



LETTER OF COMMENT NO. 10

FIAC

Financial Institutions Accounting Committee

October 10, 2006

Mr. Lawrence Smith
Director — Technical Application, Implementation Activities
and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

**Re: FASB Statement No. 155 (FAS 155), *Accounting for Certain
Hybrid Financial Instruments***

Dear Mr. Smith:

The Financial Institutions Accounting Committee (FIAC) is a group of fifteen financial professionals working in executive level positions in the banking and thrift industries and is a standing committee of the Financial Managers Society. FIAC's primary responsibility is to evaluate those accounting and regulatory matters that affect financial institutions. The comments within this letter are representative of FIAC as a whole and do not necessarily reflect views of the individual institutions represented on the Committee.

In preparing for the implementation of FAS 155, we have noted that significant questions and concerns have arisen in industry regarding its application. It also has come to our attention that some of these issues might be attributable to a misinterpretation of FAS 155 and seemingly conflicting guidance created by FAS 155.

We would like to share these issues with the Board and staff, and to the extent that the guidance in FAS 155 is being misinterpreted or conflicting guidance has been issued, we ask that clarification be provided as soon as possible.

We understand that a significant number of financial institutions and brokers and dealers of financial instruments believe that FAS 155 would require most mortgage-backed securities (MBS) to be evaluated under paragraph 13 of FASB Statement No. 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities*, with regard to the impact of an embedded prepayment option in a loan underlying a securitized beneficial interest to determine whether that option must be bifurcated and recorded at fair value (unless the entire security is recorded at fair value with changes in fair value recognized in earnings by the interest holder).

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The focal point of this conclusion is the manner in which FAS 155 amended the guidance in Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor." The amended guidance states that "in situations in which the cash flows associated with the embedded call feature are disproportionately allocated to different classes of interest holders, all interests in that MBS would be subject to the conditions in paragraph 13(b) with respect to that embedded call feature." Some constituents are interpreting the existence of a guarantee fee, a servicing fee that represents more than adequate compensation, priority or sequential distribution of cash flows to different tranches based on the timing of receipt of those cash flows, subordinated tranches or residual interests that represent credit enhancements as triggering the application of FAS 155 based on the amended guidance in B39.

That notion is bolstered by the amendment to paragraph 14 of FASB Statement No. 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities*. Paragraph 14 defines the exemption for interest-only and principal-only strips. It states that such strips "represent the rights to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument." Paragraph 14 further states that "an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose would not meet the intended narrow scope of the exception." Consequently, paragraph 14 could be interpreted to suggest that the existence of a guarantee fee or a more than adequate servicing fee creates disproportionate cash flows and subordination of those cash flows.

FAS 155 added paragraph 200C, which provided an example of a securitization involving subordination. In that example, the residual interest is noted to contain an embedded interest rate derivative because of a possible shortfall of cash flows to the senior interest holders. Although that shortfall is attributable to a difference between the interest rates on the senior bonds and the underlying loans, a similar shortfall can arise from the exercise of prepayment options embedded in the underlying loans by borrowers.

Upon concluding that most MBS would be subject to paragraph 13 of Statement 133, companies have determined that any interest purchased at a significant premium (e.g., more than 10 percent) would fail the test in paragraph 13(a) and almost any interest purchased at a discount would fail the test in paragraph 13(b). Consequently, those interest holders would need to either (1) bifurcate and record the embedded prepayment option at fair value or (2) record the entire interest containing the embedded derivative at fair value (with changes in fair value recognized in earnings).

We believe that the preliminary conclusions described above are pervasive. However, the consequences of the resulting accounting have raised concerns over whether potential buyers will be reluctant to purchase MBS and other asset-backed securities at a premium or discount, reducing their liquidity and value.

We also have observed that at least some of the confusion is the result of the seemingly conflicting guidance in the amended FAS 133 Implementation Issue No. B39. In the response section of Issue B39, it states that "the conditions in paragraph 13(b) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (issuer/borrower)." It further states that "for an embedded call option, the issuer or borrower (and not the investor) is the holder, and thus only the issuer (borrower) can exercise

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the option. Consequently, the investor does not have the unilateral ability to obtain the right to receive the high rate of return, which is contingent upon the issuer's exercise of the embedded call option.”

In the case of a prepayment option that is contained in a mortgage loan underlying an MBS, the MBS holder has no control over that option. That would seem to imply that a separate (rather than a pass-through) derivative would need to be embedded in the beneficial interest in order for paragraph 13 to apply.

However, FAS 155 amended Issue B39 to indicate that any sort of securitization structure that creates what might be deemed a disproportion in the distribution of the cash flows would require all beneficial interests in an MBS to be evaluated for a pass-through embedded prepayment option. The guiding principles underlying those two streams of thought would seem to conflict with each other.

From informal discussions with the FASB staff, we understand that constituents might be misinterpreting FAS 155. If that is the case, we urge the Board and the staff to provide clarification. However, if those interpretations are correct, then we ask the Board and staff to communicate that fact and explain why the guidance in Issue B39 does not conflict. In either case, because the effective date of FAS 155 is quickly approaching, we urge the Board to clarify these matters as soon as possible so that constituents can prepare to apply FAS 155 on the correct basis.

Thank you for your consideration of this important and time sensitive matter. We would be glad to discuss our comments with you in more detail or respond to any questions.

Very truly yours,

William C. Nunan
Chair

cc: Robert Herz, Chair, Financial Accounting Standards Board
Ron Lott, Senior Technical Advisor