November 14, 2012

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Project: Financial Instruments: Classification and Measurement

Dear Ms. Cosper:

The following are comments from the Mortgage Bankers Association\(^1\) (MBA) on the recent tentative decision made on October 17, 2012 when the Financial Accounting Standards Board (FASB) voted to adopt International Financial Reporting Standards No. 9 (IFRS 9) application guidance related to contractually linked instruments (structured securities). IFRS 9 contains certain conditions where, if present, the instrument would meet the cash flow characteristics of principal and interest in the classification and measurement model. Thus, depending on the business model, the instrument may qualify for measurement at fair value with changes in fair value going through other comprehensive income (OCI) not net income. IFRS 9 states:

B4.1.21 In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

(a) the contractual terms of the tranche being assessed for classification

\(^1\) The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 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 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.
(without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g. the interest rate on the tranche is not linked to a commodity index);

(b) the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and

(c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, this condition would be met if the underlying pool of instruments were to lose 50 per cent as a result of credit losses and under all circumstances the tranche would lose 50 per cent or less).²

Thus, if the range of expected loss for a tranche of a mortgage backed security (MBS) is greater than the weighted average range of expected losses of the underlying pool of mortgages, then that tranche would have to be measured at fair value through the income statement. Otherwise, it could be measured at fair value through OCI.

**Tranches Are Chosen to Meet Investors’ Long-term Investment Needs**

The fact that a securitization has multiple credit risk tranches is not relevant to the accounting for that asset. The use of tranches provides investors with choices of duration, yield and credit risk. Some investors desire a shorter duration and reduced credit risk and are willing to give up some yield. Others desire a longer duration and have more of an appetite for credit risk in order to achieve a higher yield. It doesn’t mean that those investors are not holding the respective tranches for long-term investment.

**Inconsistent With Principle of Accounting Following Business Model**

MBA believes that if a debt financial instrument is not held for trading purposes, it should be eligible to be accounted for at fair value through OCI or at amortized cost, depending on the business purpose of holding the instrument. For assets where the primary objective is to be used for investing purposes that may result in the asset being either held for collection of cash flows or sold at a future date, the asset should be recorded at fair value with changes in fair value reflected in OCI. This should be true regardless of the existence of tranches.

**IFRS 9 Was Written Anticipating a Two-Classification Model, Not a Three-Classification Model**

MBA notes that when IFRS 9 was written, a fair value through OCI classification was not under consideration. The use of paragraph B4.1.21 in IFRS 9 for such transactions is no longer relevant and consistent with a three-bucket classification and measurement regime. MBA notes that the use of structured finance is not prevalent in most overseas

² IFRS 9, paragraph B4.1.21, page A351.
economies, but structured finance is quite developed in the U.S. financial markets. Further, IFRS 9 is inconsistent with the FASB’s current approach in developing classification and measurement criteria. Based on recent Board meetings we understand the classification of instruments should consider both business strategy and cash flow characteristics, and, based on both characteristics, instruments should be classified as carried at amortized cost, fair value through OCI or fair value through net income.

**Existence of Credit Risk Is Not Relevant to Classification and Measurement**

Single tranche securitizations and multiple tranche securitizations all have credit risk. The potential for credit losses should not impact classification and measurement, and credit risk should be dealt with in the impairment portion of the financial instruments project.

Investors invest in different tranches to meet their long-term investment needs. If they expect losses at purchase, they do not buy the securities at par. On an ongoing basis they will evaluate for impairment and take subsequent impairment charges through net income, as appropriate. Both FASB and the International Accounting Standards Board (IASB) believe that there should be one accounting model for debt instruments acquired in whole loan or security form. If a reporting entity buys whole loans at a discount, the accounting is not required to be fair value through net income. If there is truly going to be one accounting model for debt instruments, FASB should not introduce a credit overlay as part of its measurement guidance. Rather, classification and measurement should be part of one integrated model for all debt instruments, and there should be one model for impairment measurement.

**Results in Short-term Volatility of Net Income**

Reporting short-term, unrealized losses through net income on structured securities will result in unnecessary short-term volatility of earnings as gains and losses reverse. A reporting entity’s reported income for the quarter could be dependent on the last Fed announcement, during the final hours or minutes of a quarter. This makes sense for trading account assets but not for assets held for investment.

**Impact on Marketability and Liquidity of Important Asset Class**

Structured securities support a broad range of credit finance including commercial real estate loans; residential mortgage loans that do not qualify for Ginnie Mae, Fannie Mae or Freddie Mac MBS; auto loans, and credit card loans. The proposed accounting rule would adversely impact the marketability and liquidity of this very important asset class because of the potential volatility in net income.

MBA appreciates the opportunity to share its observations with you. Any questions about the information provided herein should be directed to Jim Gross, Vice President
Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Sincerely,

David H. Stevens
President and Chief Executive Officer