



September 22, 2006

LETTER OF COMMENT NO.

Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: FAS 155 Implementation Concerns

Ladies and Gentlemen:

As you are aware, there are challenges and diversity in interpretations when applying FAS 155 and FAS 133 to securities subject to prepayment, particularly securities purchased at a discount. In particular, many members of the American Securitization Forum ("ASF")¹ are very concerned that if an investor purchases a mortgage backed security ("MBS"), the application of FAS 155 in combination with the bifurcation requirements of FAS 133 may require bifurcation of embedded derivatives for what are essentially plain-vanilla bonds.

In performing the analysis for securities subject to prepayment purchased at a discount, our industry members have highlighted various areas that we are requesting the Board to consider. Given the upcoming effective date of FAS 155, we are submitting the below points raised by our members in summary form. We would be happy to prepare a more detailed discussion or examples of these points and would like to meet with members of the Staff or Board to discuss them in person.

We note, for purposes of the discussion of the below points, that the language in Example 6 in Issue B39 was not included in the Exposure Draft of FAS 155 or the fatal flaw draft and, therefore, there was no prior opportunity to comment on the interaction of this example with FAS 155 and its application to MBS and collateralized mortgage obligations ("CMOs").

1. Paragraph 13 of FAS 133 states that "For purposes of applying the provisions of paragraph 12, 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 paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following

¹ The American Securitization Forum is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. This comment letter was developed principally in consultation with the ASF's Accounting and Tax Subcommittee, with input from other ASF members and committees. More information about the ASF, the Accounting and Tax Subcommittee and their respective members and activities may be found at the ASF's internet website, located at www.americansecuritization.com.

conditions exist:

- a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment.
- b. The embedded derivative meets both of the following:
 - (1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.
 - (2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception."
- 2. From the Board discussion and minutes from the December 14, 2005 meeting, we believe the Board's intent was clear that single class MBS are exempt from applying paragraph 13(b). Example 6 of Issue B39 indicates that paragraph 13(b) should not be applied when the associated cash flows are proportionately passed through to all the interest holders. Virtually all single class securities issued by an agency involve a guarantee or servicing fee potentially giving rise to MSRs. Some have argued that these fees create disproportionality, such that a single class MBS would be subject to the test in paragraph 13(b). However, if this view were intended by the Board, the specific language noting that certain MBS are not subject to the conditions in paragraph 13(b) would apply to virtually nothing.

Given the confusion over whether disproportionality exists, we recommend that the Board clarify Example 6 in Issue B39 to indicate that single class agency pass throughs (including ones with guarantee fees and servicing fees giving rise to MSRs) are exempt from paragraph 13(b).

3. The principle in Issue B39 is clearly expressed: "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. When the embedded derivative is an option rather than a forward contract, it is important to analyze whether the investor is the holder of that option. For an embedded call option, the issuer or borrower (and not the investor) is the holder, and thus only the issuer (borrower) can exercise the option. Consequently, the investor does not have the unilateral ability to obtain the right

to receive the high rate of return, which is contingent upon the issuer's exercise of the embedded call option."

We do not understand how the conclusion in Example 6 is consistent with this principle. The investor in an MBS has no more "unilateral ability to obtain the right to receive the high rate of return" by owning an MBS than it does by being a direct lender through a prepayable loan. It is unclear as illustrated in Example 6 of Issue B39 why the answer should differ if one holds the prepayable instrument itself or has the rights to the cash flows from the instrument by holding a security issued by a special purpose entity which holds the instrument and passes through the cash flows to the security holder. In both cases, the option is not held by the investor.

- 4. In addition, Issue B39 indicates that paragraph 13(b) should not be applied when the associated cash flows are proportionately passed through to all the interest holders. It is also not clear what is disproportionate allocation and why a security (whether or not the associated cash flows are passed through to investors proportionately) would be subject to the paragraph 13(b) test if the MBS itself does not contain an embedded call option.
- 5. Multi class CMOs are passing through prepayments which are driven by the underlying borrowers to investors and, accordingly, we believe were intended to be exempt from applying paragraph 13(b) in accordance with Issue B39. Conflicting information is leading to diversity in views and we recommend that the Board consider a technical correction of Issue B39 to clarify the principle and its application to securities subject to prepayment.
- 6. In addition, some members have questioned whether it is appropriate to apply the test in paragraph 13 to prepayment scenarios, given that all the guidance 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..." Although prepayment speed assumptions are highly correlated to interest rates, they are not driven exclusively by them.

In addition, paragraph 293 indicates that the Board decided that many of the prepayment or call options frequently included as part of mortgage loans and other debt instruments should be excluded from the scope of the Statement. Paragraph 305 indicates that embedded derivatives that bear a close economic relationship to the host contract were not intended to be bifurcated. Prepayable mortgages and other prepayable debt instruments were examples. Therefore, we believe that there is a reasonable basis to conclude that paragraph 13 should not be applied to prepayment scenarios.

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Thank you for your time and consideration of this request. Given the potential for significant market disruption in the above mentioned areas without further clarification or interpretation, we would welcome and encourage a more detailed discussion on the points made above. Please do not hesitate to contact either of the undersigned, or George Miller, Executive Director of the ASF, at 646.637.9216 should you have questions or desire any additional information.

Sincerely,

/s/Esther Mills
Chair
Accounting & Tax Subcommittee
American Securitization Forum

/s/Lisa Filomia-Aktas
Deputy Chair
Accounting & Tax Subcommittee
American Securitization Forum