



VIA Electronic Mail

April 12, 2006

Mr. Lawrence W. Smith
Director, TA&I-FSP
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856

File Reference: 1250-001

Dear Mr. Smith:

The Mortgage Bankers Association¹ is pleased to have the opportunity to respond to the Board's request for comments on the proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*, which would give entities the option of electing to initially and subsequently measure certain financial assets and liabilities at fair value (hereby the fair value option).

MBA strongly supports the guidance in the proposed Statement. MBA agrees wholeheartedly with the Board that the fair value option will improve financial reporting by giving entities the opportunity to mitigate earnings volatility resulting from the current "mixed attribute accounting" model for different financial assets and liabilities, and to recognize offsetting gains and losses on financial assets and liabilities in hedging relationships *without the complexities of hedge accounting*. As virtually all mortgage companies hedge their loan production activities using derivatives, the fair value option would produce significant across-the-board savings for the entire mortgage banking industry by enabling mortgage companies to recognize offsetting gains and losses on their loan hedge instruments and hedged loans without satisfying strict hedge accounting guidance.

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 3,000 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.

MBA is concerned, however, that mortgage companies could be precluded from recognizing the full fair values of their loans under the fair value option depending upon how the guidance in Securities & Exchange Commission (SEC) Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*, is applied to their loans:

“Question 1: In recognizing the loan commitment, may Bank A consider the expected future cash flows related to the associated servicing of the loan?”

Interpretive Response: No. The staff believes that incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. However, servicing assets are to be recognized only once the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.²

Further, no other internally-developed intangible assets (such as customer relationship intangible assets) should be recorded as part of the loan commitment derivative. Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a loan commitment either individually, in a portfolio, or in a business combination).

Footnote 2: See paragraph 61 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.²

If this guidance were to remain in place post issuance of a final fair value option standard, lenders that might elect to measure their loans at fair value might be forced to recognize discounted or artificially low fair values for their loans. Pursuant to the guidance in SAB 105, the discount from fair value would represent the value of the cash flows from the strip of interest on the loans that will be retained as compensation for servicing the loans after their sale to investors. MBA has gone on record with the FASB previously noting that the guidance in SAB 105 is inconsistent with the authoritative literature on fair value measurements, including the guidance in a recently proposed FASB Staff Position (FSP) on recognizing unrealized gains and losses on derivative instruments.

Specifically, on November 21, 2005, MBA wrote to the Board (see attached) explaining that the guidance in SAB 105 (the SAB) is inconsistent with the guidance in proposed FSP 133-a, *Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133*, for valuing derivative loan commitments. Pursuant to the above referenced guidance, the SAB prohibits measurements of the values of derivative loan commitments to include the strip of interest on the future loans that *may* be retained by the lender as compensation for servicing the loans. By contrast, the guidance in the proposed FSP *would require* that interest strip to be included in valuing the commitments consistent with “...the assumptions that marketplace participants in the reference market for the asset or liability would use in their estimate of fair value.”

MBA supports the guidance in the proposed FSP because fair value measurements are supposed to reflect values ascribed by potential, rather than current, holders of assets and

² The referenced paragraph 61 of Statement No. 140 reads, in part, as follows: “...Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.”

liabilities. MBA therefore believes that lenders should value their loans by reference to prices that potential holders would pay to acquire them, which would reflect the loans' stated interest rates rather than their stated interest rates reduced by the strip of interest that may be retained by the lender for servicing the loans after sale or that may be passed on to the buyers of the loans. Consequently, MBA also believes that the recognized values of loans³ under the fair value option should include the values of the strip of interest that may be retained as servicing, and that the Board should expand the guidance in the proposed Statement to confirm this measurement approach.

MBA also recommends that the Board clarify that loan valuation allowances existing at adoption of a final statement that are associated with loans that will be remeasured at fair value should be written off by a cumulative effect adjustment to retained earnings. That entry would be offset by the cumulative effect adjustment that would be made to measure the related loans at fair value. MBA requests confirmation also that valuation allowance accounts would be irrelevant for loans that are measured at fair value, because any "allowance" would be incorporated in their reported values.

MBA would also like to respond to the following issues which the Board specifically requested feedback on:

"Issue 2: This proposed Statement permits an entity to elect the fair value option at inception for a firm commitment that would otherwise not be recognized at inception under existing generally accepted accounting principles (GAAP) and involves only financial instruments. Should an entity be permitted the option to recognize those firm commitments at fair value at inception of the contract? If so, why is the availability of the fair value option election important for those contracts and what types of entities would likely avail themselves of that fair value option election?..."

MBA supports the Board's tentative decision to permit entities to recognize a firm commitment at fair value that otherwise would not be recognized under existing GAAP. MBA believes, however, that the Board should extend the option to firm commitments involving the acquisition of loan servicing rights because many bulk (i.e. portfolio) and flow (i.e. loan-by-loan) mortgage servicing purchase contracts provide for fixed prices in advance of the closing of the acquisition. To the extent an entity uses derivative instruments to manage the risk associated with their fixed purchase prices, the option would allow the acquiring entity to recognize offsetting changes in the fair values of the instruments and firm commitments without having to apply hedge accounting.

Consequently, a decision by the Board to extend the fair value option to firm commitments to acquire mortgage servicing rights would further reduce the costs of mortgage companies' hedge compliance costs. MBA believes this change is warranted now, under Phase I of the Fair Value Option Project, rather than later, under Phase II, because: (1) servicing rights are substantively more like financial instruments than nonfinancial instruments; (2) the contracts that mortgage bankers enter into to acquire mortgage servicing rights meet the definition of a firm commitment under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*; and, (3) the sooner the option is available to our members the sooner they will be able to reduce their hedge

³ MBA believes lenders should rely on current market prices (i.e. "spot valuation prices") in estimating the values of their loans under the fair value option, consistent with the valuation practices for other financial assets and liabilities that are measured at fair value.

accounting compliance costs associated with their servicing acquisition activities. MBA also agrees that the definition of a firm commitment under SFAS 133 is an appropriate Phase 1 scope limitation.

“Issue 3: The scope of this proposed Statement would exclude both (a) written loan commitments that are not accounted for as derivative instruments under Statement 133 and (b) financial liabilities for demand deposit accounts. The Board decided to specifically exclude those financial instruments, since the determination of their fair values involves consideration of nonfinancial components. Should an entity be permitted the fair value option election for those financial instruments? If so, why?...”

MBA believes that if the proposed Statement were adopted as written, the authoritative literature would continue to require only commitments for the *origination of loans that will be held for sale* to be accounted for as derivatives and measured at fair value.⁴ However, some people believe that the proposed Statement effectively would require loan commitments for the origination of loans that will be held for investment to be measured at fair value also if the resulting loans are measured at fair value and therefore *effectively accounted for like “held for sale” instruments under GAAP today*. MBA requests that the Board clarify whether commitments to originate loans that *would not* be held for sale but that *would* be measured at fair value under the fair value option *would not* be required to be measured at fair value consistent with the current accounting literature for derivative loan commitments.

Also, MBA believes that lenders should be permitted the option of measuring their written loan commitments (that are not derivatives currently) at fair value under this first Phase of the Board’s Fair Value Option Project. This would permit lenders to elect to measure both their loan commitments, and the resulting loans, at fair value under a final Statement. MBA notes that if written loan commitments (that are not derivative loan commitments) cannot be measured at fair value under Phase I, lenders that elect the fair value option for the resulting investment loans will recognize income upon origination of the loans equal to the difference in their fair values and cost bases.

MBA also recommends that the Board allow entities the opportunity to apply the fair value option at the beginning of any fiscal quarter, including the quarter of issuance, for which interim financial statements for that quarter have not yet been issued. Finally, MBA strongly urges the Board to proceed to release a final fair value option Statement as soon as possible, regardless of the status of the proposed Statement on *Fair Value Measurements*. As acknowledged by the Board members, there is significant guidance in place already relating to measuring the fair values of financial instruments, and most entities have significant experience estimating their fair values for disclosure and other purposes. For these reasons, MBA believes there is no need for that Statement to precede the release of a final Fair Value Option Statement.

⁴ Pursuant to paragraph 6 of Statement 133, “Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).” MBA believes that commitments for the purchase of loans that meet the definition of a derivative also should be accounted for as derivative loan commitments under current GAAP.

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In closing, MBA strongly supports the fair value option and urges the Board to release a final Statement without delay. For further information about our comments, please contact Alison Utermohlen, Staff Representative to MBA's Financial Management Committee, at 202 557 2864 or autermohlen@mortgagebankers.org.

Most sincerely,

A handwritten signature in black ink, reading "Jonathan L. Kempner". The signature is written in a cursive style with a large initial 'J' and a long, sweeping underline.

Jonathan L. Kempner
President and Chief Executive Officer

Attachment