ERNST & YOUNG

Ernst & Young LLP
5 Times Square
New York, NY 10036

Phone: (212) 773 3000
www.ey.com

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Letter of Comment No: 91
File Reference: 1220-001

Mr. Lawrence Smith
Director, TA&I
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

File Reference No. 1220-001, Proposed Statement of Financial Accounting Standards, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140*

Dear Mr. Smith:

Ernst & Young is pleased to offer the following comments on the above-mentioned Exposure Draft (the "Exposure Draft" or "proposed Standard"), *Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140*. 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.

We have the following comments concerning the proposed Standard.

Expand the Ability to Elect Fair Value for Subsequent Measurement

In paragraph 3(b) of the Exposure Draft, we believe the FASB should consider expanding and clarifying the criteria upon which to base and apply the fair value election (which is later described as based on the major asset type). 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 if the major asset type category is too broadly defined. Credit quality, asset type (e.g., residential mortgage loan vs. commercial mortgage loan), loan features, and other factors all play an important part in how or whether an entity will choose to risk manage its exposure.

For example, an entity may hedge mortgage servicing rights related to fixed rate conforming mortgage loans differently from those for floating rate nonconforming mortgage loans or home equity lines of credit. Also, servicing rights related to commercial mortgage loans may react differently to interest rate changes than those related to residential loans. Additionally, inputs needed to fair value servicing rights related to conforming residential mortgage loans may be more readily obtainable or such rights may be more interest rate sensitive than those related to non-conforming or sub-prime residential mortgage loans.

The availability of market observable inputs may also impact an entity's decision as to how or if they risk manage the assets. In paragraph A10, the Board acknowledged that entities hedge the risks inherent in only certain classes of servicing rights. While we understand the Board's preliminary decision, we believe entities should have the flexibility for a more focused election

to allow them to identify the categories at a more detailed level than major asset type to more closely align with their specific risk management objectives.

More Clearly Define When a Separate Asset or Liability Exists

Uncertainty exists in practice as to when servicing rights should be separately recognized. As is the case currently, we believe confusion will continue to arise as entities apply the first sentence of the amended paragraph 13 of SFAS 140 as well as the second to last sentence of the amended paragraph 61 of SFAS 140, where reference is made to servicing becoming a distinct asset or liability upon the sale **or securitization** of assets as well as in other circumstances. These sections could both be read to imply a servicing asset or liability exists at any time an agreement to service financial assets for others is entered into, including when no transfer takes place, when a securitization is completed that does not meet the requirements to be recorded as a sale under SFAS 140, or when an entity has completed a securitization, and yet retains all of the interests.

We believe this confusion is compounded by footnote 1 in paragraph 2 of the Exposure Draft. We suggest this language be revised as follows:

> [1]Separately recognized servicing rights are recognized as assets or liabilities and are not reported as part of the financial assets being serviced. Such rights are recognized either through purchasing pre-existing rights that had been previously recognized in connection with an agreement to perform the servicing on financial assets held by others (purchased) or from the retention of servicing on financial assets previously held by the servicer that are sold to others.

We understand the FASB does not believe servicing contracts that arise from situations other than a financial asset transfer accounted for as a sale create servicing assets or liabilities, even though the contractual rights and obligations could be the same as a transaction that did achieve sales treatment. Given the significance of this amendment to the accounting for servicing assets and liabilities, we believe the FASB should consider clarifying this view.

Definition of Servicing Asset or Liability

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 paragraph 63(f) of SFAS 140 and in paragraph 2(b) of the Exposure Draft could be misinterpreted to imply that a servicing asset exists anytime servicing revenues exceed 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. We believe the Board should clarify these sections to be consistent with the definition provided in the glossary.

Clarify the Irrevocable Election for Subsequent Measurement

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.

Transition for Securities Classified as Available-for-Sale

Instead of hedging the risk of fluctuations in fair value for servicing rights using derivatives, some entities use securities, often mortgage backed securities, classified as available for sale to offset the income statement impact of changes in fair value of servicing assets and liabilities. As noted, the Board decided not to provide a transition provision that would permit a one-time reclassification of securities from the available-for-sale category to trading without calling into question an entity's classification of such securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

The ability to elect to fair value categories of servicing is a significant change that will impact risk management strategies. 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.

We believe this one-time transfer could be provided as part of the transition provisions without the need for a specific justification/linkage into the risk management approach used. The Board could also consider expanding this to benefit entities that desired to reclassify securities to the trading category for other reasons, including after consideration of the finalization of the other than temporary impairment guidance related to the previously issued EITF 03-1 as provided in FAS FSP 115-1. We view the trading category as a more meaningful presentation and believe concerns that the Board may have about "gamesmanship" around such transfers could be alleviated through additional disclosure and the one-time nature of the change.

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We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst + Young LLP