

## COMMENT LETTER SUMMARY

### General Summary

1. A total of 24 comment letters were submitted. The vast majority of respondents generally supported the proposed changes in the ED. Ernst & Young (comment letter # 21) summarized these views stating, “Overall, we support the amendments in the proposed Standard. We believe the proposed amendments would simplify the accounting in this area and provide a practical solution to a complex issue.”
2. Only one respondent objected to the exposure draft. The Texas Society of Certified Public Accountants (comment letter #10) suggested that it may be time to reassess the approach being taken in this area of the standard setting process, stating, “The approach to date has been the piece-meal addition of increasing levels of complexity. The constant addition of amendments and periodic codifications of the related documents tends to add to the confusion surrounding the topic.” Further, “When numerous amendments to a standard keep surfacing, perhaps the original standard should be superseded by a subsequent standard that is based on a more thorough and complete analysis of the subject being addressed.” This respondent objected to all three EDs related to Statement 140.
3. The notice to recipients asked for comments from those who both agree and disagree with the provisions of the proposed Statement. Recipients were asked to identify specific paragraphs that are of concern and clearly explain their problems or questions and to describe any alternatives that the Board should consider in their redeliberations as described in paragraph 5 of this memorandum. Recipients were also asked to comment on the issue of whether provisions permitting the transfer of securities classified as available-for-sale (AFS) to the trading category without calling into question an entity’s treatment of such securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, are necessary. Paragraph 6 contains a summary of the comments on that issue.
4. Although most respondents generally supported the proposed changes in the ED, they made a number of suggestions to clarify certain aspects of the ED. The key concerns raised in the comment letters include:
  - a. Should the transfer of securities classified as AFS to trading without calling into question an entity’s treatment of such securities under Statement 115 be permitted?
  - b. There is an inherent conceptual inconsistency in the proposed amendment’s requirement to initially measure at fair value separately recognized servicing rights that an entity has elected to subsequently measure under the amortization method.

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- c. There is concern regarding the statement that, “The fair value measurement method is preferable” when viewed in the context of the guidance in FASB Statement No. 154, *Accounting Changes and Error Corrections*, and possible interpretations that the fair value measurement method is the only method permitted for subsequently measuring separately recognized servicing rights.
- d. There is concern that the wording in the ED regarding application of the fair value measurement election to major asset types defines these categories too broadly for the proposed guidance to be operational.
- e. There is concern regarding the scope of Statement 140, specifically, circumstances in which a separately recognizable servicing right would be recognized.
- f. There is concern regarding the new disclosure requirements and possible disclosure overload.

### **Response to Questions in the Notice to Recipients**

- 5. The ED requested that respondents comment on the following questions:
  - a. Do you believe that transition provisions permitting the transfer of securities classified as AFS to the trading category without calling into question an entity’s treatment of such securities under Statement 115 are necessary?
  - b. If so, do you believe there should be restrictions on the ability to make such transfers?
  - c. If you currently use securities classified as AFS to offset the income statement effect of changes in fair value of servicing assets or liabilities, is there a company-specific mechanism to designate certain securities classified as AFS for this purpose?
- 6. The majority of respondents believe that transition provisions should permit the transfer of securities classified as AFS to trading without calling into question an entity’s treatment of such securities under Statement 115. Washington Mutual (comment letter #13) stated, “When companies elect to apply the fair value method, we believe that they should be permitted to reclassify those securities used to economically hedge servicing rights that are classified as available for sale without jeopardizing the classification of other available for sale securities (ASF). FASB Statement No. 115, *Accounting for Marketable Debt and Equity Securities*, states that transfers to trading should be rare. As the fair value election for servicing rights would be based on new accounting guidance that could not have been foreseen when the investment securities originally were classified as available for sale, we believe that permitting those securities to be reclassified as trading would be consistent with the notion that such transfers should be rare and based on unforeseen events.” However, two comment letters (Deloitte & Touche, comment letter #8, and Grant Thornton, comment letter #14) did not support such

- a provision, primarily for the reasons stated in the ED dealing with concerns over how to identify the securities for which the transition provisions would apply.
7. Regarding the second question, among those that support allowing a reclassification from AFS securities to trading, comments generally supported allowing such a reclassification without restriction. The MBA (comment letter #15) stated, “MBA also recommends that no parameters be specified for reclassifying AFS securities consistent with the Board’s recent decision, within the Fair Value Option Project, not to impose “eligibility criteria” on the fair value election. The Board members reasoned that making the fair value option broadly available is more consistent with their ultimate objective of requiring such securities to be reported at fair value in the future.” Ernst & Young (comment letter #21) stated, “We believe the Board should provide for a one-time (as of the adoption date) unrestricted transfer of securities classified as available-for-sale to the trading category in the final Standard. We do not believe there should be special accounting for the transfer but that the provisions of SFAS 115 for transfers should be followed.” PriceWaterhouseCoopers (PWC) (comment letter #16) stated, “We recommend the Board allow a one-time reclassification of AFS securities to trading without calling into question the classification of other AFS securities. However, we believe that this should be allowed only (1) concurrent with a fair value election for each class of servicing rights and (2) with proper disclosure.”
  8. In response to the final question, respondents commented that companies generally designate as AFS securities, securities that are used for economic hedges. PWC (comment letter #16) noted that, “We have been informed that Banking regulators focus on the designation and tracking of AFS securities designed as economic hedges of servicing rights during reviews of entities’ overall risk management systems.” JP MorganChase (JPMC) (comment letter #5) provided information on their practices regarding mortgage servicing rights (MSRs) and stated, “Historically, JPMC has maintained a portfolio of available-for-sale securities specifically identified as instruments used to economically hedge MSRs. JPMC stated that they can easily identify the specific securities used for this economic hedge (for which the transitional provision would apply) and therefore would not call into question the accounting for all other AFS securities held by the firm for other business reasons. JPMC believes that other companies using AFS securities as economic hedges of MSRs isolate their specific securities in a similar manner. Similarly, Countrywide noted that when it has used AFS securities to hedge MSRs, it specifically identified which securities were being used for hedging purposes. Washington Mutual (comment letter #13) stated, “In order to properly evaluate its risk exposure to impairment losses on servicing rights, a company must know what investment securities are designated as economic hedges of those assets.”

### **Comments on Initial Measurement**

9. The majority of respondents that commented on the change to initially measure servicing rights at fair value supported that change. JPMC stated, “JPMC

strongly supports the proposed accounting for servicing of financial assets—specifically requiring initial measurement of servicing assets at fair value...Requiring the initial measurement of servicing assets at fair value simplifies accounting for loan sales.” KPMG (comment letter #19) stated, “However, we believe there is an inherent conceptual inconsistency in the Proposed Amendment’s requirement to initially measure at fair value separately recognized servicing rights that an entity has elected to subsequently measure by applying the amortization method. We believe it would be more appropriate for the Board to require initial measurement at allocated carryover basis for classes of separately recognized servicing rights that an entity has elected to subsequently measure by applying the amortization method, unless the servicing rights are purchased or assumed rather than undertaken in a transfer of financial assets.”

### **Comments on Subsequent Measurement**

10. One third of respondents commented on the guidance relating to subsequent measurement of separately recognized servicing rights found in paragraph 13 and other related paragraphs. The majority of those respondents supported the option to subsequently measure each class of servicing assets and servicing liabilities using either the amortization method or the fair value measurement method. The MBA (comment letter #15) summarized their support for the elective approach stating, “MBA strongly supports an elective fair value approach for subsequently measuring servicing rights because it will reduce many of our members’ FAS 133 compliance costs while ensuring that the economics of their mortgage servicing hedging activities are accurately reflected in their financial statements in the future. MBA also supports an elective approach because it will provide entities with the opportunity to align risk management strategies with the appropriate accounting and reporting treatment for their servicing rights.”
11. Several respondents expressed concern regarding the sentence in paragraph 13 of the ED that states, “The fair value measurement method is preferable to the amortization method for purposes of justifying a change in accounting principle under FASB Statement No. 154, *Accounting Changes and Error Corrections*.” Respondents noted that such a statement when combined with the guidance in Statement 154, could lead preparers to believe that the fair value method is mandatory and that preparers that continue to elect the amortization measurement method could be criticized by their auditors and audit committees. Respondents suggested clarifying that the fair value measurement method is not required by deleting the above phrase altogether or by adding additional guidance that explicitly states that the fair value measurement method is not mandatory. Respondents also suggested stating that the LOCOM approach for subsequent measurement is not inconsistent with current GAAP. In addition, as also noted in paragraph 22(a), some respondents suggested deleting the disclosure in paragraph 17(f)(1) that requires management to explain its basis for its decision not to subsequently measure a class of servicing rights at fair value.
12. Ernst & Young (comment letter #21) noted its concern regarding subsequent measurement, by stating, “The addition to the amended paragraph 63(f) of SFAS

140 could be interpreted as permitting an annual election for servicing initiated in each ensuing year after the election is made, which would be inconsistent with the Board's conclusions. It was our understanding that the election to report servicing at fair value was more in the nature of a preferable accounting policy. This may also need to be clarified in paragraph 5 of the Exposure Draft if the Board intended to provide guidance regarding transition. We suggest it would be clearer if the language referred to an 'irrevocable change in accounting policy' rather than an 'irrevocable decision,' which could be analogized to an annual tax election. A similar comment applies to paragraph 6 of the Exposure Draft."

### **Comments on the Election by Broad Asset Class for Subsequent Accounting**

13. Almost all of the respondents commented that the requirement to elect either the fair value method or the amortization method by broad asset class to subsequently account for separately recognized servicing assets and liabilities was too restrictive. Paragraph 13 states, "An entity shall apply the same subsequent measurement method to each servicing asset or liability in a class. The class of servicing assets and liabilities shall be determined based on the major asset type being serviced as described in paragraph 17(h) (for example, mortgage loans, credit card receivables, and automobile loans)." Several respondents requested more guidance in determining how to define a "major asset type." However, the majority of respondents suggested modifying the guidance to allow more "granularity" in the major asset type categorization.
14. Respondents generally recommended that the election guidance be modified to allow management to determine the appropriate level of asset class for which to apply the election because the ED's examples of major asset classes found in paragraphs 13 and 17(h) (e.g., mortgage loans, credit card receivables, and automobile loans) are too restrictive and would inhibit rather than encourage many companies from electing the fair value method. One respondent noted that entities may have different policies/risk management approaches associated with subcategories within major asset types that would make consistent accounting across major asset types impractical. Some respondents further commented that a more granular breakout of asset classes would be better aligned with common risk management practices and risk management objectives for servicing rights and that it would be more consistent with the "instrument-based" measurement approach used in the fair value option Exposure Draft and the hybrid financial instruments Exposure Draft. However, one respondent noted that, "An 'instrument-based' approach would be desirable in terms of consistency, but would be impracticable to apply to servicing rights and would complicate the analysis and comparability of servicer's financial statements." Some respondents noted that allowing additional asset categories will allow companies to convert certain asset types to fair value accounting earlier than if broad categories were used.
15. Respondents suggested several alternative ways of determining an appropriate breakout of asset classes including:

- a. By “impairment strata” as described in paragraph 63(g) (“...include financial asset type, size, interest rate, date of origination, term, and geographic location.”)
  - b. By separate mortgage loan type such as those listed in Schedule RC-C Loans and Lease Financing Receivables, of the Instructions to the June 2005 Call Report
  - c. By loan types listed in section 210.9-03 of SEC Regulation S-X
  - d. By allowing management to define asset classes based on their specific risk management objectives.
16. However, not all favored an election that was not applied to all servicing rights. The comment letter submitted by Grant Thornton (comment letter #14) summarized the opposing view, stating, “We agree with permitting entities to subsequently measure servicing assets or liabilities by either (1) amortization and assessment for impairment or (2) measurement at fair value at reporting periods; however, we believe that entities should make an election to either subsequently measure all servicing rights by amortization and assessment for impairment or subsequently measure all servicing rights at fair value each reporting period. For reasons stated in paragraphs A7 and A8 of Background information, Basis for Conclusions, and Alternative Views, we do not believe there are compelling reasons for an entity to choose different methods for different classes of servicing rights. We believe that allowing entities to choose different methods for different classes of servicing rights would result in less comparability among entities and create ranges of divergence among entities that financial statement users will find more difficult to assess.”

#### **Scope of Statement 140**

17. KPMG (comment letter #19) suggested that it would be helpful to “...clarify the circumstances in which a separately recognizable servicing right would be deemed to exist. With respect to the recognition of servicing rights, paragraph 62 states that ‘An entity that undertakes a contract to service transferred financial assets shall recognize either a servicing asset or a servicing liability, with only one exception’. It further states that ‘Each sale or securitization in which servicing is obtained or each separate purchase or assumption of servicing results in a servicing contract...Each servicing contract results in a servicing asset or servicing liability.’ We believe that the reference to transferred financial assets in the first sentence of paragraph 62 is inconsistent with the later guidance in the paragraph indicating that separately recognizable servicing rights may exist even in the absence of a transfer of financial assets. As part of the clarification of paragraph 62, we recommend that the Board address whether it is appropriate to recognize a servicing right in instances in which the servicing right is acquired for consideration other than cash or other assets.”

18. Several respondents also suggested clarifying when a separately recognized servicing asset or liability exists, particularly in cases where the fees received amount to adequate compensation. Ernst & Young (comment letter #21) summarized these views stating, “Whether a servicing asset or liability exists is the function of the relationship of servicing income to adequate compensation, as stated in the amended paragraph 62 of SFAS 140. However, the language in the amended paragraphs 63(f) and 2(b) of the Exposure Draft could be misinterpreted to imply that a servicing asset exists anytime servicing revenue exceeds servicing costs, thereby ignoring the concept of a normal profit margin expected in the marketplace that would be required before adequate compensation is achieved. Further, “servicing costs,” as used in these paragraphs, could be interpreted as permitting internal costs to be used in the determination of whether a servicing asset or liability exists.”
19. Deloitte & Touche (comment letter #8) and First Horizon National Corporation requested clarification regarding the interplay between servicing rights in a participation and the requirements of paragraph 10(d). First Horizon National Corporation (comment letter #6) stated that, “...historically servicing rights and obligations have not been recognized in accounting for loan participations because there is a presumption that the servicing fees are just enough to compensate for the servicing obligation...However, the Transfers Amendment brings new focus on participation arrangements, and we believe that the presumption of offsetting servicing rights and obligations will be challenged due to the technical requirement of paragraph 10(c).”

## **Comments on Disclosures**

### **Disclosure Overload**

20. Generally comments were evenly divided between those that felt the disclosures were overly burdensome and those that felt they were appropriate. Merrill Lynch (comment letter #7), Washington Mutual (comment letter #13), and NetBank Inc. (comment letter #1) suggested the disclosures were overly burdensome (Washington Mutual did say, however, that it would improve comparability). Netbank Inc. summed up its arguments against additional disclosures by stating, “If one of the intended benefits of the proposed accounting standard is to provide companies relief from the documentation and paperwork requirements of FAS 133, the existence of paragraph (3)(e) may very well put in place a documentation and paperwork requirement that is equally onerous. In drafting the final rule under (3), we ask that the FASB keep the documentation and disclosure requirements as simple as possible.” Merrill Lynch noted that “certain of the disclosure requirements presented in paragraphs 17(e) and 17(f), which require presentation of significant quantitative and qualitative information about servicing assets and liabilities, are unwarranted. In general, we feel that these provisions amount to disclosure overload.”
21. National City Corporation (comment letter #2) gave the opposite view in its letter. They stated, “We concur with the FASB’s proposed disclosures on servicing

assets and the instruments used to manage risks inherent in servicing activities. Given that we already disclose much of this information in our financial statements, we do not believe that it will be a significant effort to implement these disclosures.” In addition, both JPMC and Washington Mutual (comment letter #13) agreed that the proposed disclosures would improve comparability for readers of financial statements under the proposed elective fair value approach and might encourage companies to use the fair value method.

22. While constituents were divided about the usefulness of the overall disclosures, they had a number of comments pertaining to three specific areas of disclosure. Their comments focused on:

- a. **Election of Subsequent Measurement Method**—Because fair value is preferable but not required for the subsequent measurement of servicing rights, a number of constituents argue that it is unnecessary to require the disclosure of management’s basis for deciding the method it chose. Both Citigroup (Letter #12) and Washington Mutual (Letter #13) suggested removing the requirement to discuss management’s basis for deciding which method it choose.
- b. **Rollover Analysis of the Balance of Each Class of Servicing Assets and Liabilities**—There were a number of constituents that commented on this requirement. Some, like Netbank (comment letter #1) and First Horizon (comment letter #6), argued that paragraph 17(e)(3) is not a complete list and suggested that the FASB refrain from dictating the specific components of the rollover analysis. Others like Deloitte & Touche (comment letter #8), Countrywide (comment letter #9), and JPMC (comment letter #5) suggested that one of the components did not belong—contractual servicing fees—and recommended that those fees be separately disclosed for each class of servicing assets and liabilities. They argue that while the servicing fees received in the current year are included in the amortization component of the disclosure, the servicing fees earned in the period do not affect the balance of the servicing asset/liability.
- c. NetBank Inc. noted that the list given in paragraph 17(e)(3) is intended to describe a comprehensive roll-forward of the balance in capitalized serving assets; however, the list given in subparagraphs (a) through (e) is not an exhaustive list of the likely changes in value. For example, “(3) (e) appears to be attempting to delineate what NetBank calls the “time decay” of the asset. Time decay represents the value that is expected to be realized with the passage of each specific period of time. It would include more than just “contractual fees earned.” Time decay would also include ancillary income earned, benefit of escrow balances realized, the cost of servicing the underlying mortgage loans, and the cost of making required servicing related advances on delinquent loans and advances on the payment of property taxes and insurance. We recommend that the FASB add some additional granularity to (3)(e) to encompass the time decay of all strips of value or make

the language in (3)(e) more general to accommodate all elements of time decay.” Likewise, First Horizon National Corporation indicated that a roll-forward should be inclusive of all major components necessary to account for the changes in the value of each class of servicing rights.

- d. Citigroup suggested that the Board delete the term *contractual* from paragraphs 17(e)(3)(e) and 17(f)(3)(f), noting that many servicers combine free float earnings and late fees with servicing fees when disclosing cash flows from securitization trusts, as these items are closely allied with the servicing process. However, at least one constituent believes that amounts in excess of contractual servicing rights should be separately disclosed as much of the fees are lumped together in the securitization cash flow disclosure.
- e. **Usefulness of the Sensitivity Analysis**—There were at least three constituents that recommended this disclosure be eliminated. Merrill Lynch (comment letter #7), Grant Thornton (comment letter #14), and PWC (comment letter #16), recommended deletion.
- f. Grant Thornton stated that “they support the additional disclosure requirements for all separately recognized servicing rights *with the exception of* paragraph 17(f)(8) to disclose, for entities that subsequently measure servicing rights using the amortization method, a sensitivity analysis showing the hypothetical effect on fair values of unfavorable variations in key assumptions.” For such entities, the costs do not appear to outweigh the benefits to the users of the financial statements. Merrill Lynch suggested that “The sensitivity analysis required in paragraphs 17(e)(5) and 17(f)(8) are excessive and is accomplished through SEC rule 305 of Reg. S-K in which market risk for financial instruments is required to be provided.”
- g. PWC commented that they believe that a sensitivity analysis for servicing is not useful to readers of the financial statements because the analysis may only disclose the changes in fair value based on two adverse changes in each assumption used in the fair value calculation. Also, the sensitivity analysis currently performed for retained interests is prepared for disclosure purposes only and has no operational objectives associated with it. PWC suggested that the Board further research the disclosure requirements and consider alternatives that will disclose what is expected to happen to the fair value of servicing rights in the future based upon reasonably expected changes in the market conditions.

## **Transition and Effective Date**

23. The majority of the comments regarding effective date and transition provisions supported issuance of the final Statement as soon as possible. However several respondents requested clarification or minor amendments to the proposed transition provisions. Comments included:

- a. The effective date and transition guidance does not indicate the effective date of the disclosure requirements.
- b. If the final statement is issued subsequent to the first quarter of 2006, it is unclear whether previous quarters of that year would have to be restated for servicing rights recognized during those quarters.
- c. The Board should clarify that the initial recognition of servicing rights be applied in a specified quarter subsequent to the statement being issued.
- d. The Board should allow early adoption when final statements are issued.
- e. The effective date should be no less than three months after issuance and should allow early adoption.
- f. The Board needs to clarify that the decision to subsequently measure servicing rights at fair value after adoption of this Statement must be made as of the beginning of any fiscal year and that the cumulative effect adjustment is the difference between the fair value and its carrying amount at of the beginning of the year, not as of the date of election.