



November 9, 2006

Mr. Larry Smith
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
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File Reference: Proposed Issue B40

Dear Mr. Smith,

As a Director of Accounting Policy of a Fortune 100 company that holds significant beneficial interests in securitized financial assets, I am pleased to offer my comments on the FASB's Proposed Issue B40 ("B40").

Background

When recalling the industry discussions that caused the FASB to discuss this topic on October 25th and in reviewing B40, I believe B40 is completely unnecessary (and erroneously in some cases) since FAS 133 already contains guidance on this topic. That guidance is not obvious when casually reading FAS 133, but can be found by a careful analysis of FAS 133's paragraphs 6, 7, 12, 13, 176 - 200.

B40 focuses on instances when the debtors of debt instruments owned by an SPE (that has issued to investors beneficial interests that are backed by those debt instruments) can prepay their debt and those debtors will exercise that prepayment option when a decrease in general interest rates occurs (i.e., the debtor refinances their debt in order to take advantage of the new lower interest rates available in the marketplace). B40 assumes that the underlying is an interest rate or interest rate index, which is why it is analyzed under FAS 133's paragraph 13. In this B40 scenario, that interest rate or interest rate index (the underlying) is a general interest rate, not a specific interest rate documented in any of the investment or lending documents signed by the beneficial interest holder, the SPE or the debtor of the underlying collateral.

Conclusion

I contend that since an underlying (per FAS 133, paragraph 7) must be a specific interest rate or interest rate index, not interest rates in general, the "underlying" in the B40 scenario is not a true underlying since it does not meet the definition of an underlying in FAS 133. Because of this, the prepayment option in the B40 scenario cannot meet the definition of a derivative under FAS 133's paragraph 6(a) (or an embedded derivative under FAS 133's paragraph 12(c)) since there is no underlying involved, therefore an analysis under paragraphs 13(a) or 13(b) (or any other paragraph in FAS 133) would never be required when the beneficial interest and the SPE do not hold any other derivatives or contain any other embedded derivatives.

In case it lends more weight or attention to my argument, please also note that the basic argument contained in this letter was presented to our external auditors (identities withheld to protect the innocent) and their national office's derivatives expert several months ago and, as of the date of this letter, this analysis has not been rebutted or discredited by them in any way (although I am not purporting that they participated in any way in the drafting of this letter).

Basis for Conclusion

The tests in FAS 133's paragraph 13(a) and 13(b) are only used to evaluate an embedded derivative for bifurcation when that embedded derivative has an underlying that is an interest rate or interest rate index. FAS 133, paragraph 13 states:

"13. ... 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 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 conditions:
 - (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."

The definition of an **underlying** in FAS 133, paragraph 7 is:

"A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself..." (*underlining added for emphasis*)

The FASB used the word "specified" twice in this definition, which highlights the importance of the distinction the FASB was making. Furthermore, in FAS 133's "Examples Illustrating Application of the Clearly-and-Closely-Related Criterion to Derivative Instruments Embedded in Hybrid Instruments" in paragraph's 176 – 200, the FASB always used the word "specified" (or other derivations of the word, such as "specific") in examples where interest rates or interest rate indices were the underlying and always described the specific interest rate, such as "3-month US\$ LIBOR" or "10-year constant maturity treasury yields", rather than using general terms such as "interest rates" or "treasury rates". This further highlights the FASB's belief in the importance of an interest rate or index to be specifically stated in order for it to be an underlying of a derivative. I offer these two examples from FAS 133 (*underlining added for emphasis*):

"180. **Example 14: Delevered Floater.** A bond with a coupon rate of interest that lags overall movements in specified general interest rate levels or indices.

Example: Coupon = $(.5 \times \underline{10\text{-year constant maturity treasuries (CMT)}) + 1.25$ percent.

Scope Application: A delevered floater may be viewed as containing an embedded derivative (a delevered swap or a series of forward agreements) that is referenced to an interest rate index (for example, 50 percent of 10-year CMT) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract but could not

potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond (refer to paragraph 13(a)). (In this example, there appears to be no possibility of the embedded derivative increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract [refer to paragraph 13(b)].) The embedded derivative is considered to be clearly and closely related to the host contract as described in paragraph 13 of this Statement. Therefore, the embedded derivative should *not* be separated from the host contract."

"184. Example 18: Indexed Amortizing Note. A bond that repays principal based on a predetermined amortization schedule or target value. The amortization is linked to changes in a specific mortgage-backed security index or interest rate index. The maturity of the bond changes as the related index changes. This instrument includes a varying maturity. (It is assumed for this example that the bond's terms could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond [refer to paragraph 13(a)] nor is there the possibility of increasing the investor's rate of return on the host contract to an amount that is both at least double the initial rate of return on the host contract and 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 [refer to paragraph 13(b)].)

Scope Application: An indexed amortizing note can be viewed as a fixed-rate amortizing note combined with a conditional exchange option contract that requires partial or total "early" payment of the note based on changes in a specific mortgage-backed security index or a specified change in an interest rate index. Because the requirement to prepay is ultimately tied to changing interest rates, the embedded derivative is considered to be clearly and closely related to a fixed-rate note. Therefore, the embedded derivative should *not* be separated from the host contract."

Unless the possibility of prepayment due to changes in interest rates has an underlying that is an interest rate or interest rate index that is specifically stated in the documentation of the transaction entered into by the option holder, then that possibility of prepayment cannot be a derivative or embedded derivative (since it does not have an underlying required by FAS 133's paragraph 6(a)) and therefore FAS 133's paragraphs 13(a) and 13(b) would not apply to the investment. For example, if the securitized financial assets are mortgages in a CMO, then I believe that FAS 133 would require specified mortgage rates (lender, length of the mortgage, etc.) in order for there to be an underlying that is a specific interest rate or interest rate index (and therefore to apply the tests in FAS 133's paragraphs 13(a) and 13(b)). In order for FAS 133's paragraph 13 to apply to a beneficial interest in that CMO, the loan documents signed by each mortgagee (the prepayment option holders) that back the beneficial interest would have to at least specifically state the term of the mortgage interest rate (since 15-year fixed, 30-year fixed, etc. have different rates) and the lender (since different lenders can have different mortgage rates at any given time...even different geographic branches of the same lender may have different rates).

Changes Needed in B40

Based on the above analysis, I believe the following changes (at a minimum) are required:

1. The 1st paragraph in B40's "Response" section starts with the sentences "Yes. A securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 if it meets all of the following criteria: .." It should be changed to read "Yes. A securitized interest in prepayable financial assets would not be ~~subject to the conditions in paragraph 13(b) of~~ considered an embedded derivative under Statement 133 if it meets all of the following criteria: .."

2. The 2nd paragraph in B40's "Response" section starts with the sentence "The objective of this guidance is to provide a narrow scope exception from paragraph 13(b) of Statement 133 for securitized interests that contain **only** an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meets the criteria above." It should be changed to read "The objective of this guidance is to provide a narrow scope exception from ~~paragraph 13(b)~~ of Statement 133 for securitized interests that contain **only** an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meets the criteria above."
3. The 2nd sentence in the 2nd paragraph in B40's "Response" section contains the language "...those securitized interests would be subject to the requirements of paragraph 13(b) of Statement 133 ...". That passage should be changed to read "...those securitized interests would be subject to the requirements of ~~paragraph 13(b)~~ of Statement 133 ..." since any potential non-prepayment related derivatives contemplated in this sentence would be subject to FAS 133 in its entirety, not just paragraph 13(b).
4. The 2nd sentence in the 5th paragraph in B40's "Response" section that reads "When assessing the conditions in paragraph 13(b) for those instruments, an entity must consider the effect of prepayment risk" should be changed to read "When assessing the conditions in paragraph 13(b) for those instruments, an entity must consider the effect of prepayment risk if the prepayment risk qualifies as an embedded derivative that has a specifically stated interest rate or interest rate index as its underlying as required by paragraph 7".
5. The "conclusion" reached for examples 1, 3, and 4 in B40's "Response" section should be replaced with the following: "The prepayment option held by the mortgagee does not meet the definition of a derivative under paragraph 6 because the option does not contain a specifically stated underlying as discussed in paragraph 7."
6. The "conclusion" reached for example 2 in B40's "Response" section should be replaced with the following: "The prepayment option held by the mortgagee does not meet the definition of a derivative under paragraph 6 because the option does not contain a specifically stated underlying as discussed in paragraph 7. Additionally, the interest rate swap is not an embedded derivative requiring bifurcation per paragraphs 14A and 200B."
7. The "conclusion" reached for example 5 in B40's "Response" section should be replaced with the following: "Paragraph 13(b) would be applicable to the inverse floater. However, the prepayment option held by the mortgagee does not meet the definition of a derivative under paragraph 6 because the option does not contain a specifically stated underlying as discussed in paragraph 7."
8. The "conclusion" reached for example 6 in B40's "Response" section should be replaced with the following: "The prepayment option held by the mortgagee does not meet the definition of a derivative under paragraph 6 because the option does not contain a specifically stated underlying as discussed in paragraph 7. Analysis under paragraph 13(a) is required for the interest-only strip due to the requirements contained in DIG B5."
9. Although the 1st and 2nd paragraphs in B40's "Response" section refers generically to underlying prepayable financial assets, all of the examples in the "Response" section only use mortgages as the underlying prepayable financial assets. This may cause some to incorrectly believe that B40 only applies when the underlying prepayable financial assets are mortgages. I believe that B40 should emphasize that all prepayable financial assets, not just prepayable mortgages, are within the scope of B40.

Thank you,

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James M. Rokicki, CPA