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LETTER OF COMMENT NO. 15

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

Re: Proposed Statement 133 Implementation Issue No. B40, Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets

Dear Mr. Smith:

We appreciate the opportunity to comment on the abovementioned Proposed Statement 133 Implementation Issue ("Proposed Issue B40"). The Board and staff have very quickly responded to constituents' concerns about how to apply Statement 155 to certain securitized interests in prepayable financial assets.

We support the Board's efforts to isolate the type of suspected embedded derivative addressed by Proposed Issue B40 and not require its bifurcation, because we do not believe that paragraph 13(b) was ever intended to address this type of "prepayable-at-par" feature. In fact, we do not even necessarily agree that paragraph 13(b) would require the bifurcation of a "prepayable-at-par" feature (solely because the hybrid instrument was purchased at a discount) even in the absence of Proposed Issue B40. Although we agree the issue is quite intricate and complex, and there are a number of reasonable views on this topic, we believe one of those reasonable views is that the exemption to be provided by Proposed Issue B40 is not even necessary.

We are concerned that constituents rushed to the conclusion that paragraph 13(b) of Statement 133 inevitably would require bifurcation of securitized interests in prepayable financial assets, and requested an exemption from the Board without demonstrating how the "mechanical test" of that paragraph (commonly known by constituents as the "double/double" test) clearly arrives at that conclusion. Applying the mechanical test requires that the host contract of a securitized interest in prepayable financial assets be defined, and that the concept of "the investor's initial rate of return on the host contract" be understood. The test also requires that a constituent understand how to apply the concept of "the then-current market return" to a host contract that, according to some interpretations, no longer exists because it has prepaid. The root problem is

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that constituents are confused as to how to apply this mechanical test even in situations for which the test's authors contemplated, much less for prepayable features that were not contemplated. Even the Board's attempt a few years ago to illustrate the application of paragraph 13(b) to non-prepayable features did not succeed when illustrations posted to the FASB website were withdrawn a few weeks later, due to differing views among the staff on how the mechanical "double/double" test should be performed.

We do not believe that the intention of the Board when designing the "double/double test" described in paragraph 13(b) of Statement 133 was to require bifurcation of "prepayable-at-par" features in market-discounted hybrid instruments. Our recollection of the original intent of paragraph 13 was to require bifurcation of interest coupon-altering features that introduced leverage (either negative or positive) into the financial instrument. We fail to see how a securitized interest in prepayable financial assets, merely because it is acquired in the secondary market at a market discount, has met the intent of the test of paragraph 13(b). If some read the exact words of paragraph 13(b) that way, we believe the fault lies with the wording in paragraph 13(b), which simply did not contemplate prepayment features at all.

We do not believe that paragraph 13(b) was written to contemplate the possibility that an embedded derivative could alter the length, or tenor, of a hybrid contract; it seems to have been written in contemplation of features that would alter its "net interest payments" (as per the first sentence of paragraph 13). The prepayment feature that Proposed Issue B40 would address does alter "net interest payments" that were originally expected to occur by eliminating them. Their elimination is viewed by many constituents as possibly doubling the "initial rate of return" because the tenor of the hybrid instrument has suddenly shortened, and the market discount at origination is suddenly realized. The realization of the market discount through paying the par amount of principal is not an "altering of net interest payments," so we question why we are applying paragraph 13 at all. It seems counterintuitive to us that the elimination of net interest payments is interpreted as doubling the "initial rate of return on the host contract." It is true that the acceleration of the payment of par and thus the realization of the market discount sooner than originally contemplated has occurred, but this cash flow is not an "alteration of net interest payments," nor is it an incremental cash flow that would not have eventually otherwise occurred. We understand how one could calculate this prepayment event as a doubling of the initial rate of return of the entire hybrid, but we do not believe this is the result of the insertion of a leveraged term and therefore is not within the original intent of paragraph 13(b).

Assuming the host contract is viewed as having been acquired at the same market discount as the hybrid instrument, then the host contract's "initial rate of return" already included the accretion of that market discount and its eventual realization. Said another way, the "cash flow" upon the payment of par to the investor occurs with or without the hybrid being prepaid. There is not an

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incremental additional cash flow that should be necessarily viewed as doubling the "initial rate of return." It was always there.

We urge the Board to clarify that a secondary market transaction evidencing a market discount or premium should not have any effect on the double/double test of paragraph 13(b). We don't believe the Board ever intended paragraph 13(b) to be interpreted as requiring bifurcation of these types of interests when acquired at a market discount, but not when acquired at a market premium. That type of dichotomy is nonsensical. As time passes after the interests are created, market participants react to the terms of an instrument, and, depending on how interest rates have shifted since inception, "assign" a discount or premium to that interest solely to ensure that the all-in rate of return of such interests are equivalent to newly originated interests issued at par. This phenomenon appears to have nothing to do with the financial engineering that the paragraph 13(b) test is designed to discover.

We believe the necessary wording is already present in paragraph 13 to allow the Board to conclude that the exemption criteria drafted in Proposed Issue B40 are not really necessary. Rather than Proposed Issue B40 being structured as some sort of exemption that a constituent must qualify to use by applying the three criteria, we would prefer that the Board acknowledge that paragraph 13(b) was never written to contemplate prepayment-at-par features at all—for any kind of hybrid including securitized interests. Less the Board feel this is too radical an acknowledgement, we note that contingent prepayment-at-a-premium features might require bifurcation under paragraph 13(b). Prepayment-at-a-premium features, in the event some contingency triggers such a feature in lieu of prepayment at par, provides the constituent a "with or without" comparison that paragraph 13(b) could accommodate. Such features also illustrate the insertion of leverage into the instrument that we believe the Board originally intended paragraph 13(b) to address. The host contract would prepay at par, but the embedded derivative feature would require that the host contract prepay at a different amount if a particular contingency occurs or a particular underlying moves a certain way. Such a feature lends itself to the mechanical analysis of paragraph 13(b), rather than having to analyze a cash flow (payment of par) that will always occur, with only the timing varying.

We believe our idea for reconstructing Proposed Issue B40 could be done relatively simply. Our recommendation is not to structure it as an exemption that a constituent must qualify for to avoid the analysis of paragraph 13(b). Rather, we suggest that the Board instead provide a limited clarification of how to perform the paragraph 13(b) analysis when evaluating a prepayment feature for any hybrid instrument that does not fall under Statement 133 Implementation Issue B39. The simplest clarification we ask the Board to consider is to simply eliminate a feature that affects the *timing* of the return of principal from all paragraph 13 analyses on the principle that

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paragraph 13 only addresses features that alter interest payments, not those that result in investors recovering their principal earlier than the stated maturity.

Such a clarification need not scope in features we described in the paragraph above, such as the contingent prepayment at a premium, unless the Board so wishes. (Our understanding is that few securitized interests in prepayable financial assets have such features.) A prepayment at a premium can logically be analyzed as a payment of par amount, plus extra "interest" to partially compensate the investor for the reinvestment risk associated with the termination of the hybrid instrument. The Board could clarify that contingent premiums over par should be considered as the "net interest payments" that paragraph 13(b) does address and require all constituents to evaluate such features.

One of the advantages of our recommendation is that it addresses many of the concerns presented in the "Alternate View" while reaching, in most cases, the same final result as the current Proposed Issue B40. Our recommendation still requires all investors in securitized interests to consider both paragraphs 13(a) and 13(b) as Statement 155 intended. Our recommendation would also eliminate the scope exception that superseded Statement 133 Implementation Issue D1 once provided. Our recommendation would maintain the *limited* exception for principal only strips that Statement 155 intended. Our approach clarifies paragraph 13(b) just enough to address this issue without the Board having to illustrate the mechanical "double/double" test, declare what it believes the "host contract" is, or define the concepts of "initial rate of return" or "then-current market return." The Board could remain silent on all of those points and allow constituents to continue their present interpretations of the test. And finally, our recommendation does not present the practicality challenges that characterize Proposed Issue B40, particularly criteria "b".

Our recommendation does not give a "free pass" on prepayment risk. Prepayment risk, as the Alternative View points out, is a common element associated with mortgage-backed securities as prepayment risk from a securitization vehicle's assets is shifted to the interests issued by the vehicle. But prepayment risk is a sub-component of interest rate risk, and many prepayment features will be evaluated and determined to be clearly and closely related to their debt host contracts and properly not bifurcated. The mere shifting of prepayment risk does not necessarily introduce negative or positive leverage into a securitized interest. We believe the purpose of Proposed Issue B40 should be to correctly distinguish between those prepayment terms that embed negative leverage by causing the hybrid to be contractually settled without recovering substantially all of its initial recorded investment (paragraph 13(a)) or that embed positive leverage into the hybrid to produce an excessively off-market windfall return by increasing the amount of cash flows (paragraph 13(b)) from those prepayment terms that do not insert excessive leverage into the hybrid and for which bifurcation is not required.



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We believe Proposed Issue B40 should reject the suggestion that any prepayment at par of a moderately market-discounted coupon-bearing hybrid instrument represents a bifurcation event under paragraph 13(b) as contrary to the intent of Statement 133. If this had been the intent of Statement 133, would it not have been directly addressed, emphasized in paragraph 61(d), and illustrated in Appendix B, Section 2, paragraphs 176 to 200 for non-securitized interests that were never part of the scope exception in Statement 133 Implementation Issue D1?

We would prefer that Proposed Issue B40 be written the way we have suggested above, and abandon its current "exemption" structure. However, if the Board decides to pursue the exemption structure of the Proposed Issue B40, we would support its clearance while recommending that the changes to criteria "c" that we describe below be made.

Criteria "c" requires that the securitized interest itself has no other bifurcatable embedded derivative for the embedded call options in the underlying financial assets to not be subject to paragraph 13(b). We are familiar with the existence in many mortgage-backed securities of numerous embedded derivatives that meet the conditions of paragraph 13(a), but have very negligible fair values. These paragraph 13(a) derivatives exist in some of the most senior interests and essentially represent remote possibilities of principal loss in the event that the subordinated tranches are completely liquidated as a result of absorbing extraordinary interest rate risk. The remote scenarios in which this might occur are seen in vehicles with fixed rate assets and non-capped floating rate securitized interests, where floating rates increase to levels never previously experienced (say, exceeding 100.00%). Paragraph 13(b) does not permit one to disregard remote levels of interest rates, so, in theory, senior interests would be viewed as having very insignificant paragraph 13(a) derivatives embedded in them, requiring bifurcation. Another example is a securitization trust with basis risk, such as one with assets floating based on U.S. Treasury rates and liabilities floating based on LIBOR rates, with such basis risk ostensibly shifted to the subordinated interests, but no formal protection for the senior interest in the event the basis spread shifts to amounts never previously experienced, but mathematically possible. A constituent might assign a nominal fair value of \$1.00 to such derivatives. The possibility that such derivatives require bifurcation has been known since Statement 155 was issued, but it never seemed to have particular significance until now, when criteria "c" was included in Proposed Issue B40.

To address this concern, we recommend that the Board amend criteria "c" by adding the italicized phrase below:

"The securitized interest itself does not contain an embedded derivative (including an interest rate related derivative) for which bifurcation would be



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required by paragraph 12 or paragraph 13(b) other than an embedded derivative that results solely from the embedded call options in the underlying financial assets."

The addition of this phrase would alleviate the problem presented by the insignificant paragraph 13(a) bifurcated derivatives. In actuality, it appears impossible for the same hybrid instrument to contain both a significant paragraph 13(a) derivative and a paragraph 13(b) derivative, so our recommended addition would allow Proposed Issue B40 to function in the way it appears to be intended. The presence of any paragraph 12 derivative (where economic characteristics not clearly and closely related to debt are bifurcated) or other paragraph 13(b) derivative would continue to trigger criteria "c" and deny the Proposed Issue B40 exemption.

In addition, we offer the following observations about other aspects of Proposed Issue B40:

- If the Board does not agree with our recommended change to criteria "c", then Example 5's "Application of This Guidance" should be clarified by pointing out that if both an embedded derivative related to prepayment risk and one related to inverse interest rate risk were identified, both derivatives would have to be bifurcated as a single compound derivative.
- Example 2 is interesting in terms of teaching the concept that the presence of a freestanding derivative does not in and of itself result in an MBS securitized interest automatically containing an embedded derivative requiring bifurcation. However, constituents have struggled in reading criteria "b" in combination with Example 2. Many do not understand how the presence of a freestanding derivative in the trust is sometimes permissible, but the presence of a bifurcated derivative from a Trust's assets is never permissible. An explanatory paragraph would be helpful.
- We are also concerned that Example 2 is not very realistic. It may be unusual to encounter a swap that "perfectly swaps floating rate assets to a fixed rate" because of the unlikely ability of a swap to be pre-programmed to perfectly match the unpredictable prepayment pattern of the assets. (Some products known as "balance guaranty swaps" may be constructed to do this.) We would not want Example 2 to promote a false sense of security that such "perfect" swaps might be typical. The Board might consider writing a companion example to Example 2 ("Example 2b") that illustrates that the failure of the swap to notionally reduce in perfect symmetry with the prepayment of the vehicle's assets, which would create the need to evaluate all of the securitized interests for embedded derivatives requiring bifurcation. Note that our recommendation for a restructuring of Proposed Issue B40 would not alleviate the need to evaluate our Example

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2b-type scenarios for embedded derivatives. In fact, we believe that our Example 2b, where the trust's freestanding derivative is not designed to notionally reduce perfectly with the prepayments of the Trust's assets, is exactly the type of interest rate risk caused by potentially disproportionate reallocation of prepayment risk that Statement 155 is intended to address, and highlighting this sort of example may be helpful to those Board members who are concerned that Proposed Issue B40 provides a "free pass" for prepayment risk.

While we believe we understand the transition provisions, the Board may want to
consider clarifying that the transition provisions would not accommodate a constituent
who early adopted Statement 155 and now realizes it may have misapplied the basic
provisions of that standard for reasons unrelated to the central issue of Proposed Issue
B40.

We hope the Board will consider our recommendation to eliminate the exemption structure of the current Proposed Issue B40 and focus instead on a clarification of paragraph 13 and the meaning of "altering net interest payments." We believe the Board will not be violating the principle of Statement 155 or Statement 133 Implementation Issue B39 in doing so, particularly if the Board chooses to remind constituents that prepayments at other than par would not be scoped into a revised B40, nor would scenarios which we describe above as "Example 2b", where imperfect freestanding interest rate swaps do not proportionately reallocate prepayment risk to securitized interests.

We would be pleased to discuss these issues in more detail with the Board or staff at your convenience.

Sincerely,

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