September 22, 2006

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

RE: Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments

We recently have become aware of a number of differing views among practitioners and their independent accountants surrounding application of Statement 155 and Statement 133 with respect to prepayment risk in certain securities. AIG requests that the Financial Accounting Standards Board (FASB) provide guidance as to whether concentrations of prepayment risk in securitized financial assets should be considered embedded derivatives upon the adoption of Statement 155. We acknowledge that there are several other application issues with respect to this issue. We believe that this guidance is necessary in order to eliminate diversity in practice that may develop.

AIG is the world’s leading international insurance and financial services organization, with operations in more than 130 countries and jurisdictions. AIG member companies serve commercial, institutional and individual customers through the most extensive worldwide property-casualty and life insurance networks of any insurer. In the United States, AIG companies are the largest underwriters of commercial and industrial insurance and AIG American General is a top-ranked life insurer. AIG’s global businesses also include financial services, retirement services, and asset management.
Prepayment Risk versus Credit Risk

Asset backed securities, such as collateralized mortgage obligations (CMOs) and other mortgage-backed securities, that are purchased at a discount to par are of particular concern. CMOs typically hold agency mortgage-backed securities subject to prepayment risk whereby prepayments of the underlying mortgage loans result in a return of principal to beneficial interest holders of the CMO. Often, the prepayment risk is disproportionately allocated between the various classes of beneficial interest holders. If the provisions of paragraph 13(b) of Statement 133 are to be extended in these circumstances, an embedded derivative may result because an interest rate scenario may exist, however remote, that enough of the underlying loans prepay soon enough such that the investors' return could be doubled by receiving par value shortly after purchasing the security at a discount. It's worth noting that investors typically purchase these securities without any expectation of a doubling or a leveraged return. A consequence of applying such an interpretation could result in a holder of these securities having different accounting for otherwise identical securities purchased a day earlier or later.

With respect to Statement 155, the Board specifically deliberated the issue of whether concentrations of credit risk in subordinated interests in securitized financial assets should be considered embedded derivatives and concluded that they should not, for the following reasons:

- There is no obligation on the part of the subordinated financial instrument holder to transfer cash or assets (paragraph A22)
- Concentrations of credit risk are reflected in the fair value of the subordinated financial instrument, therefore, there is no need for separate recognition of credit concentrations (paragraph A23)

The applicable paragraphs of Statement 155 are repeated here for reference:

A21. The Board also considered whether concentrations of credit risk in subordinated interests in securitized financial assets should be considered embedded derivatives. Some Board members believe that concentrations of credit risk that are created by subordinating one financial instrument to another financial instrument represent, in effect, credit default swaps embedded in the subordinated financial instrument and that such credit default swaps should be identified as embedded derivatives requiring bifurcation. However, the Board decided not to define concentrations of credit risk as embedded derivatives, regardless of how they arise.

A22. The Board decided not to extend the requirements of paragraph 13(b) of Statement 133 for interest rate leverage factors to credit concentrations. Some Board members reasoned that credit concentrations in subordinated interests should not be recognized as embedded derivatives because there is no obligation
on the part of the subordinated financial instrument holder to transfer cash or assets. That is, the subordination functions through a cash allocation mechanism in which cash flows that otherwise would have been allocated to the subordinated financial instrument holder instead are allocated to the senior financial instrument holder, to effectively allocate credit losses from the senior financial instrument holder to the subordinated financial instrument holder.

A23. Other Board members reasoned that the purchase price of a subordinated financial instrument reflects the investor’s assessment of the cash flows it expects to receive, including the likelihood of default and, therefore, concentrations of credit risk are reflected in the fair value of the subordinated financial instrument. As the credit risk of the subordinated financial instrument is reflected in its fair value, there is no need for separate recognition of credit concentrations.

AIG believes that concentrations of prepayment risk that arise in asset-backed structures (as long as the risk is inherently present in the financial instruments held by the entity) should be afforded the same accounting treatment in Statement 155 as concentrations of credit risk because the rationale in paragraphs A22 and A23 can equally be made for prepayment risk concentrations. We believe that there is no reason why these risks should be treated inconsistently for financial reporting purposes. Even though prepayment risk may be considered a component of interest rate risk, the Board acknowledged in SFAS 133 that prepayments occur for reasons other than interest rates, as noted below:

...Although prepayment risk is a subcomponent of market interest rate risk, the Board notes that prepayments, especially of mortgages, occur for reasons other than changes in interest rates. The Board therefore does not consider it inconsistent to permit hedging of prepayment risk but not interest rate risk in a held-to-maturity security. (Excerpt from paragraph 431 of Statement 133)

Furthermore, in the case of securitized beneficial interests subject to prepayment risk, not only does the fair value of the subordinated financial instrument reflect this risk (as mentioned in paragraph A23) the existing income recognition model for these investments dynamically incorporates prepayment risk as reflected in the investor’s assessment of expected future cash flows under either EITF 99-20 (for lower quality investments) and Statement 91 (for investments of higher quality).

We believe potentially being required to bifurcate an embedded derivative with respect to prepayment risk for these instruments and separately accounting for a non-prepayable host would not represent an improvement over the current Statement 115 balance sheet model and Statement 91 and EITF 99-20 income recognition models.
Additionally, electing to account for the entire hybrid instrument at fair value would make these investments less attractive to most insurance companies due to the volatility that would be created in earnings.

**Unilateral Right to Returns**

Finally, in the case of a CMO investment purchased at a discount, the investor does not have the unilateral ability to obtain the right to receive the doubled rate of return specified in paragraph 13(b). Therefore, we believe additional authoritative guidance is needed to clarify the applicability of paragraph 13(b) with respect to concentrations of prepayment risk in securitized financial assets in light of the general guidance provided in Statement 133 Implementation Issue No. B39, which states the following:

The conditions in paragraph 13(b) were intended to apply only to situations that meet the two conditions specified in paragraphs 13(b)(1) and 13(b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs. (Excerpt from Response Section of Statement 133 Implementation Issue B39)

**Action Requested**

We urge the FASB to consider formally addressing this issue by providing guidance through an FSP to Statement 155 prior to the effective date of the adoption Statement 155. For those who have early-adopted Statement 155, a prospective transition approach is recommended, consistent with the original transition requirements of Statement 155. We appreciate your prompt attention to this matter, as AIG is a significant investor in these securities.

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I would be pleased to discuss our comments with the Board or the FASB staff at your convenience. If you have any questions please contact me at 212-770-6463 regarding the contents of this letter.

Very truly yours,

/s/ Anthony Valoroso
Deputy Comptroller
Director of Accounting Policy

cc:
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Executive Vice President and Chief Financial Officer

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