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LETTER OF COMMENT NO. 7

December 7, 2006

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

Proposed DIG Issue 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 proposed DIG Issue B40, "Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets" (proposed DIG Issue). We agree with the objective contemplated in the proposed DIG Issue; however, we recommend focusing the criteria in the proposed DIG Issue and clarifying its transition guidance. Lastly, we recommend that symmetrical accounting analysis be provided for economically similar instruments under paragraph 13(a) of Statement 133.

Focusing the Criteria

We believe that securitized interests in prepayable financial assets should be evaluated under paragraph 13(b) of Statement 133 in a parallel fashion to prepayable financial instruments within the scope of DIG Issue B39. Consistent with the nature of these securities as conduits of cash flows from other financial instruments, we agree with the conclusion in the proposed DIG Issue that the characteristics of both the underlying assets and the beneficial interest should be considered in determining whether a securitized interest qualifies for the scope exception. We also agree that the right to accelerate settlement should not be controlled by the investor (*criterion a* in the proposed DIG Issue) in order to be eligible for the scope exception.

Nevertheless, while we agree with the general nature of the analysis in the proposed DIG Issue, we believe more meaningful results would be produced by focusing *criterion* b on prepayment features and *criterion* c on interest rate features, rather than allowing the analysis to hinge on whether *any* embedded features in the underlying assets or the



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securitized interest require separation. Paragraph 13(b) of Statement 133 relates to interest rate features and we believe the analysis of qualification for the scope exception should also focus on interest rate features. If the existence of unrelated embedded features were allowed to determine whether a securitized interest is exempt from analysis under paragraph 13(b), similar assets with identical or nearly identical prepayment features but minor differences in unrelated embedded features would be treated differently under paragraph 13(b), resulting in dramatic differences in accounting for fundamentally similar prepayment features (it would also result in differing conclusions for securitized and unsecuritized but otherwise identical financial instruments). We note that these unrelated (non-interest rate related) embedded features must be analyzed and potentially separated in their own right under paragraph 14A of Statement 133; and we believe requiring the analysis of prepayment features to depend on an evaluation of unrelated derivative features is unlikely to produce meaningful results.

In summary, we would propose to refocus the criteria in the proposed DIG Issue as follows (key changes in bold):

- a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor
- b. The **prepayment features** in the underlying financial assets would not require bifurcation if the underlying assets were purchased directly
- c. The securitized interest itself does not contain an interest rate related embedded derivative for which bifurcation would be required other than an embedded derivative that results <u>solely</u> from the embedded call options in the underlying financial assets.

Conceptually, we believe DIG Issue B40 should provide a parallel scope exception to DIG Issue B39 that exempts securitized interests in prepayable financial assets from analysis under paragraph 13(b) when those instruments simply pass-through (whether proportionately or disproportionately) prepayment features that would qualify for the scope exception in DIG Issue B39. To that end, we believe our suggested changes produce a more operational, focused, and principals-driven model for evaluating prepayment features in securitized interests.

Transition Guidance

The proposed DIG Issue provides transition guidance for entities that availed themselves of DIG Issue D1's broad view of the Statement 133 scope exception for securitized interests prior to adoption of Statement 155. However, it is unclear to us how the

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transition guidance in the proposed DIG Issue would be applied for an entity that did not apply DIG Issue D1 prior to adoption of Statement 155. For example, an entity may have previously separated prepayment features in securitized interests under a narrow view of paragraph 14 that would not be separated under the proposed DIG Issue. It is unclear whether such an entity should retrospectively recombine instruments that would not have been separated under the proposed guidance for all periods presented or only recombine such instruments from the date of adoption of Statement 155 (for example, pursuant to the guidance in DIG Issue K5). Consistent with the first sentence in the proposed transition guidance, we believe the guidance in the proposed DIG Issue should only be applied from the date of adoption of Statement 155 in similar fashion to proposed alternative "b" (i.e. previously separated features would be recombined as of the date of adoption of Statement 155 if they no longer qualify for separation after the issuance of DIG Issue B40, and the combined instrument would be recorded, both initially and subsequently, based on the Statement 115 classification previously elected for the host instrument). Nevertheless, given the potential for diverse interpretations, we recommend that the Board clarify the transition requirements in the proposed DIG Issue.

Symmetrical Accounting Analysis under Paragraph 13(a)

We do not believe there should be different accounting results for economically similar securitized interests under paragraphs 13(a) or 13(b) of Statement 133. Providing for the same accounting would be consistent with the results currently achieved under DIG Issues B39 and B5. We recommend that the Board develop symmetrical criteria to exclude economically similar securitized interests under paragraph 13(a).

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If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Enrique Tejerina at (212) 909-5530.

Sincerely,

KPMG LLP