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October 12, 2006

Mr. Robert H. Herz Chairman Financial Accounting Standards Board 401 Merritt 7 Norwalk, CT 06856



LETTER OF COMMENT NO. 1



Dear Chairman Herz:

The American Insurance Association (AIA) is very concerned with differing interpretations of FASB Statement No. 155: Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140 (FAS 155). Although our interpretation of FAS 155 is that Mortgage-Backed Securities - including collateralized mortgage obligations and other assetbacked securities with similar prepayment options (referred to as MBS) - would continue to generally not be subject to evaluation for an embedded derivative under paragraph 13(b) of FAS 133, we understand that some believe this not to be the case. Through industry discussions we understand that a differing view would even have discounted "plain-vanilla" pass-through MBS subject to evaluation under paragraph 13(b). This interpretation troubles us for three reasons: (1) the intent of the quidance indicates to us that the prepayment option available to the underlying borrower does not create an embedded derivative for the MBS holder; (2) the interpretation would lead to vastly different accounting for the same instruments with the only difference being whether or not the security was purchased at a discount; and (3) the inherently subjective nature of the valuation of prepayment options.

Intent of the Guidance

The areas within the literature that are the cause of differing interpretations are discussed as follows:

- 1. Interaction of DIG Issue B39: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor (B39), FAS 133 and FAS 155. Below are excerpts from the current quidance:
 - a. The response section of B39 states "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."
 - b. Paragraph 61(d) of FAS 133 states "Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments

- unless both (1) the debt involves a *substantial* premium or discount and (2) the put or call option is only contingently exercisable, provided the call options (or put options) are also considered to be clearly and closely related to the debt host contract under paragraph 13. Thus, if a *substantial* premium or discount is not involved, embedded calls and puts (including contingent call or put options that are not exercisable unless an event of default occurs) would not be separated from the host contract."
- c. Example 6 of B39 (change per FAS 155) states that, "While the MBS itself does not contain an embedded call option, the Board decided as part of FASB Statement 155, Accounting for Certain Hybrid Financial Instruments, that an interest in MBS with an underlying assets containing an embedded call feature, for which all of the associated cash flows are proportionately passed through to all the interest holders, will not be subject to the conditions in paragraph 13(b) with respect to an embedded call feature. However, in situations in which the cash flows associated with the embedded call feature are disproportionately allocated to different classes of interest holders, all interest in the MBS would be subject in paragraph 13(b) with respect to that embedded call feature."

Our Interpretation

We believe Example 6 (as amended) is not internally consistent with the response section of B39. In the MBS example, the investor clearly does not have the unilateral ability to receive the high rate of return. It appears to us that the intent of the original example, along with paragraphs 13, 61(d) and 305 of FAS 133 and the response section of B39, was to capture structured securities that can experience significantly different returns from the underlying loans. We understand the genesis of the differing interpretations since the internal inconsistency within the revised B39 along with attempting to apply the provisions of paragraph 61(d) to MBS create confusion instead of clarity. Paragraph 61(d) appears to clarify what is considered clearly and closely related and indicates unless a substantial premium or discount is present, bifurcation would not be required and yet still requires consideration of paragraph 13 of FAS 133.

 Interpretation of Example 6 of B39 - What is intended by "disproportionately allocated to different classes of interest holders"? Some are interpreting this to mean that guarantee fees cause a disproportionate allocation between classes. This interpretation would cause single class MBS pass-throughs to be subject to paragraph 13(b) and potential bifurcation.

Our Interpretation

We believe that the intent of the guidance was to capture securities where the allocation among the principal holders is not proportionate and each class may receive significantly more or less than the expected return and return of initial investment. It is our belief that when evaluating the impact of a potential prepayment, we should only look to the distribution of cash flows associated with the embedded call (prepayment) only and not the general cash flows of the structure.

3. Application of the "double-double" test in paragraph 13(b) of FAS 133 to MBS.

Our Interpretation

It appears that the "double-double" test is not intended for MBS due to the illogical results it produces. Any test that is intended to capture an embedded derivative, but only identifies an embedded derivative in discounted and not all similar investments, clearly is not appropriate to that type of security.

4. Additionally, if the intent of the Board was to include these pre-payable securitized interests in the scope of 13(b), we find it peculiar that FAS 155 lacks discussion regarding the interplay with EITF 99-20 and FAS 91, since MBS purchased at a discount would no longer be subject to that literature. The lack of discussion in the basis of conclusion and the lack of acknowledgment that the scope of EITF 99-20 and FAS 91 would be impacted indicate to us that the Board did not intend for the developing interpretation that all MBS are subject to paragraph 13 of FAS 133.

Conclusion

For the reasons above, we believe that the Board should clarify that:

- 1. Guarantee fees do not cause disproportionate allocation.
- 2. The embedded prepayment option is clearly and closely related to the host contract for MBS and not subject to paragraph 13(b) of FAS 133. This would include eliminating the internal inconsistencies within B39.

Different Accounting for Like Instruments

We find it difficult to believe that the Board's intent was to have different accounting for similar or even the same investment. For instance, if we assume that one investor purchases a single class 6% mortgage-backed security at 99 and another the same security at par a day later due to an interest rate change, the investor who purchased at par would generally be subject to FAS 91 whereas the investor that purchased at 99 would potentially either have to select the fair value option or bifurcate the investment under FAS 133.

Additionally, we do not believe that it was the Board's intent to require different accounting for MBS and their underlying loans. Economically, an MBS and the underlying pool of loans are extremely similar with the only differences being a slightly lower return on the MBS due to servicing and guarantee fees, and additional liquidity.

Conclusion

As stated in the paragraph QC 37 of the Conceptual Framework Preliminary Views document, "Comparability of financial reporting information is not enhanced by making unlike things look alike any more than it is by making like things look different." We believe that requiring different accounting for MBS purchased at a discount compared to those purchased at par (or up to a 10% premium) as well as requiring different accounting for an MBS (absent another embedded) and its underlying will make like things look different and does not create representationally faithful financial reporting.

Valuation Concerns

There would be significant challenges to valuing the prepayment option from the underlying prepayable mortgages since there are factors other than interest rates that change prepayment speeds. Although there is a reasonably high correlation with interest rates, customer behavior would significantly impact the valuation. For instance, if one held a 6% mortgage-backed security and interest rates fell to zero, the chance that all of the underlying mortgages would prepay is beyond remote (This would also indicate that the "double-double" test was not intended for pre-payable securities). Some parties would be unaware of the benefits of refinance while some others may not have the ability. Without an observable market with which to calibrate, each company would have to develop models using internal assumptions for the non-market variables.

Conclusion

We believe that the valuation modeling for the prepayment option would be extremely challenging and could lead to lack of comparability between institutions. The significant challenges could also force some companies to fair value all of their MBS leading to significant income statement volatility. For those institutions that prefer to not have non-economic volatility cloud their financial statements, a change in investing behavior to only par securities or other unaffected securities could be a viable solution and an unintended result of the FAS 155.

Overall Conclusion

Our conclusion is that the intent of the guidance (FAS 133, FAS 155 and B39) does not require MBS to be evaluated under paragraph 13(b) of FAS 133. With the implementation date quickly approaching, we ask that the Board quickly confirm that this is the intent of FAS 155. If this is not the Board's intent, then we respectfully ask that the Board delay the implementation of FAS 155 and reconsider the ramifications of the unexposed change to B39.

Thank you for the opportunity to comment on this issue. If you have any questions regarding our letter, please call me at (202) 828-7170.

Sincerely,

/s/ Phillip L. Carson

Phillip L. Carson Assistant General Counsel American Insurance Association