



December 8, 2006



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

LETTER OF COMMENT NO. /2

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

Dear Mr. Smith:

The Group of North American Insurance Enterprises (“GNAIE”) and the American Council of Life Insurers (“ACLI”) appreciates this opportunity to share our thoughts and comments with you on the Financial Accounting Standards Board’s (“FASB” or “Board”) Proposed Statement 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets*

ACLI is the principal trade association of life insurance companies, representing 377 member companies that account for 91 percent of total assets, 90 percent of the life insurance premiums and 95 percent of annuity considerations in the United States.

GNAIE consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations.

Together, GNAIE and ACLI companies represent a significant population of the total investors in the mortgage and other asset-backed securities’ marketplace.

We fully support the FASB’s timely and positive response to constituents’ concerns regarding the applicability of paragraph 13(b) of Statement 133 to securitized interests in prepayable financial assets upon the adoption of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. We offer the following comments for your consideration.

*Criterion (b)*

Statement No. 155 requires that the investor in a securitized interest in financial assets understand the nature and amount of assets and liabilities that comprise a securitization structure

as well as the payoff structure and the payment priority of the particular securitized interest it holds to determine if an embedded derivative exists. In this regard, the existence of freestanding derivatives or embedded derivatives contained in the underlying assets of the structure should be understood in the context of this analysis. Their mere existence, however, would not, in and of itself, dictate or require bifurcation of an embedded derivative in the particular securitized interest.

In contrast, the inclusion of criterion (b) in the draft guidance causes the mere existence of a bifurcatable embedded derivative in the underlying assets, regardless of its relative magnitude, to require an analysis under paragraph 13(b) of Statement 133 with respect to prepayment risk for all the securitized interests. It is our understanding that criterion (b) was consciously included to require constituents to go beyond Statement 155's "nature and amount" requirements, in order to avoid a potential situation where assets that contain an embedded interest rate derivative, for example one that fails the tests in paragraph 13 (a) or 13(b) of Statement 133, are securitized and the resulting beneficial interests may not otherwise require bifurcation if prepayment risk is excluded. We understand and appreciate the Board's concern in this regard. However, we are not sure that this guidance was meant, for even an insignificant embedded derivative (for example, a bifurcatable embedded derivative in 1 securitized loan out of thousands), to cause the senior and intermediate interest holders to be subject to paragraph 13(b) with respect to prepayment risk in the underlying assets and potentially bifurcate an embedded prepayment derivative in an otherwise simple structure.

In addition, criterion (b) introduces operational challenges to investors, who, in order to obtain this exception will essentially be required to obtain sufficient information about the underlying assets in the structure in order to perform a complete analysis under paragraphs 12, 13(a) and 13(b) of Statement 133 and related implementation issues, which will be overly burdensome. It may appear that "market forces" will cure this problem, going forward, as sponsors will have the incentive to provide such information to initial investors in prospectuses. The concern we have lies with investors in the secondary market for such securities, who will be required to perform the paragraph 13 analyses for every single asset in the structure at the time they acquire their beneficial interests. Conceivably, many of these interests change hands on a daily basis, with underlying asset values changing and, in some cases the composition of assets changing frequently.

In light of these concerns, we would like to make a recommendation that we believe would make this guidance more practicable, without compromising the Board's overall goals and objectives. We recommend that the FASB consider removing criterion (b) and instead require an analysis based only on criteria (a) and (c) for the following reasons:

- It would not significantly expand the scope exception, or lead to potential abuse, because criterion (c) would essentially "catch" embedded derivatives in the underlying assets, as embedded derivatives of any significance would most likely emerge as embedded derivatives in the securitized financial interests.
- It would alleviate the burden on sponsors to provide updated information on underlying assets to investors on a daily basis

- It would alleviate the burden on investors to analyze each and every underlying asset upon acquisition to determine whether they need to consider prepayment risk in applying paragraph 13(b) to their beneficial interests
- It would improve simplicity and reduce complexity by requiring a consistent approach to analyze all securitized financial interests, in that the investor would only be required to understand the nature and amount of assets and liabilities that comprise a securitization structure as well as the payoff structure and the payment priority of the particular securitized interest it holds (consistent with the requirements in Statement 155)

*Criterion (c)*

With respect to criterion (c), we would like to raise a separate concern, which we believe is shared by many in the investor community. There are common asset-backed structures where prepayment risk is present, for which we believe the draft guidance was intended to apply, but it may not. This is because of a failure to meet criterion (c) due to the existence of an otherwise bifurcatable embedded derivative of little, or no, economic value in the securitized interest itself, which is present due to failure of the test in paragraph 13(a) of Statement 133. Appendix A to this letter includes an example fact pattern on a typical student loan securitization to illustrate our concern.

The derivative in the student loan example is an embedded interest rate basis swap. The “basis risk” swap arises because the interest rate on the student loans floats on a different basis (generally commercial paper or US Treasury bills) than the interest rates on the securitization notes (generally based on LIBOR or EurIBOR). It is possible (albeit remote) that if LIBOR were to increase significantly without a commensurate increase in the variable rate on the assets, there would be insufficient cash flows from the underlying assets to pay all the principal on the notes such that the paragraph 13(a) test in Statement 133 is failed with respect to even the highest-rated tranche. Although the embedded derivative in the in the AAA rated tranches will most likely not be ascribed a fair value that is measurable, nonetheless, an embedded derivative technically still exists.

The purpose of bringing out the details in this example is to demonstrate that although the basis risk derivative does exist to a measurable extent in the lowest tranche (that is, the lowest tranche receives the risks and rewards of substantially all of the structural basis risk), that derivative has virtually no impact on the value of the AAA rated tranches. In accordance with criterion (c) of the draft guidance, because this “other” embedded derivative technically exists (regardless of its economic value) in all tranches, every investor would be subject to paragraph 13(b) with respect to prepayment risk in the underlying assets and potentially would be required to bifurcate an embedded prepayment derivative.

We would like to make another recommendation that we believe would make this guidance more practicable, without compromising the Board’s overall goals and objectives with respect to criterion (c). We recommend that the FASB consider clarifying criterion (c) with the addition of following guidance: “For the purposes of applying criterion (c), if it has been determined, based on the specific facts and circumstances, that an otherwise bifurcatable embedded derivative in

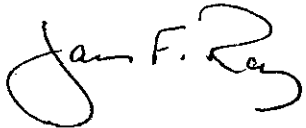
the securitized interest itself would initially have a fair value of zero, or near zero, criterion (c) would still be met.”

The rationale for recommending that the fair value of the embedded derivative only be considered at initial recognition, is to reduce complexity and to be consistent with the paragraph 13 tests, themselves, which are only required to be applied once, upon the acquisition of the securitized interest.


Again, we understand the Board’s specific goals and objectives with respect to this guidance, and the comments and recommendations included in this letter are solely intended to assist the FASB making this guidance more practicable to ensure that the such goals and objectives will indeed be met when this guidance is actually applied in practice.

If you have any questions regarding the contents of this letter, please contact the undersigned at anytime to discuss our comments and recommendations. Thank you in advance for your consideration in this matter.

Sincerely,



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## **Appendix A**

### **Student Loan Securitization Example Fact Pattern**

The following facts are based on Sallie Mae, Inc.'s securitization of Federal Family Education Loan Program student loans via its SLM Student Loan Trust 2006-10, an approximately \$4 billion trust collateralized with student loans. The student loans are fixed rate loans (to the individual borrowers) extending up to 10 or more years in maturity. However, the U.S. Education department subsidizes the banks making these loans and the subsidy is based on a floating spread over 90 day commercial paper or 91 day U.S Treasury bills. Therefore, the student loans pay an interest rate to the trust that, when the U.S. Education Department subsidies are included, floats based on either 90-day commercial paper (96%) or 91-day US Treasury bill (4%) interest rates.

In contrast, the approximately \$4 billion notes (including the approximate \$500 million value of approximately €400 million notes) issued by the Trust to pay for the collateral have a floating interest rate based on 3 month LIBOR or EurIBOR, as appropriate.

As described in the Fitch rating analysis, which assigns the highest tranches an "AAA" rating, stressing the basis risk did not cause a significant impact on the AAA tranches due to the CP/LIBOR basis having demonstrated less volatility than U.S. Treasury/Eurodollar spreads. In addition, the U.S. Education Department's special allowance payments will offer floor income on a portion of the student loans in a declining interest rate environment.