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December 8, 2006

Mr. Larry Smith
Director of Technical Application
& Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

File Reference: Proposed Issue B40

Dear Larry:

The American Bankers Association¹ appreciates the opportunity to comment on proposed Statement 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets* (Issue B40). The American Bankers Association is concerned about the potential impact of the recently released Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments* (SFAS 155), on certain types of beneficial interests in securitized assets.

Since the release of SFAS 155, many of the Financial Accounting Standards Board's (the Board) constituents have been analyzing the standard to determine whether the standard applies to certain types of investments in securities, including mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs). It is our understanding that a large portion of beneficial interests in securitized assets could be subject to SFAS 155. Such application, along with its potential results (mark to market for either a portion of the security or for the whole security, with changes in values reported in earnings), has taken many by surprise.

It appears that the recently proposed Issue B40 will alleviate concerns regarding securitized instruments that contain only an embedded derivative that is tied to prepayment risk (prepayment derivatives), by not requiring bifurcation and fair value. However, Issue B40 does not appear to provide a practical exception for prepayable securitized instruments that include unrelated, but insignificant derivatives, which many beneficial interests contain. We encourage the Board to clarify that such derivatives do not, in and of themselves, result in application of paragraph 13(b) to any prepayment derivative. Additionally, we encourage the Board to consider whether it would be appropriate to clarify that failure to bifurcate an insignificant derivative does not result in a de-facto election to fair value the entire beneficial interest under SFAS 155.

Background

Beneficial interests in securitized assets were previously granted an exemption from the bifurcation (and mark to market) requirements of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), by Derivatives Implementation Group (DIG) Issue No. D-1 (DIG D-1). In DIG D-1, the accounting guidance for these securitized assets was Statement of Financial Accounting Standards No. 140, *Accounting for Transfers of Financial Instruments* (SFAS 140).

¹ The ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes the ABA the largest banking trade organization in the country.

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Analysis

Paragraph 305 of SFAS 133 states that “[m]any hybrid instruments with embedded derivatives that bear a close economic relationship to the host contract were developed many years ago, for reasons that clearly were not based on achieving a desired accounting result. Prepayable mortgages and other prepayable debt instruments are examples of such familiar compound instruments with embedded derivatives” (emphasis added). Additionally, paragraph 305 states that “only an embedded derivative that is not considered to be clearly and closely related to its host contract should be accounted for separately.”

Our understanding of this paragraph is that beneficial interests in securitized assets that are prepayable debt instruments were to remain exempt from the bifurcation requirements of SFAS 133 and were not subject to the “clearly and closely related” tests of Paragraphs 13(a) and 13(b) of SFAS 133. However, prepayment derivatives that pass these tests (paragraphs 13(a) and 13(b) and Issue B40) could fail the paragraphs 13(a) and 13(b) tests if the security includes other insignificant derivatives and security structures. A good example of this is a beneficial interest in a structure with variable-rate securitized assets where the underlying assets contain periodic or lifetime rate caps. Frequently the beneficial interests do not contain similar caps because the structures are designed so that the residual interest holders would bear the cash flow shortfall in anything other than an interest rate environment previously unseen in the U.S. If the cash flow waterfall structure includes principal and interest in the same distribution rule, it is conceptually possible – though statistically extremely improbable – for such an interest rate environment to result in the holders of tranches below the senior-most tranche not to recover substantially all of the recorded investment. In many cases these tranches are AAA-rated, and the described 13(a) derivative is completely disregarded by the market in valuation of the beneficial interest. Yet, regardless of how insignificant its value, and how unlikely for the derivative to have any cash flow impact, it appears to us that its existence would nullify the protection of Issue B40 for prepayment characteristics.

Concerns

Practicability

One concern is that of practicability. There are many smaller institutions that hold a share of these highly-rated asset-backed securities and would be unable to comply with the bifurcation and fair value requirements of the standards; they lack the staff resources with requisite knowledge, and they cannot meet the time constraints imposed by the close approaching required adoption date. These institutions purchase [highly-rated] asset-back securities for their low-risk income stream qualities, not to speculate on the unlikely impact of embedded derivatives.

Regulatory Requirements

Some institutions are required by their regulators to maintain a portion of their assets in residential mortgages and related assets, and mortgage-backed beneficial interests are often an important part of an institution’s ability to satisfy this regulatory requirement. This change could make CMOs and MBSs much less appealing as an investment, resulting in a significant disruption of operations and change in portfolio risk as institutions reduce their holdings of these investments to avoid unintended accounting consequences.

Relevance/Usefulness

Investors in asset-backed securities are fully aware that beneficial interests in securitized assets contain prepayment options in the underlying assets that are exercisable by the borrowers, that movements in interest rates can impact the speed and timing of those prepayments, and that those prepayments can have an impact on the return on investment. Changing the measurement of these prepayment arrangements due to an unrealistic and restrictive test does not provide users of financial statements with any improved or more relevant information.

Default Election Presumption

There is also a concern that insignificant derivatives that are not identified at acquisition could lead to entire instruments being treated as having been elected for fair value treatment under SFAS 155. For

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instance, if a preparer fails to identify and bifurcate an embedded derivative at inception, there is concern that a subsequent reviewer (an auditor or securities regulator) may interpret the lack of bifurcation as a default election to value the entire instrument at fair value according to SFAS 155 rather than as a bifurcated derivative that needs to be identified and accounted for separately.

Potential Impact

If an exemption for prepayment risk in securitized interests is not, in fact, what the Board intended, the proposed change could very well result in increased volatility in earnings for security holders. Widespread aversion to this volatility, due to negative market perceptions and a higher cost of capital for companies that invest in these securities, will likely lead to either a decreased appetite for these securities (and reduced liquidity) or significant changes in risk management. Either of these events could hamper the ability of banks and others to manage risk.

Conclusion

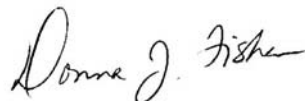
If the Board did not intend for a large portion of securitized interests to be subject to the bifurcation and fair value recognition requirements of SFAS 155, this should be clarified in Issue B40 by addressing the effect of insignificant derivatives and unlikely interest rate scenarios. It is important that these issues be addressed at this time in order to avoid confusion and misinterpretation.

One way to address the impact of unlikely scenarios and insignificant derivatives is to apply a reasonableness test to the criteria of Issue B40. This would apply to any non-prepayment risk related derivatives embedded in the beneficial interests or the underlying assets (criteria "b" and "c" in Issue B40) and interest rate scenarios. This could serve to weed out those that are unlikely to have a significant impact on the performance of the security.

Additionally, in order to avoid future confusion as to application of SFAS 155, we suggest that the Board explicitly indicate that a preparer's failure to identify, bifurcate, and fair value an embedded derivative does not automatically result in a fair value election for the entire beneficial interest.

Thank you for your consideration of this matter. Please contact Charlie Gilman, ABA's Accounting Policy Advisor (202-663-4986 or cgilman@aba.com), or me with any questions.

Sincerely,



Donna J. Fisher

Cc: Leslie Seidman
Edward Trott
George Batavick
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