



VIA ELECTRONIC MAIL

August 24, 2004

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5516

Dear Mr. Herz:

The Mortgage Bankers Association respectfully requests that the Board reconsider its decision to ratify the guidance in Emerging Issues Task Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (Issue 03-1). As explained on the following pages, we believe the guidance in Issue 03-1 represents a significant change in the accounting for “available-for-sale” (AFS) securities under FASB Statement No. 115, *Accounting for Investments in Certain Debt and Equity Securities* (FAS 115). We are concerned that the change in guidance could adversely affect some of our members’ business practices for little to no improvement in their financial statements.

The Mortgage Bankers Association is the national association representing the real estate finance industry, an industry that employs more than 400,000 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 prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of over 2,700 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies, Wall Street conduits, and others in the mortgage lending field. For additional information, visit MBA’s Web site: www.mortgagebankers.org.

I. MBA Position

MBA believes the guidance in Issue 03-1 represents an amendment of the guidance in FAS 115 regarding the circumstances in which an "other-than-temporary" (OTT) write-down must be recognized for a security that is otherwise "temporarily" impaired.¹ More specifically, we believe Issue 03-1 amends FAS 115 by requiring OTT write-downs for temporarily impaired AFS securities due, for example, to increases in interest rates, if an enterprise MIGHT sell the securities in the future. Based on our reading of the authoritative literature, an OTT write-down is not required for a temporarily impaired AFS security that an enterprise does not plan to sell at the reporting date.

We understand that some people believe the guidance in Issue 03-1 has been required guidance for many years and that it improves upon a flawed reporting model for reporting certain debt and equity securities. We disagree with the first statement based on our research of the authoritative literature, as described on the following pages. We also disagree with the second statement which suggests to us that "the end justifies the means" based on our understanding of the Board's "due process" for changing an existing FASB pronouncement.

Consistent with that process, we believe the guidance in Issue 03-1 should be withdrawn and reconsidered after it has been exposed for comment and constituent comments have been received.

I. Background on Issue 03-1

At its March 17-18, 2004 meeting, the Emerging Issues Task Force (EITF) reached a consensus that the guidance reflected in the flowchart in Exhibit 03-1A of the Issue Abstract should be used to determine whether an investment that is within the scope of Issue 03-1² is "other-than-temporarily" impaired, and how such impairments should be measured and accounted for.

According to the flowchart, an enterprise's AFS securities would be deemed "other-than-temporarily" impaired if management does not have the express intent and ability to hold the securities until recovery of their fair values up to or beyond cost. If the securities are deemed to be "other than temporarily" impaired on this basis, they would have to be reported at fair value with unrealized losses reported in earnings. Pursuant to paragraph 12 of Issue 03-1: "...a pattern of selling investments prior to the forecasted recovery of fair value

¹ In our estimation, if it were clear that a security was "other-than-temporarily" impaired, it would be unnecessary to require a write-down based on a possible future sale of the security since the security should have to be written-down to fair value regardless.

² The investments affected by Issue 03-1 include those that are within the scope of FAS 115, such as agency- guaranteed and private-label mortgage-backed securities, corporate bonds, and certain equity securities.

may call into question the investor's intent."³ This guidance is being interpreted by some to mean that if an enterprise MAY sell some impaired securities within the next year, based in part on sales in prior years, that similar impaired AFS securities must be written-down at the reporting date.

The EITF reached consensus that the guidance on OTT impairments should be applied in evaluations made in reporting periods beginning after June 15, 2004, but that additional accompanying disclosures should be made retroactive to fiscal years ending after December 15, 2003. The Board ratified these consensus on March 31, 2004.

III. Explanation of MBA Position

A. Contrast of Guidance in FAS 115 and Issue 03-1

For more than a decade, our members have understood that FAS 115 permits impaired AFS securities to be sold to meet legitimate business needs without calling into question the future accounting treatment of other impaired AFS securities. This is consistent with the notion of "available-for-sale" in FAS 115 which explicitly provides for a specific accounting treatment of securities that are available for sale, and thus *might* be sold.

In developing FAS 115, the Board expressly incorporated the AFS securities category to give management flexibility in terms of disposing of specified securities, including those with unrealized losses, to meet legitimate business needs, as indicated by the following paragraphs in that Statement:

"9. An enterprise shall not classify a debt security as held-to-maturity if the enterprise has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to:

- a. Changes in market interest rates and related changes in the security's prepayment risk.
- b. Needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims).
- c. Changes in the availability of and the yield on alternative investments.
- d. Changes in funding sources and terms.
- e. Changes in foreign currency risk."

And,

³ We understand there is substantial confusion over the phrase a "...pattern of selling investments..." and how it should be applied in practice.

“82... Additionally, the available-for-sale category will include debt securities that are being held for an unspecified period of time, such as those that the enterprise would consider selling to meet liquidity needs or as part of an enterprise’s risk management program.”

The guidance in FAS 115 does not impose limits on management’s flexibility to sell AFS securities to those whose fair values are above cost, nor does it impose penalties for selling impaired AFS securities by forcing a more austere accounting treatment on future impaired AFS securities. Moreover, there is no indication that an enterprise must have the intent and ability to hold impaired AFS securities in order to qualify for the special accounting treatment prescribed for them.

This is supported by the FAS 115 Special Report⁴ wherein the Board states that OTT impairments of securities should be recognized in the *period in which the decision to sell is made*:

“47. Q.-Should an enterprise recognize other-than-temporary impairment when it decides to sell a specific available-for-sale debt security at a loss shortly after the balance sheet date?

A-Generally, yes, if the enterprise does not expect the fair value of the security to recover prior to the expected time of sale. In that case, the write-down for other-than-temporary impairment would be recognized in earnings in the period *in which the decision to sell is made*, not the period in which the sale occurs...” [Emphasis added]

Pursuant to this guidance, if a decision has not been made to sell securities as of the reporting date they should not be treated as having been sold by recognizing a write-down of the securities at that time, as opposed to later *when the decision to sell is made*, pursuant to this guidance.

Consider also that the Board expressly stated in FAS 115 that sales of AFS securities should not automatically result in a change in their accounting treatment:

“81... Other respondents suggested that all securities classified as current should be classified as trading securities. The Board believes that available-for-sale securities should not be automatically transferred to the trading category because the passage of time has caused the maturity date to be within one year or because management intends to sell the security within one year.”

⁴ See the FASB Special Report: *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*.

Again, there is no indication that this guidance relates only to sales of unimpaired AFS securities. Thus, we believe it applies to all AFS securities that an enterprise MAY sell within the foreseeable future but has no explicit plans to do so at the reporting date.

We note also that the FASB Special Report includes the following:

“46. Q-Paragraph 16 provides an example of when a decline in the fair value of a debt security is other than temporary. What other factors indicate that impairment is other than temporary? How is an equity security evaluated for other-than-temporary impairment?”

A-Statement 115 does not specifically address these questions, but incorporates by reference two other sources of literature that should be considered in evaluating impairment.....Although paragraph 16 of Statement 115 mentions a decline in a security’s value due to a deterioration in the issuer’s creditworthiness, recognition of other-than-temporary impairment also may be required if the security will be disposed of before it matures or the investment is not realizable and the decline in a security’s value is due to an increase in market interest rates or a change in foreign exchange rates since acquisition.”

We submit that this guidance would not apply to a situation in which management may – *or may not* – dispose of a security, or in which the investment is realizable because management anticipates receiving “...all amounts due according to the contractual terms of the debt security...”⁵ By contrast, under Issue 03-1, the security would be deemed to be OTT impaired – even if the investment is realizable⁶ -- unless management has the express intent and ability to hold the security until recovery of its fair value, possibly until maturity.

In essence, the focus on intent and ability to hold in Issue 03-1 is a departure from the concept of a true OTT impairment in FAS 115.

B. Practical Implications of Issue 03-1

In the decade since FAS 115 was released, our members have structured asset/liability and risk management strategies around the prescribed accounting treatment of AFS securities. These strategies were designed to give management flexibility to reduce earnings volatility associated with the current mixed attribute accounting model which provides for the reporting of only some assets and some liabilities at fair value. The guidance in Issue 03-1 would put an end to many of these sound business practices by prohibiting companies from utilizing their AFS securities for these purposes.

⁵ See paragraph 16 of Issue 03-1.

⁶ This would be true for securities that fall within paragraphs 10 and 16 of Issue 03-1.

This conflicts directly with the Board's stated intent in creating the available-for-sale category as indicated in FAS 115:

"79. The Board decided that those investments in debt and equity securities should be reported at fair value. However, because of concerns about the potential volatility that would result from reporting the fair value changes on only some assets, and no liabilities, in earnings, the Board determined that the unrealized holding gains and losses for available-for-sale securities should be excluded from earnings..."

We are troubled that there has been no formal acknowledgement of the fact that Issue 03-1 fundamentally changes the "rules of the game," so to speak, in terms of how it affects companies' flexibility to design asset/liability and risk management policies. We also believe constituents deserve an explanation as to how circumstances have changed such that this flexibility is no longer called for or needed, with a transition period that allows them to make careful changes to their policies.

Mortgage banking companies stand to be affected by the change as some mortgage companies utilize the AFS security category as a relatively inexpensive means for hedging their mortgage servicing assets -- which currently must be reported at their lower of cost or market values -- by selling selected AFS securities to offset changes in the assets' reported values. Under Issue 03-1, these companies would be forced to alter their strategies because any AFS securities that are impaired due to changes in market interest rates and that are SUBJECT TO SALE would have to be written-down at each reporting date. Consequently, because only unrealized gains in the values of those securities would be permitted to be recognized in equity, mortgage companies could not anticipate selling some impaired AFS securities on an as needed basis to reduce earnings volatility related to unanticipated increases in the values of their mortgage servicing rights.

Our members that utilize this type of hedging strategy are hurriedly and unexpectedly working to change their risk management strategies and to revise their 2004 earnings projections. For example, some companies may be considering the far more expensive alternative of developing a derivative based hedging program, while others may be contemplating transferring their AFS securities to the trading category in anticipation of a possible change in the accounting for mortgage servicing rights. In the meantime, however, Issue 03-1 would create volatility in earnings for those companies until that change goes into effect which, realistically, may not be until this time next year.

Still other companies may be contemplating changing their business models entirely, by divesting of portions of their servicing portfolios if they are required to recognize OTT write-downs of their impaired AFS securities. In that instance, the

companies would be able to offset the unrealized losses on their impaired AFS securities with realized gains on their mortgage servicing assets. Unfortunately, this reaction may be to the long-term detriment of these companies, as well as the servicing market, because the changes would be undertaken for accounting, rather than economic reasons.

IV. Conclusion and Recommendation

MBA believes the guidance in Issue 03-1 amends the guidance in FAS 115 by requiring OTT write-downs of temporarily impaired securities if they are subject to sale. This guidance is very different than the guidance in FAS 115 which requires OTT write-downs of temporarily impaired AFS securities (i.e. due to temporary market, credit or other conditions) ONLY IF the enterprise plans to sell them at the reporting date. We believe there is substantial evidence in the accounting literature to support our point of view, as evidenced by more than ten years of industry practice in selling impaired AFS securities.

We understand there is substantial desire within the accounting community to overhaul the guidance in FAS 115, and to move more closely to a fair value standard for securities as well as other financial instruments. Regardless of the merits of the arguments, we believe the release of an EITF Issue is not the proper means for achieving that goal as it would undermine the integrity of the FASB process. As mentioned, we believe that a change in the circumstances in which OTT write-downs are required under FAS 115 should be exposed for comment and that any final rule should address the Board's rationale, including how circumstances have changed since FAS 115 was released.

As strong supporters of the FASB process, we strongly urge the Board to withdraw its decision to ratify the guidance in Issue 03-1. If you have specific questions about the comments in this letter, please do not hesitate to contact Alison Utermohlen, Staff Representative to MBA's Financial Management Committee, at 202/557-2864.

Very sincerely,



Jonathan Kempner

Cc: Lawrence W. Smith, Chairman, FASB Emerging Issues Task Force
Donald T. Nicolaisen, Chief Accountant, Securities & Exchange
Commission