



LETTER OF COMMENT NO. /

CAPITAL MARKETS  
EQUITY RESEARCH  
INVESTMENT BANKING  
INDEPENDENT SERVICES  
STRATEGIC ALLIANCES

Financial Accounting Standards Board  
Director of Major Projects and Technical Activities  
401 Merritt 7  
Norwalk, CT 06856-5116

September 8, 2006

Dear Sir or Madam:

We are concerned that certain provisions of FAS 155 could be applied to certain discount priced CMOs even though that does not appear to be within the spirit of the pronouncement. We have received a number of inquiries from institutional investors about the topic and request that you issue guidance to clarify the issue.

We understand the prevailing question is whether bifurcation is required for the embedded prepayment option of the underlying borrower. The "clearly and closely" related test in paragraph 13 of FAS 133 states that a derivative is considered to be clearly and closely related unless [and we focus on condition (b)]:

"The embedded derivative could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality."

The world of fixed-income securities is such that there are many ordinary CMOs in the marketplace today that could have a return (yield) that is double the initial return (yield anticipated). This would require a substantial increase in prepayment rates (likely triggered by lower interest rates).

For discussion purposes, we are using the terms "return" and "yield" (or income) interchangeably. The investor's total return at any given point in time is a combination of yield (income) and the appreciation or depreciation in the market price of the security. These two measures will converge over time as all of the investor's ultimate return consists of the income realized by holding the security.

We illustrate the possibility for a doubling of return with these two ordinary CMOs. Each is a relatively low-risk security that would ordinarily be favored by conservative investors and the bank regulators. Note, however, how the yield triples when interest rates decrease and the average life shortens due to higher prepayments. This shortening of the average life accelerates the realization of the discount between their purchase price and par, and thus increases the return far above what was originally anticipated.

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Tranche	coupon	price	Yield		Avg Life (yrs)	
			initial	dn 300	initial	dn 300
FHR 2583 PK	4.00%	97.34	5.37	16.08	2.0	0.2
FNR 2003-52 KR	3.50%	94.31	5.42	17.39	3.3	0.4

Some believe this would cause the embedded prepayment option to not be considered “clearly and closely related” and thus cause the CMOs to be subject to the provisions of FAS 155. However, we don’t believe this result is within the spirit of FAS 155.

Paragraph 305 of FAS 133 (discussing the basis for the Board’s conclusions on “clearly and closely related”) states in part:

“Many hybrid instruments with embedded derivatives that bear a close economic relationship to the host contract were developed many years ago, for reasons that clearly were not based on achieving a desired accounting result. Prepayable mortgages and other prepayable debt instruments are examples of such familiar compound instruments with embedded derivatives. The accounting for those types of hybrid instruments is well established and generally has not been questioned.”

Accordingly, we request that you issue clarification on this matter by adding it to the agenda of the EITF or another appropriate venue.

We appreciate your consideration.

Sincerely,



Mike Heflin  
Executive Vice President  
FTN Financial Capital Markets

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