

Letter of Comment No: 4/ File Reference: 1200-001 Date Received: 07/3//03

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July 31, 2003

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1200-001: Exposure Draft on Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

Dear Ms. Bielstein:

Washington Mutual would like to take this opportunity to comment on the Exposure Draft ("ED") referenced above. Based on our consolidated assets at December 31, 2002, Washington Mutual, Inc. ("WaMu") was the largest thrift holding company in the United States and the seventh largest among all U.S. bank and thrift holding companies. WaMu actively sells mortgage loans and servicing rights in securitization transactions and retains servicing responsibilities as well as senior and subordinated interests. In 2002, WaMu was the largest servicer and second largest originator of mortgage loans in the nation.

We understand that one of the FASB's main objectives in developing the ED was to make qualification for Qualifying Special Purpose Entity ("QSPE") status a higher hurdle and further clarify the isolation criteria for transferred assets. We believe that the objective of these proposed amendments is to eliminate QSPE qualification for a limited number of transaction types where control is effectively maintained and/or significant risks and rewards are retained by the transferor, its affiliates or agents. By virtue of achieving QSPE status, these transactions currently are exempt from the accounting prescribed under FIN 46, Consolidation of Variable Interest Entities, due to a scope exclusion.

Although we recognize the importance of prohibiting certain structures from circumventing the accounting prescribed under FIN 46, we are concerned about the Board's seemingly broad approach to amending SFAS 140. In its current form, the ED would impact many more transaction types than we believe were originally intended.

We believe the ED would impact the existing structure of many common transactions using QSPEs, resulting in higher costs to the mortgage banking industry, with no notable benefits to users of financial statements. As a result, a large number of transactions common to the industry would fail to meet the new QSPE criteria even though the transferor does not maintain control or retain the risks and rewards of ownership over the transferred assets.

Consequently, we believe that the FASB's approach in the current ED would result in a greater than intended impact to the mortgage banking industry, thereby leading to significant collateral damage and hidden costs, with no demonstrated improvement in financial statements. We also believe that the FASB's goals could be achieved and its efforts better directed by narrowing the focus of the proposed amendment, providing requirements specific to certain deal characteristics while additionally providing scope exceptions for others.

I. Executive Summary

We have a number of comments on the ED, which are covered in the remainder of this letter as follows:

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Unintended Impacts and Hidden Costs

We believe that the ED could impact members of the mortgage banking industry in several unintended ways, thus leading to significant costs and unnecessary burdens if the ED is adopted as drafted. Mortgage companies use securitization transactions for liquidity purposes and to improve operational efficiency, thereby reducing the ultimate cost passed down to mortgage consumers. Securitization transactions are not necessarily used for the purpose of issuing a guarantee or maintaining effective control over the transferred assets. In many instances, the ED would either force companies using SPEs that effectively transfer control over the transferred assets to apply FIN 46 or continue to account for the loans as owned assets, thereby increasing operating costs and reducing liquidity. This would have a detrimental impact on the residential

mortgage industry as well as other industries that utilize the capital markets for liquidity purposes.

As drafted, the ED would also prohibit certain activities that do not truly jeopardize asset isolation since these activities do not enable the transferor to maintain effective control over the transferred assets. Many of these activities such as normal representations, warranties and indemnifications thereof are normal industry practices used to demonstrate due diligence, minimize transaction costs and add market liquidity and do not provide any form of credit enhancement. Unless modified and clarified the ED could render SPEs with such standard industry terms as being deemed non-qualified.

Summary of Recommendations

- 1. Clearly carve-out specific areas and functions from inclusion in the ED such as:
 - a. Standard representations, warranties and indemnifications thereof
 - b. Certain types of standard servicing advances or functions
 - c. Pre-funding and spread accounts
 - d. Certain two step transactions lacking a QSPE
- 2. Provide clarification on current ED terminology to more clearly illustrate application:
 - a. Agent
 - b. Equity security
 - c. Re-issuance
- See Appendix A for submission regarding fair value accounting for mortgage servicing rights.

II. Limits on Continued Involvement and Legal Isolation by Transferors, Affiliates and Agents

<u>Indemnification Provisions for Breaches of Normal Reps and Warranties and Other Customary Commercial Terms</u>

The ED adds paragraph 35(e) to SFAS 140. This new paragraph states that a QSPE "may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77-79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its Beneficial Interest Holders ("BIHs"). That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE" (emphasis added). The general blanket coverage of paragraph 35(e) raises concerns as to the FASB's intended approach in limiting continued involvement by the transferor. Although this paragraph has been drafted using a generalized tone, we believe the FASB's intent for this requirement is to only eliminate specific types of

continued involvement, such as forms of credit guarantees and mechanisms that cause the transferor to retain effective control.

The lack of specificity in paragraph 35(e) could call into question whether the transferor's responsibility to repurchases loans failing to meet certain specified qualities (at the time of sale) and documentation requirements under standard representations and warranties could deem an SPE non-qualifying under the new standard. Without clarification, such responsibilities could be deemed *financial guarantees* even though the transferor does not provide credit guarantees or maintain control over the transferred assets as a result of those stipulated responsibilities.

It is commonly known throughout the mortgage banking industry that standard industry representations, warranties, covenants and remedies are provided to ensure adherence to agreed upon underwriting guidelines. The typical remedy for a breach of representations, warranties, covenants and remedies is for the transferor to either replace the defective collateral with collateral that meets these contractual provisions or repurchase the defective collateral. It should be noted that these provisions are not intended to guarantee the credit standing of the loans, which is an element outside of the control of the transferor. Further, the terms of these representations, warranties and remedies is specified at the closing of a transaction so there is no decision making required subsequent to the transfer. If the FASB were to disallow these types of deal features involving OSPEs both market liquidity and transaction efficiency would be reduced, thereby negatively impacting the mortgage banking industry. If such terms were to prohibit an SPE from being a QSPE the likely result would be nearly 100% due diligence reviews by purchasers on the collateral, resulting in exorbitant operating costs with no significant benefits.

Typically, a 10-30% due diligence review is performed by investors on normal industry loan sales and securitizations. If 100% due diligence was required by investors (as a result of there not being representations and warranties), WaMu would need additional employees to manage the process, additional space for expanded due diligence team reviews, and additional shipping costs for loan file transfers. More rigorous examinations would drive up the costs to both WaMu and its counterparties (at least \$13 million annually), without a demonstrated improvement in the quality of the financial statements or the underwriting process. Counterparties would certainly attempt to pass these costs along to WaMu, which would ultimately affect product pricing.

With respect to rated mortgage-backed security offerings, the rating agencies are likely to increase subordination levels in the event that the proposed accounting rules are accepted, since the risks ordinarily retained by the depositor or other parties for the defects typically covered by the mortgage loan representations and warranties will be borne by the trusts established in connection with the securitizations. Higher subordination levels result in a greater allocation of the principal balance of deals to the

subordinate classes. Subordinate classes are sold at lower prices than senior classes and, therefore, the overall pricing of securities offerings will be adversely affected.

It is recommended that the FASB clarify paragraph 35(e) to note that normal representations, warranties and indemnifications thereof (i.e. those used to clarify specified loan characteristics and documentation requirements at the time of sale, etc.) should not by themselves prohibit an SPE from being a QSPE. Such a clarification also would be consistent with the Federal Bank regulators' risk-based capital rules, which exclude from the definition of recourse any industry standard representations and warranties that are not meant to serve as credit guarantees when determining whether sales criteria has been met.

Servicing Advances

If adopted as written, the ED would prohibit a OSPE from permitting certain forms of servicing advances that are part of the mortgage banking industry's normal servicing function. These advances, defined by well established parameters that are known at the close of a transaction, are used by the servicer to maintain operational efficiency and not for the transferor to retain a form of effective control over the transferred assets. Paragraph 35(e) of the current ED states that a QSPE "may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77-79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its BIHs. That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE" (emphasis added). As drafted, paragraph 35(e) raises concerns as to the FASB's intended approach in limiting continued involvement by the transferor, who in many cases is also the servicer. Although this paragraph has been drafted using a general tone, we believe that the FASB's intent for this requirement was to eliminate those forms of continued involvement that result in the transferor providing liquidity commitments or financial guarantees that result in credit enhancement or maintaining effective control.

Note that footnote (*) to paragraph 35(e) reads "this prohibition does not include a commitment for servicing advances if the servicer can choose not to make the advance if it believes recovery of the advance from collections on the assets of the SPE is in doubt" (emphasis added). This scope exception would include many of the mortgage banking industry's types of normal servicing advances, however, other normal types of advances, such as compensating interest (as described below), would not be covered under this scope exception since the servicer is required to make an advance under the servicing agreement in those cases.

Compensating Interest: Upon prepayment of a loan, a servicer may be required to advance a full 30 days interest, this requirement is known as compensating interest. It is true that the servicer is required to advance funds, however, this advance is compensated for via additional float from which the servicer benefits as the pay-off is

held until the next remittance cycle. The servicing industry has adopted this practice as a way to ease operational burden, which allows for less frequent remittance cycles. As such, the industry views this as a normal servicing function. Prohibition under the ED would therefore prove counterproductive, as compensating interest is part of the normal servicing function and is not used by the transferor as a means of providing a financial guarantee, liquidity commitment or retaining effective control over the transferred assets. Eliminating such arrangements would provide no additional benefit to users of financial statements.

Other Types of Advances: For other common types of servicing advances (i.e. Ginnie Mae, FHLB, sales of loans under the Ginnie Mae Early Buyout Program, etc.) certain amounts (e.g. first two months of interest or certain foreclosure losses for Ginnie Mae servicing) may not be ultimately reimbursable. These normal servicing advances are used for the purpose of easing operational burden to the servicer and are not intended to cover credit losses or provide the transferor with a form of effective control over transferred assets. These advances facilitate liquidity in the marketplace and benefit all industry participants. Eliminating such arrangements would provide no additional benefit to users of financial statements.

As drafted, the aforementioned advances would be considered forms of liquidity commitments under the proposed amendment. The prohibition of liquidity commitments is contrary to SFAS 140, which allows for certain forms of continued involvement by the transferor, to the extent that involvement is not in the form of a credit guarantee. Servicing advances where the servicer is required to make an advance (outside of the servicer's control) are typically used for purposes of maintaining operational efficiency and not to provide financial guarantees, therefore they do not appear to violate the basic principles of SFAS 140. Accordingly, paragraph 35(e) should contain a scope exception for these common servicing advances used in the mortgage banking industry.

Written Options

If adopted as written, the ED would prohibit certain forms of written options that are part of the mortgage banking industry's normal transactions and servicing function (e.g. the requirement that loans more than 90 days past due be put back to the transferor or servicer). Paragraph 35(e) of the current ED states that a QSPE "may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77–79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its BIHs. That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE" (emphasis added). Paragraph 35(e) raises concerns as to the FASB's intended approach in limiting continued involvement by the transferor. Although that paragraph is unclear we believe that the FASB's intent was to eliminate any forms of continued involvement over the transferred assets that

constitute a credit guarantee by the transferor or cause the transferor to maintain effective control.

We believe that the prohibition against written options is contrary to the original guidance in SFAS 140, which allows for certain forms of continued involvement by the transferor, to the extent that such involvement does not result in the transferor retaining control over the transferred assets. For example, under SFAS 140 paragraph 9(c), calls (other than conditional calls) are prohibited for assets to be deemed transferred. Puts that do not interfere with legal isolation are, however, allowed under SFAS 140. Forms of recourse outside of the transferor's control, for example, where the transferor is short a put, do not appear to violate the basic principles of control or legal isolation under SFAS 140. Accordingly, paragraph 35(e) should exclude written options from its scope.

Pre-Funding and Spread Accounts

Paragraph 35(e) of the current ED states that a QSPE "may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77–79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its BIHs. That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE" (emphasis added). Providing a scope exception for forward contracts used in a revolving period securitization is consistent with the notion that the FASB intended to exclude arrangements where the transferor does not maintain effective control over assets that have previously been transferred.

If adopted as written, it is unclear whether the ED would prohibit pre-funding arrangements in a QSPE, as these arrangements are not revolving period securitizations. A pre-funding arrangement is where an SPE issues securities to investors and any excess (e.g. the extent to which the net transaction proceeds exceed the purchase amount or cost of the acquired loans) on the closing date are held in a pre-funding account. The excess proceeds, which remain in the trust, are applied from time-to-time thereafter to pay for subsequent transfers of assets from the transferor. In addition, some non-revolving securitizations may use a spread account as an additional credit enhancement that is funded from time-to-time with excess cash flows from the assets in the trust (rather than full funding at transaction inception).

We do not believe that pre-funding or spread account arrangements should be prohibited by the ED since these arrangements are not used by the transferor to maintain effective control over any of the transferred assets. This is evidenced by the fact that the transferor relinquishes control over these assets at the point of transfer into the trust. Up until the point where assets are transferred into a trust using a prefunding arrangement, such assets remain on the books of the transferor. In addition, these arrangements do not involve discretion on behalf of the QSPE, but instead serve to minimize transaction costs (e.g. hedging costs). While it is true that the transferor

has the option to transfer loans into a pre-funding account, that option does not serve as a form of a credit enhancement over the transferred assets. In the event that those excess proceeds are not fully utilized to acquire additional assets a principal distribution is made back to the investors. Prohibiting these arrangements would eliminate a commonly used transaction feature without demonstrating any benefits to investors or financial statement users. Since these arrangements are not used by the transferror to maintain effective control over the transferred assets and these transactions do not involve any discretion on behalf of the QSPE, the amended standard should provide a scope exception for pre-funding and spread account arrangements, similar to that provided for forward contracts in revolving period securitizations.

Requirement that QSPEs be used in transactions involving 2-step transfers

The current draft of the ED amends paragraph 83 of SFAS 140 to state that if the result of a transfer is to issue BIs then a two-step transfer must use a QSPE as the second step for the transfer to qualify for sales treatment. We believe that this proposed amendment contradicts the interpretation provided in Q&A 22A of A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, which seems to allow QSPE qualification:

Q—Assume an entity transfers financial assets to an entity that is not a QSPE. The transferee is significantly limited in its ability to pledge or exchange the transferred assets. The transferor receives cash in return for the transferred assets and has no continuing involvement with the transferred assets –no servicing responsibilities, no participation in future cash flows, no recourse obligations other than standard representations and warranties that the financial assets delivered met the delivery requirements under the arrangements, no further involvement of any kind. Does the transfer meet the requirements of paragraph 9(b) of Statement 140?

A—Yes. For a transfer to fail to meet the requirements of paragraph 9(b) the transferee must be constrained from pledging or exchanging the transferred asset and the transferor must receive more than a trivial benefit as a result of the constraint. As noted in paragraph 166 of Statement 140, "...transferred assets from which the transferor can obtain no further benefits are no longer its assets and should be removed from its statement of financial position."

For transfers to an entity that is not a QSPE after which the transferor does have any continued involvement, an evaluation should be made as to whether the requirements of paragraph 9(b), as explained by paragraphs 29-34 of SFAS 140, have been met. If those requirements are met, sales treatment should be permitted even if neither of the SPEs in the two-step structure are QSPEs. Consequently, we recommend removing the proposed changes to paragraph 83, as the language contradicts paragraph 9(b) of SFAS 140 and O&A 22A, which results in an internal inconsistency within the standard.

III. Clarification of Terminology

Definition of Agent

Paragraph 35(e) of the current ED states that a QSPE "may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77-79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its BIHs. That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE" (emphasis added). When referring to SFAS 140's glossary (Appendix E), an agent is defined as "a party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor."

We believe that the term "agent" is ambiguous and therefore requires further clarification. For example, it is unclear whether an underwriter in a loan securitization would be considered an agent under the ED. We do not believe that this would be the case since the underwriter typically enters into a "take-down" agreement, whereby the underwriter effectively purchases the securities and sells those securities on the secondary market for a commission. As such, the underwriter is acting as a principal to the transaction (on its own behalf) and not as an agent of the transferor. If the underwriter is not deemed an agent, then it becomes clear that the underwriter could enter into derivative contracts with the QSPE without violating the rules of the ED.

If the underwriter to transactions were to be deemed an agent this would result in lower execution pricing as there would be fewer parties available to serve as the counterparty to derivative contracts involving the QSPE. We recommend that the FASB clarify in the ED that underwriters to a transaction are excluded from the paragraph 35(e) "agent" definition.

Equity Securities

Paragraph 35(c.1) is revised by the current ED to state that a QSPE may hold only "financial assets transferred to it that are <u>not equity instruments and that are passive</u> in nature (paragraph 39)" (emphasis added). To prevent misinterpretation we recommend that the ED refer to the definition of equity instruments in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

Re-issuances

Paragraph 35(f), which has been added under the current ED, imposes limitations if a transaction is a "re-issuance" of BIs. To prevent misinterpretation we recommend that the ED define "re-issuance" under Appendix E when modifying SFAS 140. We would like the definition to state that a "re-issuance" does not include a situation such as a re-

marketing event, whereby existing BIs are purchased at an auction and reissued on the secondary market.

IV. Transitional Rules

Paragraph 12 of the ED states "public entities (i.e. WaMu) shall apply this Statement prospectively to transfers occurring after the beginning of the first interim period after the issuance of the final Statement." If the ED were to be accepted as drafted we believe that there should be an additional year of transition time. In that case, the required transition activities would cause all industry participants to incur significant operational changes and costs, such as changing various servicing functions and the structure of future deals.

V. Conclusion

We appreciate the opportunity to provide the foregoing comments in response to the ED. We continue to be available for further discussions and assistance in identifying real-life examples for the Board to use as a "field test" of its conclusions.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact Rob Miles, Corporate Controller at 206.377.5957; Larry Gee, Deputy Controller at 206.377.3684; or Marc Malone, Financial Accounting Controller of the Mortgage Banking Group at 206.490.1349.

Please see Appendix A for additional comments submitted to the FASB.

Very truly yours,

Robert H. Miles Senior Vice President and Controller

Appendix A

Fair Value Accounting for Mortgage Servicing Rights

We would like to take this opportunity to raise another concern related to the accounting promulgated under SFAS 140. We are aware of the FASB's ongoing movement towards a fair value accounting model. As such, we are submitting a request for the FASB to consider requiring fair value accounting for mortgage servicing rights ("MSRs") as part of its SFAS 140 amendment.

I. Executive Summary

We have a number of comments on this suggested movement towards fair value, provided in the following order:

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Due to consolidation in the financial services industry and the desire to benefit from economies of scale, most mortgage loan servicing is performed by the largest mortgage loan industry players. These servicers report significant MSR assets on their balance sheet, the value of those assets being very sensitive to changes in economic conditions As such, most servicers economically hedge their MSR and other risk factors. positions as a way to reduce their overall economic risk. The decision to hedge the MSR asset is a critical decision and will not change regardless of accounting implications; however, the current accounting rules essentially penalize companies for making the prudent economical decision to hedge their MSR assets. Under existing literature, SFAS 140 prohibits recognition of increases in the fair value of MSR assets above the carrying amount, as SFAS 140 requires that MSR assets be reported on the balance sheet at the lower of cost or market value ("LOCOM"). SFAS 133. Accounting for Derivative Instruments and Hedging Activities, requires derivatives, which are used to hedge the MSR asset, be reported on the balance sheet at their fair market value. As a result, changes in the fair value of the MSR asset and the derivative create an asymmetry in the income statement treatment (assuming a rising interest rate environment, where increases in the fair value of the MSR asset are beyond the carrying amount).

Benefits of Fair Value Accounting for MSRs

- 1. Improved financial statements as investors will have better tools (i.e. fair value measurement) to assess a company's performance and valuation.
- 2. Elimination of the inherent asymmetry in the income statement between MSR assets and the respective hedge instruments will reduce operational costs and burdens. Seeking hedge accounting treatment under SFAS 133 results in significant operational costs and burdens for industry participants with no real benefit (that could not be derived from our proposed solution) notable to users of financial statements.

Summary of Recommendations

- Adopt fair value accounting for MSRs, with changes in fair value reflected currently in earnings.
- 2. Prospective transition, consistent with the effective date of the ED.

II. Current Accounting and Related Guidance

Definition and Current Guidance

Servicing rights are contracts to service loans, receivables, or other financial assets under which the servicer is obligated to perform specific administrative functions and is compensated with contractually specified servicing fees. Servicing rights are recognized as distinct assets or liabilities only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or when separately purchased or acquired. SFAS 140 requires that any impairment of servicing assets, which is the amount by which the carrying amount of the servicing assets for an individual stratum exceeds their fair value, must be recognized in current earnings. However, an increase in the fair value over the carrying amount of servicing assets for an individual stratum may not be recognized in current earnings.

Related Guidance and Difficulties in Hedging MSRs and Achieving Hedge Accounting under SFAS 133

In March 2001, the FASB issued as cleared guidance SFAS 133 Implementation Issue F8, Fair Value Hedges: Hedging Mortgage Servicing Right Assets Using Preset Hedge Coverage Ratios ("DIG Issue F8"). DIG Issue F8 noted the following regarding the difficulties of hedging MSRs:

a. Mortgage banking companies may wish to use hedge accounting of MSRs because of the asymmetrical accounting between servicing assets and the related derivatives. That is, because MSRs are measured at LOCOM, companies are not able to achieve substantial offset in earnings of gains and losses of servicing assets and a forward contract when economically hedging those assets with forward contracts unless special hedge accounting could be applied. Absent the application of hedge accounting, a decrease in the fair value of the MSR below its carrying amount will be recognized in current earnings as an impairment charge and the increase in the fair value of a derivative functioning as an economic hedge is available to offset some or all of that impairment charge. However, in accordance with SFAS 140, an increase in the fair value of the MSR above its carrying amount is not recorded in earnings, while the corresponding decrease in the fair value of the derivative would be recognized in current earnings.

b. DIG Issue F8 discusses the difficulty in meeting the requirements to apply fair value hedge accounting. The fair values of MSRs do not change in a linear fashion as interest rates increase or decrease. MSR fair values are most significantly impacted by changes in interest rates and the corresponding effect of those changes on prepayment speed estimates and other interest-rate-based assumptions. Decreases in interest rates generally increase prepayment speed estimates on the underlying loans, which reduces the expected cash flows to be received over the life of the MSR and in turn reduces the MSRs fair value (increases in interest rates have the opposite effect). However, when interest rates fall, prepayment speeds increase at a faster pace than they decrease when interest rates rise. When interest rates decrease, prepayment speeds accelerate until they reach a certain threshold, beyond which they accelerate at a slower pace. Therefore, the effect of changes in interest rates on the fair value of MSRs could be significantly different depending upon the extent of the movement in interest rates because of the asymmetrical rate of prepayment and because they lose value at a faster pace when rates fall than they gain when rates rise (that is, they exhibit negative convexity). As a result, if required to establish a single hedge coverage ratio over a time horizon of any length, companies may be unable to establish at the inception of the hedging relationship that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk across the entire yield curve, and, as such, the hedging relationship may not be able to qualify for fair value hedge accounting under SFAS 133.

c. DIG Issue F8 noted that "companies that service certain types of financial assets may wish to designate as the hedged item in a fair value hedge a pre-specified percentage of the total change in fair value of those servicing rights (attributable to the hedged risk) that varies based on changes in a specified independent variable. Because the percentage for each specified independent variable can be presented in a rectangular array that method of determining the hedged item retroactively based on the actual independent variable is sometime referred to as the matrix method." F8 concluded that "in a fair value hedge of a portion of a recognized servicing right asset, a company may not designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset and then determining at the end of the assessment period what specific percentage of the servicing right asset is the actual hedged item for that period based on the change in a specified independent

variable during that period. Thus, the matrix method would not be a valid application of the provisions of Statement 133."

In November 2000, concurrent with the FASB staff reaching the conclusions in DIG Issue F8, but prior to issuing cleared guidance, the FASB staff sent a letter to members of the DIG noting the following:

Board members and staff are concerned about the difficulties associated with hedging servicing assets in light of the above conclusion. As an outgrowth of the discussions of that issue, the Board intends to consider adding a limited-scope project to its technical agenda that would require measurement of all servicing assets currently accounted for in accordance with paragraphs 13 and 63 of SFAS 140 at fair value, with changes in value recognized currently in earnings. A fair value measurement model for recognized servicing assets would eliminate the need for hedge accounting under SFAS 133 because it would provide the same measurement and income recognition for both those assets and the derivative instruments used to hedge them. The Board intends to consider adding that project to its technical agenda at a public Board meeting in the near term.

Meanwhile, DIG Agenda Item 15-8, Hedging-General: Separation of Risks in an Embedded Prepayment Option, was added to the agenda for the March 15, 2001 DIG meeting. Agenda Item 15-8 was drafted as a FASB Staff Tentative Conclusion to Inquiry (i.e., there were no opposing views presented in the Agenda Item write-up). Agenda Item 15-8 noted the difficulty in identifying the changes in fair value of MSRs due solely to changes in benchmark interest rates. MSRs themselves do not have an embedded prepayment option, but the loans they relate to do have an embedded prepayment option. The exercise of this option will affect the value of the MSRs that are being hedged. The exercise of a mortgage's prepayment option may be affected by changes in interest rates, but the exercise often is in response to events that are not directly related to interest rates (such as equity build-up in underlying properties, death, divorce, and transfers).

The question posed in Agenda Item 15-8 was whether the analysis of the changes in fair value of MSRs due to changes in the benchmark interest rate could exclude prepayments that were not a result of interest rate changes. The tentative conclusion of the FASB Staff proposed for DIG concurrence was that "when measuring ineffectiveness in a fair value hedge of MSRs for the risk of changes attributable to the designated benchmark interest rate, an entity cannot exclude an estimated effect of changes in prepayments of the mortgage loans underlying the MSRs that are not attributable to changes in the benchmark interest rate."

Results

The complications noted above, which make the application of SFAS 133 hedge accounting for MSRs extremely challenging, make it imperative that the Board address the issue of accounting for MSRs. If MSRs were accounted for in the manner we have

proposed in this comment letter, financial statements would more accurately reflect the performance and value of the company and the burdens of achieving hedge accounting under SFAS 133 could be avoided.

III. Benefits of Fair Value Accounting for MSRs and Recommendations

MSRs should be recorded at fair value, with changes in fair value recognized currently in earnings

Financial statement users would benefit as this would result in a clearer picture of the performance and value of the company. This is evidenced as follows:

- a. LOCOM accounting is not evenhanded: The current requirement to use LOCOM for MSRs is not evenhanded because it recognizes the net diminution in value but not the net appreciation in the value of those assets.
- b. Greater relevance of fair value information: Most people believe that fair value information is more relevant than cost (or LOCOM) information in helping users and others assess the effect of current economic events on the enterprise.

As noted above, there are significant complications that make the application of SFAS 133 hedge accounting for MSRs extremely challenging. These issues center on the application of SFAS 133 and do not affect the economics of the hedge or the actual industry practice being utilized. Being unable to achieve hedge accounting under SFAS 133 only hurts industry participants and results in critical accounting issues. In summary, the implications of being unable to achieve hedge accounting for MSRs are too severe and the proposed solution would allow for similar accounting effects without incurring such significant costs.

MSRs are similar to interest-only ("IO") strips, which are accounted for as financial assets subject to the SFAS 115, Accounting for Certain Investments in Debt and Equity Securities, definition of equity securities and are marked-to-market. We believe that the best reflection of a company's performance would result from including changes in fair value in earnings.

As noted above, the FASB staff letter (regarding the difficulties associated with hedging servicing assets) to the DIG members appears to favor accounting for MSRs at fair value, with changes in fair value recognized currently in earnings. This proposal is asking the FASB to consider acceleration of that decision.

IV. Transition Rules

We propose that fair value accounting for MSRs be applied prospectively with a reported cumulative effect of change in accounting principle. Upon adoption, all MSRs should be marked-to-market.

V. Conclusion

For the reasons noted above, we believe that the most appropriate accounting treatment for MSRs is for them to be reflected at fair value, with changes in fair value reflected currently in earnings.