



March 12, 2004

Mr. Robert H. Herz  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7, P. O. Box 5116  
Norwalk, CT 06856-5116

Dear Mr. Herz:

The Mortgage Bankers Association (MBA) is keenly interested in the "Mortgage Servicing Rights at Fair Value" project which was added to the FASB agenda on January 14, 2004, to consider changing the accounting for mortgage servicing rights (MSRs), both initially and on an ongoing basis. The project has significant implications for our member companies which service more than 70% of the estimated \$6.9 trillion in outstanding mortgage debt in this country. MBA would like to take this opportunity at the start of the project (herein referred to as the "MSRs project") to offer a proposed conceptual framework for accounting for MSRs. We believe that the proposed framework will offer the requisite flexibility during what has become a lengthy journey to full fair value accounting for financial instruments.

MBA is the national association representing the real estate finance industry. The association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand home ownership 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 approximately 2,800 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. MBA members currently originate over 50% of the residential mortgage loans, and over 20% of the commercial and multifamily loans, in this country every year.

## **I. Introduction**

MBA commends the Board for undertaking a project on MSRs. We support the project because it has the potential to significantly reduce some of our larger members' costs of doing business while simultaneously improving the accuracy of their financial statements. MBA is committed to assisting the FASB throughout the course of the project, and we encourage your staff to contact us as needed for information and support.

The objectives of the MSR project are to consider: (1) whether MSRs should be reported at fair value; and, (2) whether the accounting for MSRs should be changed on day one (i.e. from a relative fair value allocation approach to a fair value approach) as well as thereafter. For the reasons described on the following pages, MBA strongly supports the proposed change to a fair value reporting model for MSRs **provided the change can be applied on an elective basis**. MBA also recommends that consideration of day one accounting for MSRs not be addressed at this time.

## II. Mortgage Banking Business Models

Our members' views differ with respect to the potential advantages of a fair value reporting standard for MSRs. For example, some of our larger members (which use derivatives for MSRs hedging purposes) strongly support a fair value reporting model because it would increase the accuracy and transparency of their financial statements (by providing symmetrical treatment of their hedging instruments and hedged MSRs) while reducing their costs of doing business. However, other MBA members, including a few large companies that also use derivatives, believe a fair value reporting approach would introduce unwarranted volatility into their financial statements and thereby increase their costs of doing business.

While it is true that most (but not all) of the largest servicers in the country<sup>1</sup> use derivatives to hedge their MSRs, the size of a company's investment in MSRs and its use of derivatives to hedge the MSRs are secondary influences in terms of a company's support of a MSR's fair value reporting standard. Based on our research, the primary factor influencing a company's view of a fair value reporting standard for MSRs is the company's business model. We have identified three (general) mortgage banking business models which impact how different companies' view the MSR project, as described below.

### #1. Privately or publicly owned but operated as independent enterprises whether or not part of a larger enterprise. (i.e. including subsidiaries of larger enterprises)

These enterprises tend to be accountable to investors and others for their operating performance, separate and apart from the results of activities of any related enterprises (such as a parent). As such, these enterprises are managed *primarily* as independent, stand-alone entities, regardless of their affiliations. Due to their independent natures, these enterprises often utilize derivative instruments to hedge their MSRs since changes in the values of other assets or liabilities within their reporting group do not hedge the fluctuations in MSR values. These companies may or may not apply hedge accounting. They may also be expected to sell some of their servicing portfolio from time to time for various reasons.

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<sup>1</sup> See enclosed list published in National Mortgage News, a subsidiary of Thomson Media (see [Mortgagestats.com/Quarterly Data Report](http://Mortgagestats.com/Quarterly Data Report)). While the majority of the largest servicers in the country service approximately 67% of the total mortgage debt in the country and use derivatives to hedge their MSRs, the vast majority of medium to small mortgage companies do not. Moreover, while the largest companies service most of the outstanding mortgage debt, they represent a small percentage of the total number of companies that have MSRs on their balance sheets, including MSRs which are material to their balance sheets.

Companies sharing this business model believe that a fair value reporting standard is the most appropriate reporting measure for their MSR's. They note that the industry has substantial experience estimating the fair values of MSR's as a result of the longstanding lower of cost or market value (LOCOM) measurement requirement. Moreover, they note that a fair value reporting standard is more consistent with the accounting for other, similar financial instruments under GAAP today. A fair value reporting standard is also consistent with the Board's objective to require financial instruments to be reported at fair value.

While MSR's, technically, do not meet the Board's definition of a financial instrument, the Board has acknowledged that they are more like financial instruments than non financial instruments. MBA has supported this view for many years. In commenting on a draft of Statement 125, *Accounting for Transfers & Servicing of Financial Assets & Extinguishments of Liabilities* (FAS 125), on January 19, 1996, MBA wrote:

“Servicing rights are, essentially, hybrid assets with characteristics in common with financial as well as non financial assets. They are, however, most like financial assets as their values are dependent on market factors (the effect of interest rate fluctuations) and, to a lesser extent, credit factors (foreclosure of the underlying loans). They are unlike most non-financial instruments where historical cost often bears a relationship to current reproduction cost or other determinants of value.

While servicing rights have nominally been treated as "non-financial" assets because they are associated with servicing obligations that have a cost component, the costs involved are effectively taken into account in the fair market valuation of the rights, and the risks of incorrectly estimating such costs are generally insignificant in comparison to the effects of market and credit risk on servicing values. Moreover, such servicing costs and risks are exactly the same as those borne by mortgage lenders who have not chosen to sell their servicing, yet the corresponding asset, in that case, the loan receivable, is still treated as a financial asset.

In deciding to combine the accounting for "excess" servicing fees (a true financial instrument) with the accounting for normal servicing rights, the Board effectively acknowledges that servicing rights are primarily a financial asset. The very fact that the accounting for excess servicing fees and normal servicing rights *can* be combined reflects the fact that they are fundamentally similar assets. The same accounting would neither be feasible nor appropriate for distinct financial and non financial assets.”

Members who share this business model support a MSR's fair value reporting standard because they believe it would:

- Increase the transparency and clarity of their financial statements by providing for their MSR's and related hedging instruments to be accounted for the same way.
- Greatly reduce their costs of doing business by decreasing the operational and systems burdens imposed on mortgage companies by the guidance in Statement 133, *Accounting for Derivative Instruments & Hedging Activities* (FAS 133).

A change to a fair value reporting standard would significantly reduce these companies' costs of complying with FAS 133 while simultaneously providing symmetrical accounting treatment for their hedging instruments and hedged MSR. Under the current LOCOM measurement approach, mortgage companies must expend substantial resources to continuously value, allocate and reallocate MSRs to hedged portfolios, and to balance and rebalance their MSR hedge positions in order to recognize changes in the values of the MSRs above amortized cost pursuant to the guidance in FAS 133. Moreover, these mortgage banking companies are continuously at risk, due the unusual nature of MSRs, of incurring additional costs associated with the earnings mismatch that would result if their MSR hedging activities failed to qualify for hedge accounting in a given period. Under a fair value reporting model, companies could forego hedge accounting because their MSRs would be marked-to-market simultaneously with the derivatives used to hedge them.

(2) Privately or publicly owned but operated as a component part of another enterprise, such as a division or subsidiary of a larger financial institution.

These enterprises also are accountable to investors and others for their operating performance, but that performance is influenced or related to the activities and performance of a parent or affiliated enterprise. As such, they are managed as integral components of a larger enterprise whereby their MSR risks are often offset by risks embedded in other asset or liability positions of affiliated enterprises. Enterprises that share this business model prefer the existing LOCOM reporting model because their earnings performance is integrated with a related enterprise whose other asset and liability positions, including certain debt instruments, are not reported at fair value.

Members who share this business model oppose a mandatory MSRs fair value reporting model because they believe it would:

- Increase their costs of doing business by forcing them to undertake more costly derivative based hedging practices to avoid the earnings volatility that would be introduced by a mandatory fair value reporting standard.
- Be an inappropriate accounting model for an asset that is held for investment or that otherwise is rarely, if ever, traded. A fair value reporting model would subject mortgage companies to more volatility in earnings than enterprises that hold similar instruments but that can account for those instruments as available for sale, with changes in value reported in equity, or as held to maturity assets at amortized cost.
- Impede the ability of risk managers to off-set risk positions imbedded in the balance sheet of the company as a whole. Risk management for these enterprises is normally accomplished at the institution-wide level. Change in market value is estimated using the entire balance sheet, including MSRs. A fair value reporting standard would force MSRs to be excluded from this evaluation as they would be reported on a different basis from the company's other financial instruments.

(3) Privately or publicly owned with MSR portfolios for which there is limited servicing portfolio turnover due to underlying mortgage terms and for which the interest rate risk may be limited.

These enterprises are engaged in servicing loans primarily for investors under private or deal specific investor agreements. In some cases, the unique terms of some of the investor servicing agreements have discouraged the development of a market for the servicing rights and, in some cases, actually preclude or limit the transfer of the servicing rights from one entity to another. The majority of these enterprises would likely prefer the existing LOCOM reporting model because it better reflects the normal practice of holding the MSRs on a long-term basis and normally without the need to use derivatives or other means to hedge the MSRs.

Companies sharing this business model oppose a mandatory MSRs fair value reporting model for the same reasons outlined under (2) on the previous page.

MBA believes there is merit in our members' arguments for and against a mandatory fair value reporting standard for MSRs *at this time*. We believe current GAAP has created a tension in terms our members' views of the MSRs project as: (1) few financial instruments are *required* to be reported at fair value today; and (2) GAAP provides for exceptions from fair value reporting of financial instruments if they are held-to-maturity assets. Consequently, and until such time as all financial instruments are required to be reported at fair value, ***which is an objective MBA supports***, we recommend the following elective MSRs fair value reporting approach.

### III. MBA Recommendation

MBA recommends that the Board consider an "all or nothing" approach whereby a mortgage company could elect to continue to apply current GAAP to their MSRs or, alternatively, to report their MSRs at fair value. The fair value election would be available to companies provided: (1) they agree to apply it to their entire MSRs portfolios, including subprime servicing rights, etc.; (2) the election is permanent such that companies electing to apply a fair value reporting approach could not elect to "change back" to the LOCOM approach in the future. However, companies electing to continue to apply existing GAAP to their MSRs could elect to change to a fair value reporting approach in the future.

Under this approach, mortgage companies would fall into two reporting camps: (1) those that report their MSR at LOCOM, with all the attendant complexities of amortizing, stratifying, getting hedge accounting treatment and measuring direct write-downs; and (2) those that report their MSR at fair value, with those complexities eliminated but, in the view of some, other complexities introduced (i.e. potentially greater earnings volatility and costs).

We realize that some may consider a dual reporting approach too unusual to warrant serious consideration. However, we believe it has theoretical accounting and practical business strengths that make it a cleaner and more disciplined accounting approach than the approaches prescribed for other retained interests under GAAP today.

### IV. Merits of MBA's Recommendation

In terms of theoretical strengths, we believe our fair value proposal is superior to the current treatment prescribed for other retained interests that are subject, for example, to Statement 115, *Accounting for Certain Investments in Debt & Equity Instruments* (FAS 115). Under FAS 115,

the same entity can account for identical instruments differently depending on the entity's intent with respect to the instruments. ***By contrast, our proposal would take "intent" out of the equation and force companies to one of two distinct playing fields, or reporting models.***

Some arguments supporting our elective fair value proposal are described below:

### **Fair Value Election**

Under our proposal, companies electing to report their MSR's at fair value would be required to apply it:

- **Consistently**, such that all changes in the fair values of companies' MSR's would be reported in earnings, not just those that are designated as "trading." Moreover, a company electing to adopt a fair value reporting proposal could not choose to report some of its MSR's at fair value and others at LOCOM or some other basis of accounting.
- **Permanently**, such that a company electing a fair value reporting approach could not elect to change back to a LOCOM or other basis of accounting in the future.

For these reasons, our proposal would force all mortgage companies that might elect to report their MSR's at fair value to report them uniformly within and across companies.

### **LOCOM Election**

Companies electing a LOCOM measurement approach would be required to apply it:

- **Consistently**, such that all their MSR's would be reported similarly. Under FAS 115, the same instruments are reported at cost or market value depending on a company's intentions with respect to the instruments.
- **Permanently, although** the company could elect in the future to convert to a fair value reporting standard. In that case, the election would be permanent and would be applicable to all MSR's held by the entity.

The most obvious possible objection to our proposal is that some may contend it would be inappropriate for a company to be allowed to choose between two distinct reporting approaches for the same asset. On the other hand, we believe a company based election is more supportable than an instrument based election by company, pursuant to the guidance in FAS 115 for similar retained interests. We also think the discipline that would be imposed on companies electing our fair value approach is more rigorous and less subjective than the discipline imposed by FAS 115 whereby companies can elect to report their debt instruments as either "available for sale" (with unrealized gains or losses recognized in a component of equity) or "trading" assets (with unrealized gains and losses recognized in earnings) at fair value under FAS 115.

**In summary, under our proposal, companies electing to report their MSR's at fair value would be required to report all of their MSR's at fair value with unrealized gains and losses reported in earnings, permanently.**

## **V. Day One Versus Day Two**

It has been proposed that the scope of the MSR's project include consideration of a change in the accounting for MSR's initially (i.e. on day one), as well as thereafter (day two). Currently, MSR's are recognized as separate assets upon the sale or securitization of a loan based on a relative fair value allocation approach, which generally results in the recognition of an amount nominally less than the full fair value of the MSR's. This initial measurement approach could give rise to additional income immediately thereafter if the MSR's are subsequently reported at fair value.

MBA opposes the inclusion of day one accounting in the scope of the MSR's project for two primary reasons. First, we believe the expansion of the scope of the project will delay its completion to the disadvantage of preparers and users of mortgage companies' financial statements. Secondly, we believe any reconsideration of day one accounting could be undertaken when, and if, day one accounting is reconsidered for other similar retained interests.

## **VI. Reporting Loans Held for Sale at Fair Value**

On a related topic, virtually all of our members support a change in accounting for loans held for sale to report them at fair value. Currently, mortgage loans held for sale are subject to a LOCOM reporting standard pursuant to FAS 65, *Accounting for Certain Mortgage Banking Activities*. As our members universally hedge their loans held for sale, a change in accounting from LOCOM to fair value would greatly ease their FAS 133 compliance costs, as well as increase the accuracy of their financial statements. MBA, therefore, strongly recommends that the Board change the accounting for loans held for sale to require that they be reported at fair value.

## **VII. Disclosures**

Under our recommended "all or nothing" approach, companies would continue to make the disclosures that are required in par. 17.e. (2) of FAS 140 regarding the method and significant assumptions used to estimate the fair value of the MSR's. The guidance in that Statement would have to be amended to clarify that the other disclosures required by that paragraph (e.g. disclosures regarding the amounts of servicing assets and liabilities amortized during a period) are applicable only to those companies that elect to continue to report their MSR's at amortized cost.

In addition, we recommend that companies make the following additional disclosures:

### LOCOM Reporters:

- A disclosure describing the reasons for their election of a LOCOM reporting approach

### Fair Value Reporters:

- A disclosure describing the reasons for their election of a fair value reporting approach
- The period in which the election was made

- In the period of election only, the effect on current period income as a result of a change in accounting principle

### **VIII. Conclusion**

The MBA continues to support the FASB's long-term objective of moving from historic cost to fair value accounting for financial instruments. Because all financial assets and liabilities are not being moved to full fair value accounting simultaneously, anomalies will occur from time to time that need to be corrected. Mortgage companies economically hedge the interest rate risk inherent in MSR's with a variety of financial instruments. Some of these instruments are derivatives and are marked to market. Some are marked to market through the equity section of the balance sheet under FAS 115. Still others are carried at amortized cost or at the lower of cost or market value. We believe our proposal for an "all or nothing" election of either fair value or LOCOM accounting for MSR's will provide the flexibility needed until fair value accounting is required for all financial assets and liabilities.

On behalf of the MBA, thank you for the opportunity to share our views on important accounting matters. If you have questions about our proposal, or if the MBA can assist you in your deliberations on this important topic, please do not hesitate to contact Alison Utermohlen, Staff Representative to MBA's Financial Management Committee, at 202/557-2864.

Sincerely,



Robert M. Couch, CMB  
Chairman

Enclosure

Cc: Lawrence W. Smith, FASB Director – Technical Application and Implementation  
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