



December 8, 2006

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

**Re: File Reference: Proposed Issue B40**

Dear Mr. Smith:

The American Securitization Forum ("ASF") and the International Swaps and Derivatives Association ("ISDA") are pleased to offer the following comments in response to the Financial Accounting Standards Board's ("FASB") Proposed Statement 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets*, ("Proposed Issue B40").

The comments that follow were developed and are being presented jointly by representatives of the respective accounting policy committees of ASF and ISDA. Collectively, the membership of these committees has substantial professional expertise and practical experience addressing the accounting policy issues and questions raised by this tentative guidance with respect to financial instruments. A description of our organizations is contained in Attachment I.

We applaud the FASB's prompt and effective response to preparers' and the industry's concerns regarding the implementation of Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, to financial instruments subject to prepayment. Our constituent group fully supports the issuance of Proposed Issue B40 ahead of the adoption of Statement No. 155 by many preparers. There is one matter, however, that we wish the FASB to further consider and address in the final Implementation Issue.

We understand the FASB's concern over issuing guidance that would exempt derivatives embedded in securities from bifurcation. Our understanding of Statement No. 155, DIG Issue B39, *Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor*, Proposed Issue B40 and other related literature is to focus on the investor's exposure to risk embedded *within* an instrument in order to identify embedded derivatives that would require bifurcation. Statement No. 155 provides that the investor in a

securitized interest in financial assets be required to understand the nature and amount of assets and liabilities that comprise a securitization structure as well as the payoff structure and the payment priority of the investment it holds to determine if an embedded derivative exists. This is also consistent with the examples in Proposed Issue B40, including Example 2 which indicates that a transaction structure with a freestanding derivative does not necessarily create an embedded derivative that requires bifurcation.

Therefore, we do not understand the need for criterion (b) in Proposed Issue B40, which precludes the application of the scope exception to securitized interests in which the underlying financial assets contain an embedded derivative requiring bifurcation. We believe that the analysis and the conclusion should not be different for a transaction in which the underlying financial assets contain a bifurcated derivative as compared to a transaction which contains a freestanding derivative.

Application of criterion (b) to a securitized interest in prepayable financial assets could require bifurcation of a prepayment derivative from an otherwise benign security. Examples of securities which do not have an embedded derivative other than the borrowers' call option but that would not be eligible for the Proposed B40 exemption, if criterion (b) were to remain, are a fixed rate mortgage-backed security purchased at a discount that is created via a recombination of either (1) an interest-only and principal-only class backed by the same pool or (2) a floating rate class and an inverse floating rate class backed by the same pool.

Accordingly, we recommend that the FASB consider removing criterion (b) and instead require an analysis based only on criteria (a) and (c). We believe that eliminating criterion (b) would not significantly expand the scope exception provided by Proposed Issue B40 since the requirement of an investor under criterion (c) to evaluate whether a securitized interest in prepayable financial assets contains an embedded derivative that requires bifurcation, other than an embedded derivative that results solely from the embedded prepayment options in the underlying financial assets, would identify the derivatives intended to be bifurcated without the operational burden of applying criterion (b). We believe that the inclusion of criterion (b) would place undue cost and burden on preparers in applying Proposed Issue B40 without providing any significant improvement to transparency in financial reporting.

If however the FASB does not accept our recommendation to remove criterion (b) as outlined above, we recommend in the alternative (and at a minimum) that FASB issue guidance in the final Implementation Issue to clarify that, in applying criterion (b) to a fixed rate mortgage-backed security purchased at a discount that is created via a recombination of either (1) one or more interest-only and principal-only classes or (2) one or more floating rate classes and inverse floating rate classes, it is appropriate to look through the securities held by the securitization issuance vehicle to the underlying mortgage pool (or pools) that provide 100% of the cashflows for those securities as well as the recombined securities. We believe that this approach is consistent with and contemplated by the language contained in the second paragraph of Example 6 of Proposed Issue B40, which indicates that it is appropriate in the case of interest-only and principal only strips to look through to the underlying source of cashflows to determine whether the underlying financial assets contain an embedded derivative that requires bifurcation.

**CONCLUSION**

ASF and ISDA appreciate the opportunity to provide the foregoing comment and reiterate our strong support for the expeditious issuance of a final Implementation Issue. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact any of the undersigned at the telephone numbers provided, or George Miller, Executive Director of ASF at 646.637.9216 or Robert Pickel, Director and CEO of ISDA at 212.901.6020.


Sincerely,



Esther Mills  
*Morgan Stanley*  
Chair, ASF Accounting and Tax Subcommittee  
212-276-4364



Lisa Filomia-Aktas  
*Ernst & Young*  
Deputy Chair, ASF Accounting and Tax Subcommittee  
212-773-2833



Laurin Smith  
*J.P. Morgan Chase & Co.*  
Chair, Accounting Policy Committee  
International Swaps and Derivatives Association  
212-648-0909

**Attachment I**

**The American Securitization Forum** (the “ASF”), is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. More information about the ASF and their respective members and activities may be found at the ASF’s internet website, located at [www.americansecuritization.com](http://www.americansecuritization.com). The ASF is an adjunct forum of the Securities Industry and Financial Markets Association (SIFMA).

**International Swaps & Derivatives Association Inc. (ISDA)**, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 725 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).