



LETTER OF COMMENT NO. 40



VIA Electronic Mail

March 7, 2007

Mr. Lawrence W. Smith
Director
Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: 1510-100

Dear Mr. Smith:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the proposed Statement, *Disclosures about Derivative Instruments and Hedging Activities*. The proposed Statement would expand entities' financial statement disclosure requirements to include information about how they use and account for derivatives, and how the derivatives affect their statements of financial position, results of operations, and cash flows. As mortgage banking companies use derivatives primarily to hedge the price risk associated with producing loans for delivery to investors in the secondary market, our comments focus on the implications of the proposed Statement to their loan hedging activities.

MBA Position

The MBA supports the Board's efforts to increase readers' understanding of how and why an entity uses derivatives, and how the derivatives affect the entity's financial statements. MBA believes, however, that certain changes must be made to the proposed tabular disclosures to ensure that mortgage banking companies could provide the required information and that readers would derive the most benefit from the information. MBA also believes that the effective date of the proposed Statement should

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.

be delayed for one year to years ending on or after December 15, 2008, to give entities the opportunity to determine how new Statements 157, *Fair Value Measurements*, and 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, will affect the measurements of their derivatives and hedged items for disclosure purposes before the proposed Statement goes into effect.

MBA's position on the proposed Statement is described below in response to questions for which the Board solicited responses.

MBA Responses

Issue 3: This proposed Statement would require an entity to provide information on derivative instruments (including, but not limited to, notional amounts and fair value amounts), hedged items, and related gains and losses, by primary underlying risk, accounting designation, and purpose in the tabular format shown in Appendix A.

Do you foresee any significant operational concerns or constraints in compiling the information in the format required by this proposed Statement? Are there any alternative formats of presentation that would provide the data more concisely?

MBA Response: If the sample disclosure on page 15 of the proposed Statement is to be relied upon as illustrative of the required tabular disclosures,² gains and losses on derivatives would have to be displayed separately according to whether the derivatives are in asset/liability positions at year-end. Further, gains and losses on derivatives in open positions would have to be linked to the gains and losses on the hedged items to which they relate. Additionally, aggregate gains and losses on derivatives that were closed during the year would have to be displayed with aggregate gains and losses on related hedged items that are no longer held or are no longer in designated hedging relationships.

According to several large MBA members, it would be practically impossible for them to segregate the gains and losses reported on their hedging activities in the manner suggested above. More specifically, given the nature of their loan hedging activities, they would simply *be unable* to segregate periodic gains and losses on derivative instruments into open and closed positions, and further into open asset/liability positions for the purpose of (1) linking gains and losses on open asset/liability positions to gains and losses on specific hedged items at year-end, and (2) linking gains and losses on closed positions to gains and losses on specific hedged items that existed earlier in the year or that are no longer in designated hedge relationships at year-end. Moreover, mortgage companies do not have the systems capabilities to identify and track gains and losses in the manner proposed.

Unlike the static hedging relationships described in the examples in the proposed Statement, mortgage banking companies by necessity employ highly dynamic hedging

² While the guidance in paragraph 3.b. of the proposed Statement does not explicitly require derivatives in open positions to be displayed as separate assets and liabilities, the sample tabular disclosure on page 15 suggests that they should be broken out. Although it is not entirely clear, the break-out of open derivative positions into asset and liability positions is suggested also by guidance in that paragraph (i.e., the proposed new paragraph 44.C.d. of Statement 133) that would permit gains and losses on *only* closed positions to be presented on an aggregate basis (presumably on a net basis).

practices to protect themselves from the risk of delivering loans to investors in the secondary market at a loss. Because a mortgage company on any given day may have *tens of thousands* of (1) interest rate lock commitments (IRLC), (2) purchase loan commitments,³ and (3) loans in its hedged loan portfolio (i.e., its loan "pipeline"), its derivative holdings would be correspondingly very large. The combination of large volumes of derivatives, and hedged IRLCs, purchase commitments, and loans necessitates an extremely 'hands-on' hedging process involving near constant monitoring of risk exposures, and frequent rebalancing of hedge relationships to ensure that a company is effectively protected against loss at all times because the population of loans and IRLCs and purchase commitments is changing constantly.

This hedging process involves frequent allocations of derivatives or groups of derivatives to IRLCs, purchase commitments, and loans (with derivatives allocated to loans designated as Statement 133 hedge instruments). Although the frequency with which companies' hedge positions are rebalanced varies by company, it is fairly common practice among the largest mortgage companies for this allocation process to occur on a daily basis using highly sophisticated methods. Smaller companies may employ similar rebalancing techniques but on a less frequent basis using their own, internally developed procedures.

Nevertheless, under all scenarios, a derivative, or a portion of a derivative, that may be economically hedging an IRLC or purchase commitment on one day may be designated as a Statement 133 fair value hedge (or cash flow hedge of the forecasted sale) of a loan on another day during the same reporting period. On any given day, a single derivative may be allocated between a fair value hedge of a loan and an economic hedge of an IRLC or a purchase commitment. Additionally, derivatives that are assets one day can convert to liabilities the next day, such that any distinction between derivative assets and derivative liabilities within the context of a mortgage company's hedging operations is very transient, and therefore not meaningful. Also, designated hedged items at the end of a reporting period may have been designated as of that date, whereas the related derivative could have been a designated hedging instrument throughout the reporting period.

These considerations in combination with mortgage companies' current systems constraints make the proposed tabular disclosures on gains and losses operationally infeasible. As an alternative, MBA would like to propose that for both the Fair Value and Cash Flow sections of the table the:

- Line item titled "Positions no longer open at period end" be deleted;
- Column titled "Amount of Gain/Loss Recognized on Derivative" be changed to make the word "Derivative" plural such that the aggregate gains and losses on all derivatives for the period would be captured in one box (i.e., not broken out by derivative asset/liability positions), including gains and losses on open/closed positions;

³ Pursuant to the guidance in Statement 133, commitments to originate or purchase loans that will be held for sale and that otherwise meet the definition of a derivative in paragraph 6 of Statement 133 are required to be accounted for as derivatives.

- Column titled "Amount of Gain/Loss on Hedged Item Recognized in Income Attributable to the Hedged Risk" be changed to make "Item" plural such that the aggregate gains or losses on all hedged items would be captured in one box (i.e., not broken out by derivative asset/liability positions) for the period, including gains and losses on existing/non-existing hedged items.

In addition to making the disclosures practical to provide, MBA believes the above changes would make the resulting disclosures more meaningful to readers of mortgage companies' financial statements. More specifically, MBA believes readers would benefit most from knowing how the net gains/losses on all derivatives for the period compared to the net gains/losses on all hedged items. The difference would give the reader a better sense of the purpose for which a mortgage company uses derivatives, including the extent to which the derivatives were effective in offsetting the risks hedged, than would be true under the more discrete disclosures in the proposed Statement.

Consequently, MBA strongly recommends that the Board amend the proposed tabular disclosure to remove any requirement that gains and losses be segregated by open and closed positions, and then by open asset and liability derivative positions, and then tracked to existing and non-existing (or undesignated) hedged items.

Issue 5: This proposed Statement would require disclosure of notional amounts in tables that also will include fair values of derivative instruments by primary underlying risk, accounting designation, and purpose. Do you agree that this proposed Statement should require the disclosure of notional amounts? Why or why not?

MBA Response: MBA does not believe notional amounts should be disclosed in the tables because gross notional amounts do not necessarily represent the net risk. As an example, a company may enter into a long forward contract as a hedge and then pair out of it by entering into a short forward contract. In that case, the notional should be shown as the sum of these two contracts because the cash has not been settled yet for either contract, so technically they are both still open positions, but really we have no further P&L exposure because they completely offset one other. Consequently, the notional disclosures are not meaningful, especially for dynamic hedging strategies involving constant buying and selling of positions. Furthermore, notional amounts that are unrelated to specific derivative instruments are meaningless.

Issue 6: Do you agree that this proposed Statement should not require the disclosure of the aggregate notional amounts related to derivatives that no longer exist at the end of the reporting period? Why or why not?

MBA Response: MBA believes that disclosing notional amounts on positions that are no longer open definitely would not be meaningful to a reader.

Issue 8: Should additional information about an entity's overall risk management strategies be provided as part of the tabular disclosure required by this proposed Statement?

MBA Response: MBA agrees that the proposed Statement should NOT require disclosure of risks that are not hedged under Statement 133. MBA agrees with the Board that an expansion of the scope of the proposed Statement to include economic

Mr. Lawrence W. Smith
March 7, 2007
Page 5

hedging relationships would involve a long-term project. More importantly, an expansion of the scope of the Statement for this purpose would negate a main benefit of measuring instruments at fair value under new Statement 159, which would be to eliminate the need for entities to capture and report this type of information on an ongoing basis.

Issue 11: The Board's goal is to issue a final Statement by June 30, 2007. The proposed effective date would be for fiscal years and interim periods beginning after December 15, 2007. At initial adoption, comparative disclosures for earlier periods presented would be encouraged, but not required. Beginning in the year after initial adoption, comparative disclosures for earlier periods presented would be required.

MBA Response: MBA believes the Board should delay the effective date of the proposed Statement by one year to years ending on or after December 15, 2008. Recently released Statements 157 and 159 will consume many of the same resources that would be needed to provide the disclosures in the proposed Statement. Moreover, Statement 157 may impact the measurement of derivatives. By year-end 2008, the earlier Statements will be well in place and many of the implementation issues related to them will have been addressed. On the other hand, if the effective date of the proposed Statement is not delayed, the information disclosed at December 31, 2007 might change significantly upon adoption of those Statements and it could put the proper implementation of those Statements at risk. Moreover, it is important to note that hedging strategies and the use of derivatives will change significantly upon adoption of Statement 159.

MBA also strongly recommends that the Board reconsider how the proposed disclosures might interact with the disclosures in Statements 157 and 159 to ensure that the final outcome is a well integrated package of disclosures.

Conclusion

MBA supports the Board's efforts to improve financial statement readers' understanding of how entities use and account for derivatives but believes some of the proposed tabular disclosures must be changed to ensure mortgage banking companies could comply with them.

MBA appreciates the opportunity to share these comments with the Board. Any questions about MBA's comments should be directed to Alison Utermohlen, Senior Director and Staff Representative to MBA's Financial Management Committee, at (202) 557-2864 or autermohlen@mortgagebankers.org.

Most sincerely,



Jonathan L. Kempner
President and Chief Executive Officer