



VIA Electronic Mail

October 10, 2005

Mr. Lawrence W. Smith
Technical Director
Financial Accounting Standards Board
401 Merritt 7, P. O. Box 5116
Norwalk, CT 06856-5116

File Reference: 1225-001

Dear Mr. Smith:

The Mortgage Bankers Association¹ appreciates the opportunity to comment on the Exposure Drafts, *Accounting for Transfers of Financial Assets* (the ED). The ED would amend the guidance in Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities* (FAS 140), to, among other things, clarify and/or change: the terminology used to describe transferors' interests in securitized financial assets; the initial measurement of transferors' beneficial interests; the permitted activities and assets of qualifying special purpose entities; and the guidance relating to isolation of transferred assets. MBA has studied the guidance in the ED and would like to offer some suggested changes for the Board's consideration.

I. MBA Position

MBA supports the Board's efforts to clarify the guidance in FAS 140 to better align the accounting treatment and economics of financial asset transfers. MBA believes, however, that further clarifications of the guidance in the ED are needed with respect to the circumstances in which legal opinions are necessary to support assertions of isolation under paragraph 9.a. of that Statement. MBA also believes that a few additional clarifications of the guidance would improve the guidance in the ED, as explained in the following pages.

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,900 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

II. Isolation of Transferred Assets

A. Background

FAS 140 describes several conditions that a transferred financial asset must meet to be accounted for as a sale, including a condition in paragraph 9.a. of the Statement that an asset must be isolated from the transferor, including "...put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership."² In developing the guidance in the ED, the Board decided that further clarification of paragraph 9.a. is necessary "...because of questions and apparent inconsistencies in practice."³ MBA believes the guidance in the ED is unlikely to meet this objective without further clarification of the circumstances in which legal opinions are needed to support assertions of isolation under that paragraph.

During a recent conversation, MBA members expressed very different views on the proper interpretation of the guidance in the ED on isolation, particularly the guidance in proposed new paragraph 27A of FAS 140, which appears in paragraph 3.i of the ED. In discussing transfers of loans⁴, some of our members argued that legal opinions generally are required to support isolation if recourse is retained beyond some "de minimus" amount⁵ whereas others argued that legal opinions generally are required *only if* a consideration of all available evidence does not provide *reasonable assurance* to support an assertion of isolation. Others conceded that they do not know when legal opinions are required.

MBA believes these inconsistent interpretations are due to unclear guidance in the ED and in the authoritative literature generally. The use of terms like "reasonable assurance," "available evidence," "persuasive evidence,"⁶ "put presumptively beyond the reach of," and other similar terms that are not defined under GAAP or under the law have encouraged debate and disagreement about their intended meaning. Compounding the problem is that the current body of literature on isolation in: (1) the ED; (2) FAS 140; (3), the FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and (4) the AICPA Interpretation⁷ (hereby the AICPA Interpretation) is confusing.

MBA believes the guidance is particularly confusing in terms of what constitutes a "reasonable basis" for a transferor to conclude that an asset has been isolated without the need for a legal opinion. For example, many of our members are puzzled by the following sentence in proposed new paragraph 27A of FAS 140:

² See paragraph 9.a. of FAS 140.

³ See paragraph A. 9. of the ED.

⁴ In other words, the loans are not exchanged for guaranteed mortgage backed securities.

⁵ MBA understands that practice in some areas has evolved to treat recourse of less than 10% of the outstanding balance of transferred assets as an indication that an asset has been isolated without the need for a legal opinion because that amount of recourse generally is not considered sufficient to call into question a sale of an asset under most existing laws and regulations.

⁶ See paragraph .15 of the AICPA Interpretation referenced below.

⁷ The Interpretation is entitled: "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140."

“A legal opinion is not required if a transferor has a reasonable basis to conclude that the appropriate legal opinion or opinions would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if it had experience with other transfers with the same facts and circumstances, including under similar applicable laws and regulations.”

While some MBA members believe a “reasonable basis” as used in paragraph 27.A. refers to circumstances in which legal opinions have been obtained for similar transactions in the past, others believe it refers to all available evidence that supports or questions an assertion of isolation, regardless of whether legal opinions have been obtained in the past.

Still other members have questioned whether the need for legal opinions is predicated on whether such opinions generally are required by parties to the transactions, as is generally the case in many types of securitization transactions. MBA notes, for example, that paragraph 152 of FAS 140, which would not be amended by the ED, indicates that the Board developed the isolation criterion: “...in large part with reference to securitization practices.” Further, in paragraph 153 of FAS 140, which also would not be amended by the ED, the Board responded to constituents who expressed concern about the feasibility of an accounting standard based on legal considerations by stating: “...that having to consider only the evidence available should make that requirement workable.”

In addition, the guidance on isolation appears to be contradictory with respect to the level of assurance that is required to support an assertion of isolation. For example, the guidance in FAS 140, and the ED, relies on a standard of reasonable assurance that all *available* evidence supports an assertion of isolation whereas guidance in the AICPA Interpretation indicates that the conclusions in a legal opinion must provide *persuasive* evidence to support an assertion of isolation.⁸ This suggests two different levels of assurance should be met depending upon whether the available evidence includes a legal opinion; that is, a level of “reasonable assurance” is sufficient if a legal opinion is unavailable but a higher level of assurance is required if a legal opinion is available.

In summary, MBA believes the guidance in the ED would be unlikely to reduce questions relating to the need for legal opinions to support assertions of isolation. Further, as practitioners generally default to the most conservative interpretation when guidance is unclear, MBA believes that legal opinions would be required under the ED for most transactions involving recourse above a “de minimus” amount, regardless of the available evidence. MBA believes this would increase business costs for little added assurance as to the reliability of transferors’ financial statements.

For example, we understand legal opinions are being required by auditors to support isolation of loans that are transferred to Fannie Mae under the agency’s Delegated Underwriting and Servicing (DUS) Program despite significant evidence that the loans could not be reclaimed by transferors or their creditors.

B. Transfers of Multifamily Loans under Fannie Mae’s DUS Program

Under Fannie Mae’s DUS Program, participating lenders transfer multifamily loans to Fannie Mae under standard loss sharing arrangements. Under the standard loss sharing arrangement for non-bank DUS lenders, lender losses cannot exceed 20% of the original principal balance of

⁸ See paragraph .13 of AICPA Interpretation.

the loan, where under the "pari passu" loss sharing arrangement for bank DUS lenders, lender losses cannot exceed 33 1/3% of the original principal balance of the loan. MBA understands that the vast majority of DUS lenders only share losses to these levels.

Some believe that these standard loss sharing amounts are indicative of the need for legal opinions to support isolation, regardless of other considerations which might support an assertion of isolation. MBA, however, believes other facts and circumstances relating to the DUS Program would support a legal analysis that isolation has been achieved and thereby provide reasonable assurance that loans transferred to Fannie Mae under the Program are isolated from the transferors. However, others believe legal opinions would still be required based on a consideration of the amount of recourse only.

Under the DUS Program:

- Transfers of loans cannot be revoked by transferors, under any condition;
- In the event a loan must be repurchased as a result of a breach of a *standard* representation and warranty provision, a lender is required to repurchase the loan at the unpaid principal balance, plus accrued and unpaid interest, plus any premium paid by Fannie Mae to acquire the loan. This determination is made by Fannie Mae; the lender cannot unilaterally decide to repurchase a loan. This is true for residential loans sold to Fannie Mae also;
- Lenders who participate in the Program are required to establish liquidity reserves which serve as collateral in the event they do not fulfill their obligations to service the loan properly or to settle their loss sharing obligations with Fannie Mae;
- Lender losses are capped at pre-specified amounts, such that any additional losses above those caps are the responsibility of Fannie Mae;
- Lenders' compensation is received primarily in the form of enhanced servicing fees which helps to ensure that lenders are motivated to perform to continue to receive the benefits of servicing. The fees indicate that a servicing arrangement exists rather than a financing arrangement;
- Fannie Mae closely monitors lenders' equity positions and financial standings and the agency reserves the right to transfer servicing rights in the event a lender fails to abide by the terms of the servicing contract which lends support to the fact that Fannie Mae controls the transferred assets;
- Fannie Mae often transfers loans acquired under the DUS program to qualifying special purpose entities for the purpose of selling beneficial interests in the assets (generally in the form of REMIC securities) to parties that are unaffiliated with the transferors, further restricting the ability of the transferor and/or its creditors to reclaim the loans;
- The Fannie Mae DUS program has been in existence for almost twenty years and during that time no participating DUS lender has gone into bankruptcy or receivership. Further, in the event a lender is having financial difficulty, Fannie Mae reserves the right to

transfer the servicing on the loans, or to take other actions under the Program to ensure the owners' interests in the loan are protected; and

- Fannie Mae accounts for transferred loans under the Program as loan purchases.

MBA believes the facts and circumstances of the Fannie Mae DUS Program provide a reasonable basis for rendering an assertion of isolation under paragraph 9.a. Indeed, if the available evidence for these transactions is insufficient to support an assertion of isolation, we question when the evidence for any transfer of a financial asset involving recourse above a "de minimus" amount would represent a reasonable basis for rendering an assertion of isolation. In that case, the FASB might as well revert to a standard based on a recourse threshold because that will be the standard under which transferors effectively will be forced to operate.

III. Additional MBA Comments

A. Participating Interests

1. Servicing Rights

The guidance in proposed new paragraph 8A.b. of FAS 140, as proposed under paragraph 3.a. of the ED, describes one of several characteristics of a participating interest as follows:

"8A.b. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its consolidated affiliates, or its agents) in proportion to the share of ownership represented by each, **except for servicing fees representing adequate compensation and, if applicable, a share of the contractual interest representing all or a portion of the transferor's gain on sale received by the transferor as consideration related to the sale of the participating interest.** The ownership shares remain constant over the life of the original asset." (bolding added)

MBA believes the bolded phrase is a reference to servicing fees that will be received by transferors subsequent to the sale or securitization of the loans. If so, we would recommend that the phrase be revised to simply state: "...except for servicing fees representing a share of the interest that will be received by the transferor subsequent to the sale or securitization of a financial asset."

2. Reference to Recourse

The guidance in proposed new paragraph 8A.c. of FAS 140, as proposed under paragraph 3.a. of the ED, includes a reference to recourse as follows:

"8A.c. Participating interest holders have no recourse to the transferor (or its consolidated affiliates or agents) or to each other, and no participating interest is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder."

MBA notes, however, that the word “recourse” is defined in the Glossary of the ED to include standard representation and warranty provisions.⁹ Those provisions, however, do not affect the priority of holders’ participating interests, but serve to ensure that the transferred assets meet buyers’ requirements. Our members agree that it would be virtually impossible to sell any mortgages, in any form, without standard representations and warranties other than in what is commonly referred to as “a scratch and dent market” at significantly reduced sales prices.

Consequently, MBA recommends that the definition of recourse be revised to exclude any reference to standard representations and warranties. MBA believes this change in the definition would serve to clarify also that these provisions are not “continuing involvement” by the transferor.¹⁰ As recourse is otherwise “continuing involvement,” a change in the definition to exclude standard representations and warranties also would clarify the circumstances in which asset transfers are presumed to be sales, and therefore not subject to the qualifying criteria in paragraph 9 of FAS 140.

B. Beneficial Interests

Some MBA members have questioned whether “servicing rights” are a form of “beneficial interest” which would disqualify most transfers of loans to QSPEs with servicing retained as sales, pursuant to 3.b. of the ED, which would amend paragraph 9.b. of FAS 140 to include the following sentence:

“If the transferee is a qualifying SPE, each holder of beneficial interests issued by that qualifying SPE (including the transferor itself if it holds a beneficial interest) has the right to pledge or exchange its beneficial interests, and no condition both constrains the holder from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.”

MBA understands that servicing rights are not beneficial interests based on language in paragraph 2.e of the ED, which indicates that servicing rights are referred to in the ED either specifically or as “other interests,” but not as “beneficial interests.” MBA nevertheless recommends that the Board clarify that servicing rights are not “beneficial interests,” as the guidance as currently written is confusing to some readers.

C. Passive Derivatives Held by QSPEs

MBA also requests clarification of the guidance regarding the types of passive derivative instruments that can be held by a QSPE. Specifically, we recommend that the Board clarify whether the phrase “those beneficial interests” in paragraph 40.b, which would be amended by paragraph 3.n. of the ED, is a reference to all beneficial interests issued, or only those beneficial interests that stand to benefit from the derivative. Although MBA believes “those” refers to “all” beneficial interests issued by a QSPE in the ED, the fact that the word “all” is not used in this instance could lead to questions in practice.

⁹ Recourse is defined as follows: The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

¹⁰ FASB EITF Topic D-99, *Questions and Answers Related to Servicing Activities in a Qualifying Special Purpose Entity under FASB Statement No. 140*, characterizes no continuing involvement with the transferred assets as “no servicing responsibilities, no participation in future cash flows, no recourse obligations other than standard representations and warranties that the financial assets transferred met the delivery requirements under the arrangement, no further involvement of any kind.”

IV. Conclusion and Recommendations

In conclusion, MBA believes the guidance in the ED regarding the circumstances in which legal opinions are needed to support legal isolation under paragraph 9.a. of FAS 140 is confusing and should be clarified. MBA also believes the definition of "recourse" in the Glossary of the ED should be amended to exclude standard representations and warranties to clarify that they do not represent "continuing involvement" by the transferor for purposes of evaluating isolation or for determining whether an interest is a participating interest under the ED. MBA also believes the term "...those beneficial interests..." as used in paragraph 3.n of the ED should be clarified to indicate that it refers to "all beneficial interests" issued by the QSPE.

In terms of the guidance on isolation, MBA recommends that the Board amend the ED to emphasize that auditors must first rely on all available evidence before determining that a legal opinion is needed to support an assertion of isolation, and that recourse above a certain threshold should not be assumed to trigger a requirement for a legal opinion. MBA further recommends that the FASB incorporate some general guidelines into the standard which will assist readers in understanding the types of evidence that would provide a *reasonable basis* or *reasonable assurance* for concluding that an asset has been isolated. Although MBA appreciates the Board's hesitancy in providing examples of this nature in the literature, we believe an example in this instance would go a long way towards ensuring that auditors do not rely on the more expedient and more expensive approach of always requiring legal opinions, regardless of the available evidence, to support assertions of isolation.

Again, MBA greatly appreciates the opportunity to comment on the ED. For more information about our comments on the ED, please contact Alison Utermohlen, Senior Director of Government Affairs and Staff Representative to MBA's Financial Management Committee. Alison can be reached directly at (202) 557-2864 or autermohlen@mortgagebankers.org.

Most sincerely,



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