under B40. We recommend that B40 include transition guidance for the latter scenarios.