Financial Management Services, Inc.

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December 6, 2006

Mr. Larry Smith
Director of Technical Application & Implementation Activities
FASB
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

LETTER OF COMMENT NO. 7

Re: Proposed Issue B40

Dear Mr. Smith:

Financial Management Services, Inc. (FMSI) appreciates the opportunity to comment on Proposed Issue B40 regarding Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets. We believe the amended narrow scope exemption is a step in the right direction, but continues to exhibit flawed logic for the proper accounting treatment of financial institutions. The following two step test to determine whether an asset has an embedded derivative requiring bifurcation appears to still contain a large level of confusion, unnecessary cost, single entry accounting, and a potential disincentive to mitigate the interest rate risk in a financial institution's balance sheet.

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 rate of return 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.

"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:

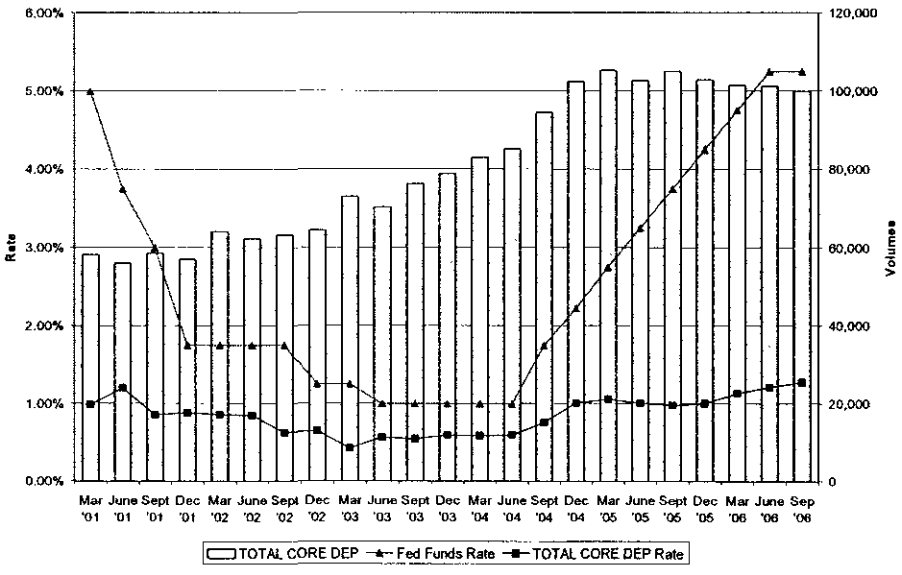
A. The right to accelerate the settlement of the securitized instrument can not be exercised by the investor,
B. The underlying financial assets do not contain an embedded derivative that requires bifurcation, and
C. The securitized interest itself does not contain an embedded derivative that requires bifurcation (including an interest rate related derivative), which is not solely related to the reallocation of pre-payment risk inherent in the underlying financial assets."

Our firm is in the business of helping community banks manage their net interest margins. Their goals are to manage interest rate risk such that earnings volatility is controlled and not volatile. Our clients are almost exclusively private, family owned businesses with asset sizes typically between $100 million and $2 billion. Our clients rely on us to help manage their investment portfolios and balance sheet's due to financial resource limitations. They simply can't afford to hire someone with our skills and background. Many banks don't have the size to purchase off balance sheet derivatives to manage interest rate risk. FAS 155 will create an additional barrier for community banks to face when managing their balance sheet.

FMSI utilizes many different strategies to manage interest rate risks including the use of mortgage securities such as Interest Only (IO) Collateralized Mortgage Obligations (CMO), Principal Only (PO) CMO's, and Inverse Floating Rate CMO's. We also use callable agency securities, long dated callable municipal securities, fixed rate loans, mortgage loans, etc. On the liability side of the balance sheet, we use core deposits, FHLB advances, and brokered deposits. Requiring certain types of assets to be marked to market through earnings, while not requiring the same treatment for other assets or liabilities doesn't seem practical. **The FAS 155 accounting pronouncement goes against dual entry accounting. Accounting in its simplest form is: Assets = Liabilities + Equity. FAS 155 will introduce GAAP earnings volatility to the income statement that produces false and erroneous accounting results.**

For example, banks have core deposits (DDA, NOW, savings accounts, etc.), which are not rate sensitive liabilities, and can support rate sensitive securities such as inverse floating rate CMO's. Core deposits are not being marked to market in tandem with the Inverse Floating rate CMO. Shown below is a time series plot of one of our client's core deposit base. This bank shows a similar trend for each core deposit account if you analyzed the data at the account level. The bar graph corresponds to the right axis and illustrates how core deposit volumes have fluctuated over time. The line graph shows the Fed Funds rate vs. the weighted average rate paid on core deposit accounts. Core Deposit volumes exhibited a stable and increasing trend in environments when the Fed was both increasing and decreasing interest rates. This graph shows volumes over a full interest rate cycle. The weighted average rate paid on core deposits for this time period never exceeded 1.28%. Account balances have grown during the most recent tightening cycle that started in June 2004, which saw the Fed Funds rate increase from 1.00% to 5.25%. The volume growth is significant as a greater incentive existed for depositors to move money into higher interest bearing accounts. In addition, volumes actually grew when the bank decreased the rate paid on core deposits during the easing cycle (2001 - 2003). The conclusion that can be drawn from this data is these deposits represent non-rate sensitive, stable deposits. Core deposits should be considered a longer maturity liability even though these deposits don't have a defined maturity date. These depositors place greater importance on the safety and convenience of these accounts.

Total Core Deposit Rate/Volumes vs. Fed Funds March 2001 - September 2006 (Quarterly)

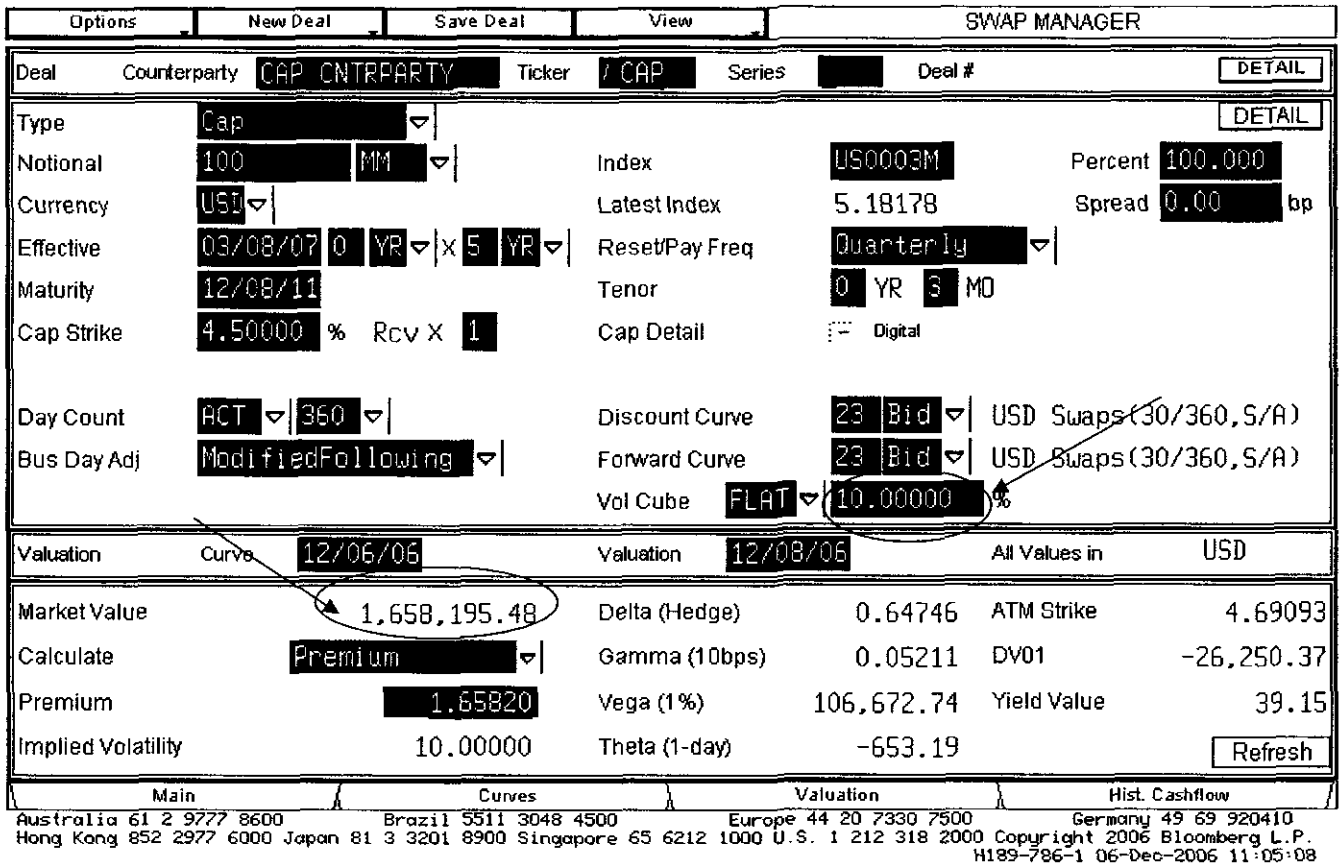


The value of a bank is found in these types of core deposit accounts. Core deposits are one of the main reasons why a bank's franchise value sells at a multiple of book value. Core deposit balances are recorded on the balance sheet at no premium even though the alternative cost to borrow these funds would be much greater. Specifically, in this example the cost would be more than 4.00% over the current interest rate paid on this account. Core deposit balances are held typically with a significant unrealized gain, which could easily be viewed as equity to the bank, if marked to market on a regular basis. In summary, core deposits for all banks are worth significantly more than their book value. If a bank is using core deposits to purchase an inverse floating rate CMO, or other derivatives, it seems only logical that if the asset was required to be marked to market so should the corresponding liability.

The example above drives home an important flaw in marking to market only a particular asset on a financial institution's balance sheet. FAS 155 is potentially going to require mark-to-market accounting treatment for only one side of the balance sheet? What about the offsetting liability on the other side of the balance sheet? If a financial institution were able to mark-to-market the offsetting liability there may be no change to earnings. A financial institution's entire balance sheet should be marked to market through earnings if that is the objective of FAS 155. A financial institution's assets and liabilities are mostly a set of pre-defined cashflows that can be discounted to current day using prevailing market rates. There is a regulatory expectation this is performed by every financial institution on a quarterly basis for all assets and liabilities to be marked-to-market for interest rate risk analysis. The logic of FAS 155 to mark-to-market only certain assets doesn't seem logical or equitable to the remainder of the balance sheet.

Is it the intent of the rule to require vanilla floating rate CMO's to be tested? The research suggests these investments must be tested, but are likely to pass these tests. However, these tests will likely create additional work and costs to manage an investment portfolio. Is a series of tests to determine whether a fairly simple investment has embedded derivatives the true intent of FAS 155?

FAS 155 promotes subjective accounting versus objective accounting. The ability to bifurcate the embedded derivative will cause subjective calculations. Consider the many variables that determine an options value such as volatility, strike price, asset price, time, etc.. Some of these variables are totally subjective and theoretical, but have a substantial impact on the derivative valuation. Does the FASB really want to get into the business of determining whether bifurcation assumptions are appropriate? Will FASB provide guidance on the methodology and assumptions it expects from the bifurcation process? If bifurcating the option was an easy and objective process, then this accounting rule may not be so problematic. Options pricing is very subjective in nature when compared to a more objective discounting of cashflows. This is best illustrated with simple examples of valuing an interest rate cap. Caps are common and embedded in many types of loans and mortgage investments. Shown on the following page is an example of a $100 million cap, 4.5% strike price, and 5-year maturity. The only difference between these two Bloomberg screen shots is the assumed volatility assumption.


Options
New Deal
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Currency USD
Effective 03/08/07 0 YR X 5 YR
Maturity 12/08/11
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Index USD0003M
Latest Index 5.18178
Reset/Pay Freq Quarterly
Tenor 0 YR 3 MO
Cap Detail Digital
Percent 100.000
Spread 0.00 bp
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Discount Curve 23 Bid USD Swaps(30/360,S/A)
Forward Curve 23 Bid USD Swaps(30/360,S/A)
Vol Cube FLAT 10.00000 %
Valuation Curve 12/06/06
Valuation 12/08/06
All Values in USD
Market Value 1,658,195.48
Calculate Premium
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Gamma (10bps) 0.05211
Vega (1%) 106,672.74
Theta (1-day) -653.19
ATM Strike 4.69093
DV01 -26,250.37
Yield Value 39.15
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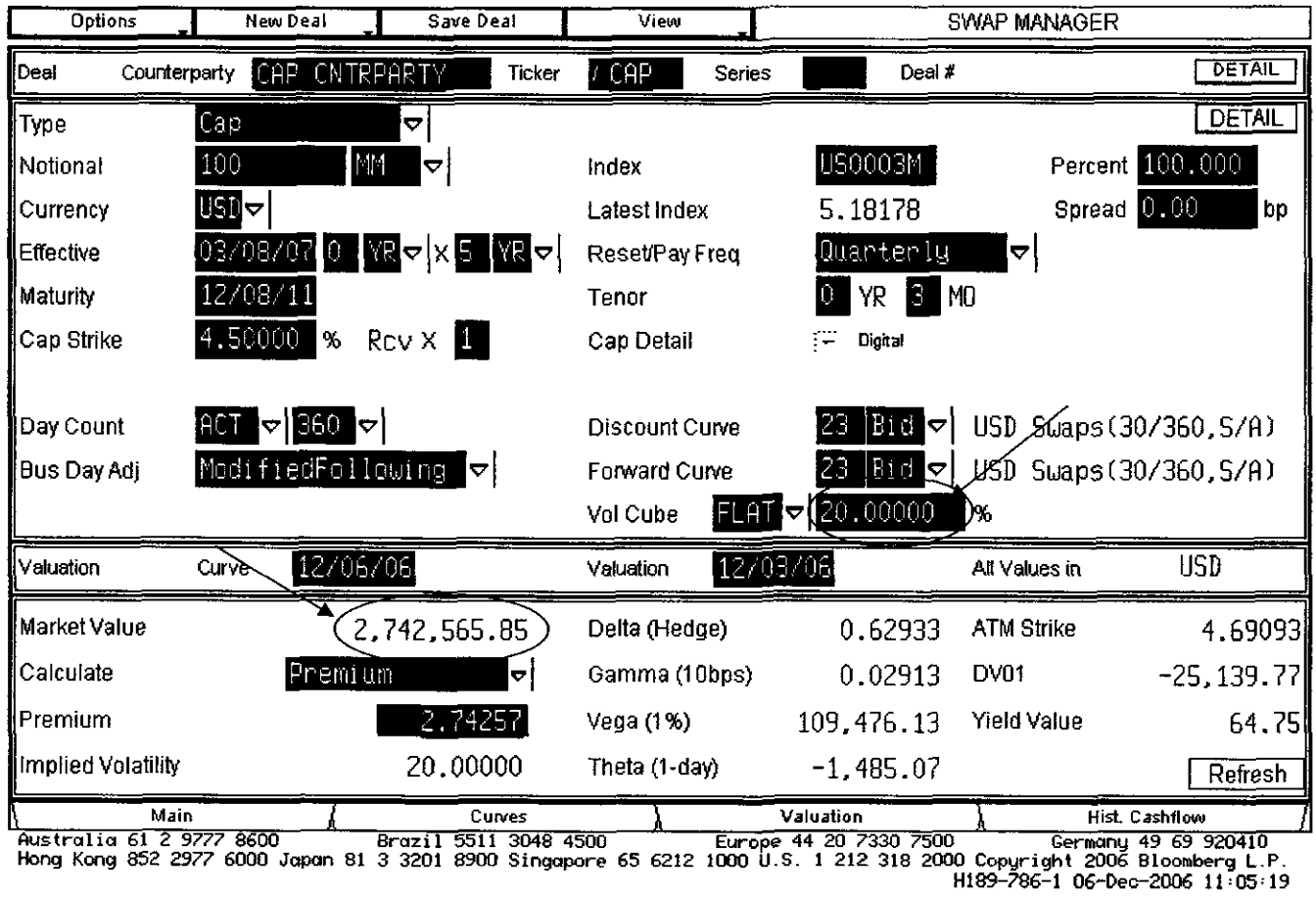
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Forward Curve 23 Bid USD Swaps(30/360,S/A)
Vol Cube FLAT 20.00000 %
Valuation Curve 12/06/06
Valuation 12/03/06
All Values in USD
Market Value 2,742,565.85
Calculate Premium
Premium 2.74257
Implied Volatility 20.00000
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Gamma (10bps) 0.02913
Vega (1%) 109,476.13
Theta (1-day) -1,485.07
ATM Strike 4.69093
DV01 -25,139.77
Yield Value 64.75
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Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2006 Bloomberg L.P.
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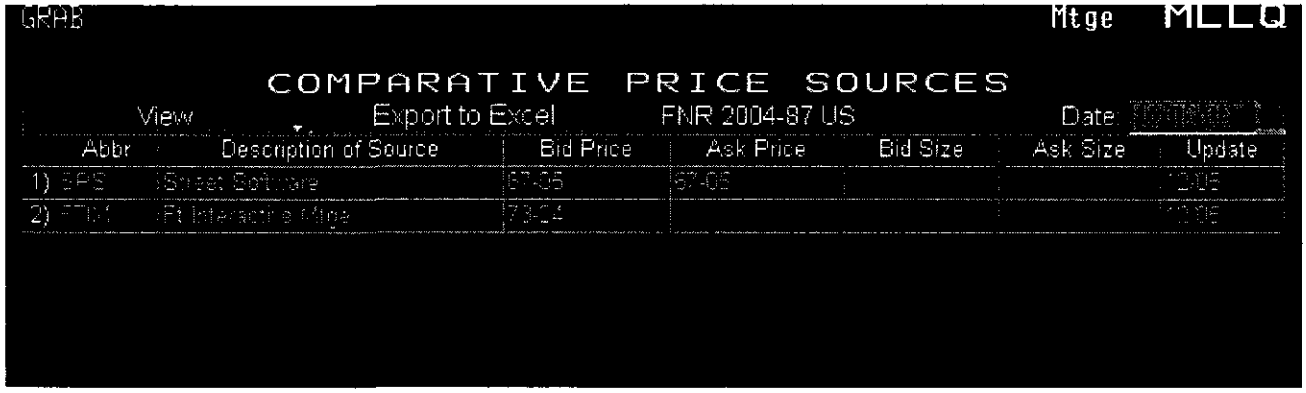
This analysis using the Bloomberg SWPM analytics illustrates the impact a change in the volatility assumption has on the market value of the cap. The cap has a market value of $1.6 million utilizing a 10% volatility assumption. The market value increases to $2.7 million if a 20% volatility assumption is utilized. A volatility change of 10% changes the market value by a significant $1.1 million. Volatility is only one variable utilized in pricing an option. This example shows the potential manipulation and subjectivity that could be employed when valuing a very simple option.

Subjectivity also goes into the market values provided by different pricing sources for complex mortgage investments. For example, the following inverse floating rate CMO security, FNR 2004-87 US, is held in one of our client's investment portfolios. Please note the sole intent for the purchase of this security was to reduce this bank's earnings volatility under falling interest rate scenarios. The Bloomberg MLLQ screen shows two significantly different prices for this security. Street Software provided a price of 67 5/32 and Ft Interactive Mtge provided a price of 73 24/32. A difference of over 6.5 points or 11.31%.



The interest rate cap and inverse floating rate CMO examples confirm the large degree of subjectivity required in options and mortgage security pricing. FAS 155, as it is currently written, will require accounting methodologies that will be very subjective in nature rather than the objectivity accounting and investment communities rely upon. The reality of FAS 155 is the entire asset will need to be marked to market rather than just the "so-called" embedded derivative. Even then subjectivity will be required as the inverse floating rate CMO example confirmed. Perhaps most importantly, FAS 155 will discourage the purchase of such an asset due to accounting complications. The investment may make economic sense, but a disincentive exists due solely to an accounting pronouncement such as FAS 155.

Certain types of mortgage investments allow our clients the ability to manage and control interest rate risk. FAS 155 may create a potential disincentive to minimize these risks for our clients, but also for financial institutions as a whole. We don't believe this is the FASB's intent. Also, FAS 155 fails to recognize the market value of the offsetting liability on a financial institution's balance sheet. The bottom line is this pronouncement has both economic and accounting flaws for a financial institution.

In summary, creating barriers for financial institutions to test and utilize mortgage investments is counterproductive to the management of an investment portfolio and balance sheet. Discouraging the use of certain types of mortgage investments may force financial institutions to look to alternatives that are demonstrably more costly, thereby reducing profitability or accepting higher levels of interest rate risk. We believe the FASB should either reconsider implementation of FAS 155, require mark-to-market accounting for the entire balance sheet, or consider a specific exemption for financial institutions. We would be happy to discuss FAS 155 with you and/or provide additional analysis if it would be helpful.

Sincerely,

Douglas Williams, President
Charles Crouch, CFA