



LETTER OF COMMENT NO.

September 22, 2006

via email: director@fasb.org, fasbcomments@fasb.org

Financial Accounting Standards Board 401 Merritt 7
Norwalk, Connecticut 06856-5116

RE: FASB Statement No. 155 Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140

Ladies and Gentlemen:

The purpose of this letter is to express concern regarding interpretations on FAS 155 which have only recently emerged, provide illustrations of certain inconsistencies and issues the interpretations could create, and suggest clarifications which might achieve the intended objective of the Statement and consistent treatment among securities with comparable risk and embedded derivatives.

The issues arise from three factors:

- 1. Statement 155's elimination of the temporary exemption DIG Issue D1 provided to beneficial interests in securitized financial assets.
- 2. The focus of DIG issues and other FASB guidance related to FAS 133 has been on instruments, issues, and transactions which were subject to FAS 133 (unlike the beneficial interests excluded by D1), and,
- 3. The fact that we in industry and in the financial markets did not fully understand, absorb, and foresee the implications for these instruments upon adoption of FAS 155. Only after many months did interpretations illuminate the issues.

Now that the issues are becoming clear, I am hopeful that you will receive valuable comments from constituents and be able to respond with guidance which remains consistent with the longstanding intent of the FASB relative to FAS 133 and other Statements. I believe that the interpretations which are now causing concern in the market and among amortized cost investors are consistent with a literal reading of the existing accounting guidance including FAS 133 and DIG issues but are inconsistent with the Board's intent, inequitable and inconsistent with the accounting treatment of other similar instruments, and contrary to the objectives of providing meaningful financials for financial statement users.

The primary instruments about which I am concerned are Mortgage Backed Securities (MBS), Collateralized Mortgage Obligations (CMOs) and Asset Backed Securities (ABS) which contain no embedded derivative instruments (such as swaps, caps, floors, etc.) but which appear, based on newly publicized interpretations and the existing set of accounting guidance, to fall subject to FAS 133's "double/double" test. Such securities:

• Are generally collateralized by generic residential first lien mortgage loans which typically enable the underlying borrowers to prepay their loans, and

 Pass through the payments from the underlying loans [less compensation (which is typically immaterial in the overall valuation) for servicing and guarantor fees] to investors in a rational and systematic fashion.

The MBS, CMO, and ABS securities about which I am concerned are substantially similar to other instruments which have been exempted from bifurcation. As examples:

- Prepayable loans were exempted under DIG Issue B39 which clarified the treatment of an
 embedded call option (including a prepayment option) that can accelerate the settlement
 of a hybrid instrument containing a debt host contract, and
- FAS 133 and subsequent interpretations have held that call options on debt securities are deemed to be clearly and closely related to the host contract and therefore do not require bifurcation under FAS 133.

Application of FAS 133 to Certain Pass-through Securities

For an investor, pass-through securities issued by FNMA, FHLMC, and GNMA are, in behavior and based on their cash flows, nearly indistinguishable from directly holding the loans which underlie the securities. For example, the only differences in holding a FNMA 5% 30 year mortgage backed security and a 30 year 5% mortgage loan are that:

- Ownership of the security does not require the investor to service the loan,
- The security has a guarantee to protect the investor from credit loss,
- The security carries greater liquidity, and
- The security is accounted for on the books of the investor as a security rather than as a loan.

Otherwise, the loan and the security are essentially the same. The prepayment option embedded in the loan and all other characteristics of the loan are merely passed through to the investor as-is.

It has been stated that the servicing fee and guarantor fee related to such securities cause a disproportional allocation of cash flows and therefore subject the security to the "double/double" test of FAS 133. Such interpretations seem to overlook the substance (that the loan and pass-through securities are substantially similar) and focus on the minutia (that, in the securitization process, there are relatively minor expenses and structural differences which arise). The interpretations fail to consider FASB's desire for a principles-based approach which values substance over form.

The determination of whether the security contains an embedded derivative should be made on the same basis as the determination of whether the underlying loans contain embedded derivatives. DIG issue B39 clarifies the issue for loans.

Recommendation One

To clarify, through a DIG issue, FSP, EITF or other pronouncement, FASB could extend the guidance in B39 to holdings of securities which, in essence, represent beneficial interests in loans whose only embedded derivative is a prepayment option which is held by the mortgagor.

Application of FAS 133 to Beneficial Interests such as CMOs and ABSs It is now clear that, absent further guidance, CMOs and ABSs will fall subject to FAS 133's "double/double" test. Almost any such securities, regardless of structure, which are purchased at discount prices will fail the "double/double" test as that test is being currently interpreted.

Such securities, when purchased at a discount, fail the "double/double" test because assumptions that all of the underlying loans pay off immediately and simultaneously trigger a complete payoff of the securities at par, creating incomprehensibly high yields / returns to the investor which are more than the "double/double" test would allow.

Interestingly, countless callable debt securities purchased at discounts would also fail the "double/double" test for the identical reason, but would not be subject to bifurcation, because the call option is (and in my opinion, correctly) deemed to be clearly and closely related to the host contract. Also, unsecuritized loans purchased at market discounts would fail the "double/double" test.

Ironically, in the real world, the doubling of yield, even though quite unlikley, is far, far more probable on such callable debt securities than it is on the overwhelming majority of CMO and ABS securities. Why? Because an immediate, substantial decline in interest rates would cause many issuers to call their debt securities but mortgage and consumer loan borrowers whose loans underlie the CMO and ABS securities are, in many cases, unable to so quickly refinance.

The simple process of tranching of cash flows without adding additional derivatives should not create different accounting determinations about the existence of embedded derivatives.

Assuming no addition of an embedded derivative, securitizing and allocating the cash flows from a group of mortgage loans into tranches should not trigger different accounting treatment for those tranches than existed for the underlying loans.

While there could be cases where the securitization process could create embedded derivatives between the class holders which are not clearly and closely related to the host contracts or the nature of the underlying collateral, in almost all cases, there are no embedded derivatives created which did not exist in the underlying loans.

Recommendation Two

In order to treat all securities with similar characteristics in a consistent manner, through a DIG issue, FSP, EITF or other pronouncement, FASB could acknowledge prepayment options held by the underlying borrowers are not embedded derivatives requiring bifurcation.

Thank you in advance for considering these thoughts and recommendations. Please feel free to contact me if I may be of any assistance whatsoever.

Sincerely,

Mark Evans, CFA Senior Vice President

Director of Investment Strategies