LETTER OF COMMENT NO. 5

Via Electronic Mail

May 24, 2007

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7, P. O. Box 5116
Norwalk, CT 06856

Re: MBA Position Paper

Dear Mr. Herz:

The federal banking regulatory agencies recently issued a joint release[1] encouraging financial institutions to work with homeowners who are unable to make their mortgage payments. For example, an institution might modify loan terms, including changing the interest rate from floating to fixed to provide financially-stressed borrowers with predictable payments. The Mortgage Bankers Association[2] prepared the attached position paper entitled "FAS 140 Implications of Restructurings of Certain Securitized Mortgage Loans" to address several key accounting questions raised by these types of loan modifications.

The paper sets forth MBA's positions on the continuing status of securitization trusts as qualifying special-purpose entities (QSPEs) under Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities*, upon the restructurings of certain securitized residential mortgage loans that are widely anticipated to go into default. The paper was developed by MBA members after careful study and consideration of the authoritative accounting literature. Consequently, MBA believes the positions set forth in the paper are theoretically sound.

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[1] See http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070417/default.htm

[2] 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.

MBA welcomes any comments or questions you, or other FASB members or staff, may have regarding our interpretation of the literature as it relates to the types of troubled loan restructurings addressed in the paper. Please direct those questions or comments to Alison Utermohlen, Staff Representative to MBA's Financial Management Committee, at (202) 557-2864 or autermohlen@mortgagebankers.org.

MBA greatly appreciates the opportunity to share our thoughts on important accounting issues with you.

Most sincerely,

John M. Robbins, CMB
Chairman

Attachment

Cc: Conrad Hewitt, Chief Accountant, Securities & Exchange Commission
Zane Blackburn, Chief Accountant, Office of the Comptroller of the Currency
Robert Storch, Chief Accountant, Federal Deposit Insurance Corporation
Charles Holm, Chief Accountant, Federal Reserve Board
Jeffrey Geer, Chief Accountant, Office of Thrift Supervision

Position Paper

FAS 140[1] Implications of Restructurings of Certain Securitized Residential Mortgage Loans

I. Introduction

The Mortgage Bankers Association (MBA) recently considered the continuing status of securitization trusts as qualifying special-purpose entities (QSPEs) in connection with restructurings of certain securitized residential mortgage loans that are widely anticipated to go into default and, ultimately, foreclosure.[2] The project was undertaken in support of Congressional and regulatory efforts to keep borrowers in their homes by encouraging mortgage servicers to restructure loans that are in default or for which default is reasonably foreseeable[3] (hereby troubled loans) unhindered by concerns that such restructurings could adversely affect the qualifying status of the issuing trusts. This paper, therefore, focuses on the proper interpretation and application of the relevant accounting literature, namely the guidance in FAS 140, to restructurings of troubled loans that are held by QSPEs.

As explained in this paper, MBA believes the types of troubled loan restructurings being contemplated by servicers of certain securitized residential loans are 'troubled debt restructurings' pursuant to the authoritative accounting literature.[4] This paper does *not* consider whether restructurings, or modifications, of loans are 'new lending,' which is an activity that would violate QSPE status under FAS 140. Moreover, because 'new lending' is a subject that may be addressed within the Financial Accounting Standards Board's current 'Transfers of Financial Assets Project,' it is not discussed here.

In addition, the positions in this paper are the positions of MBA, and have not been cleared or otherwise approved by any authoritative accounting body. Readers are advised, therefore, to consult with their accountants regarding the proper accounting treatment of restructurings of troubled loans.

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[1] Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities*.

[2] The loans that are most often mentioned as likely to default and go into foreclosure are '2/28 or 3/27" adjustable rate mortgage loans that were originated in the past few years with generally fixed below market rates for the first two or three years, respectively, with adjustments thereafter in relation to designated indices. As the rates on many of these loans are expected to adjust upwards for the first time in coming months, it is anticipated that many borrowers will be unable to make their new mortgage payments.

[3] As used in this paper, a loan is considered in 'default' if the borrower has missed one or more mortgage payments and the loan is not expected to cure. Default is 'reasonably foreseeable' if there has been actual contact with the borrower, an assessment of ability to continue to pay, and a reasonable basis for concluding that the borrower will be unable to continue to make their mortgage payment in the foreseeable future. MBA believes this description is consistent with the general interpretation of the term "reasonably foreseeable default" in the tax law for Real Estate Mortgage Investment Conduits (REMICs).

[4] Therefore, the restructurings addressed in this position paper are not subject to evaluation under EITF Issue Nos. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*, and 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*.

II. MBA Positions

MBA believes restructurings of troubled loans that involve granting concessions to debtors experiencing financial difficulty that the creditors[5] would not otherwise consider are 'troubled debt restructurings' (TDRs) pursuant to the guidance in Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15). As such, MBA believes they are 'restructures or workouts of loans' which are permitted activities of a QSPE based on interpretive guidance in *A Special Report: A Guide to Implementation of Statement 140*.[6] MBA also believes that mortgage servicers' planned activities in connection with these TDRs would be 'significantly limited' and would involve decisions that are 'inherent in servicing' consistent with the other limitations on the activities of a QSPE, as described in more detail below.

III. Background

Under the guidance in Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities* (FAS 140), a holder of a loan may only account for the transfer of that loan to a third party as a sale if the transfer meets certain specified conditions.[7] Those conditions include a requirement that a transfer of a loan to a 'special purpose entity' (SPE) (commonly a trust) in a mortgage securitization transaction typically be a '***qualifying*** special purpose entity' or QSPE. Consequently, if lenders *want to treat transfers of their loans in securitization transactions as sales, the vehicles to which* the loans are transferred *must be QSPEs* unless (1) the transferor does not have ***any*** continuing involvement in the transferred loans, or (2) the SPE has the ability to pledge or exchange the transferred assets[8] and there are no constraints on that ability that provide more than a trivial benefit to the transferor.

If a QSPE ceases to be qualifying because it no longer meets the qualifying conditions in FAS 140, a transferor of the loans to the QSPE would be required to record a 'repurchase' of any remaining previously transferred loans to the QSPE and recognize any liabilities assumed.[9] The effect would be an expansion of the transferor's balance sheet to include loans to which they no longer have legal title and liabilities they are not legally obligated to pay, with negative financial statement and regulatory capital implications for the company.[10] Consequently, if it were determined that restructurings of troubled loans would cause QSPEs to cease to be qualifying, mortgage servicers could be discouraged from restructuring loans that are expected to end up in foreclosure, to the disadvantage of transferors, servicers, investors, borrowers and communities.

IV. Description of QSPE Guidance

The guidance in paragraph 35 of FAS 140 sets forth several conditions which a SPE must meet to qualify as a QSPE, including:

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[5] Restructurings that involve securitized loans are undertaken by servicers acting on behalf of the securitization trust (i.e. the creditor) and its beneficial interest holders. Thus, creditors as used in this paper refer to servicers.
[6] See response to Q28.B. of the Special Report which is included in the attached Appendix.
[7] If those conditions are not met, the transfer must be accounted for as a secured borrowing arrangement.
[8] This would not be met for a SPE that is a Real Estate Mortgage Investment Conduit (or REMIC) under the tax rules.
[9] See paragraph 55 of FAS 140.
[10] For example, repurchasing previously transferred loans could adversely affect the transferors' financial statement ratios rendering them out of compliance with rating agency, creditor and other requirements.

Qualifying SPE

"35.b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interest in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a *majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents*..."

"35.c. It may hold only:
(1) Financial assets transferred to it that are passive in nature..."

"35.d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
(1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them..."

The above guidance, and related guidance (see Appendix), in FAS 140 has raised the following questions:

- Would restructurings of troubled loans that involve granting concessions to debtors experiencing financial difficulty that the creditors would otherwise not consider be *troubled debt restructurings* (TDRs) pursuant to the authoritative literature, and therefore permitted 'restructures or workouts' of loans which are permitted activities for a QSPE (consistent with the response to Q28.B. in the Appendix)?

- If these troubled loan restructurings *are* TDRs, would the activities involved in restructuring the loans, including contacting borrowers to assess probability of default and to initiate conversations regarding restructuring of their loans, be considered 'significantly limited,' consistent with the permitted activities of a QSPE in 35.b.(1)?

- If these troubled loan restructurings *are* TDRs, would the decisions involved in restructuring the loans, including contacting borrowers to assess probability of default and to initiate conversations regarding restructuring of their loans, be considered 'decisions inherent in servicing,' consistent with the limits on the types of assets a QSPE may hold in 35.c.(1)?

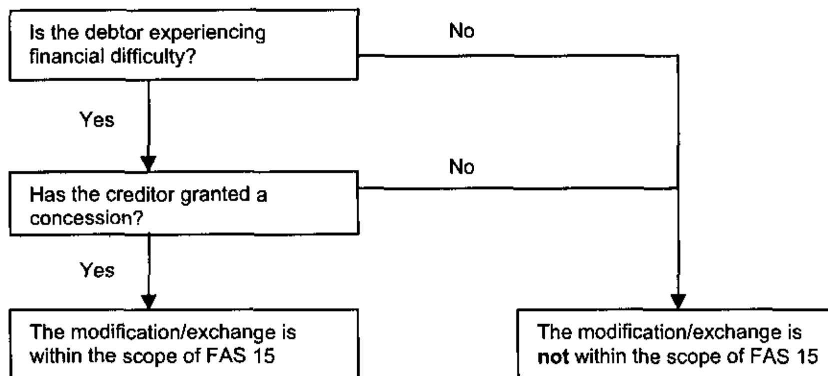
In considering these questions, MBA assumed all other conditions of a QSPE would be met.

V. MBA's Responses to Questions Raised by Guidance

Question 1: Would restructurings of troubled loans that involve granting concessions to debtors experiencing financial difficulty that the creditors would otherwise not consider be *troubled debt restructurings* (TDRs) pursuant to the authoritative literature, and therefore permitted 'restructures or workouts' of loans which are permitted activities for a QSPE (consistent with the response to Q28.B. in the Appendix)?

***MBA Response*:** Yes, because they meet the definition of 'troubled debt restructurings' in FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as clarified by the guidance in FASB Emerging Issues Task Force Issue No. 02-4, "Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15."

Issue 02-4 includes the following model for determining whether a restructuring is a TDR and within the scope of FAS 15:



Issue 02-4 lists several factors that would indicate that a debtor is experiencing financial difficulty, including:

> "9. Based on ***estimates and projections*** that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity." [emphasis added]

MBA believes this is analogous to the current situation involving borrowers who will be unable to make their mortgage payments, for example, due to an increase in their interest rates upon expiration of the initial fixed rate period. While servicers may have reason to believe that a borrower will be unable to make their mortgage payments based on estimates and projections, a decision to restructure loans would not be made until the borrower confirms they will be unable to make their mortgage payments and they provide evidence to support their assertion. Consequently, MBA believes this condition would be met for restructurings of troubled loans because they would be triggered by the inability of borrowers to continue to make their mortgage payments under the original terms of the loans.

Issue 02-4 also states that the following factor would be *determinative* of whether a restructuring is subject to FAS 15:

> "11. The Task Force reached a consensus that a creditor is deemed to have granted a concession if the debtor's effective borrowing rate on the restructured debt is less than the effective borrowing rate on the old debt immediately prior to the restructuring."

This condition would be met for the vast majority of restructurings of troubled loans (again, loans that are in default or for which default is reasonably foreseeable). Other types of concessions would also meet this condition to the extent they represent changes that the creditors would otherwise not consider pursuant to guidance in Issue 02-4[11] and FAS 15.[12]

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[11] Paragraph 5 of 02-4 includes the following: "...The Task Force reached a consensus that no single characteristic or factor, taken alone, is determinative of whether a modification or exchange is a troubled debt restructuring under Statement 15. That is, the fact that a single characteristic is present in a transaction...should not be considered sufficient to overcome the preponderance of contrary evidence. The Task Force noted that determining whether a transaction is within the scope of Statement 15 requires the exercise of judgment..."

[12] Paragraph 3 of FAS 15 states: "Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability or receipt, by granting the concession than by not granting it."

Consequently, MBA believes that restructurings of troubled loans that involve granting concessions to debtors experiencing financial difficulty that the creditors would not otherwise consider are TDRs and therefore permissible loan workouts for QSPEs pursuant to the guidance in FAS 140.

Question #2: If these troubled loan restructurings *are* TDRs, would the activities involved in restructuring the loans, including contacting borrowers to assess probability of default and to initiate conversations regarding restructuring of their loans, be considered 'significantly limited,' consistent with the permitted activities of a QSPE in 35.b.(1)?

MBA Response: Yes, discretion is 'significantly limited' if the restructuring is limited to loans that are in default or for which default is reasonably foreseeable pursuant to the legal documents that established the SPE, per paragraph 35.b.(2) of FAS 140.

Unless the terms 'default' or 'reasonably foreseeable default' are defined more narrowly in the legal documents, a loan would be considered in 'default' if the borrower has missed one or more mortgage payments and the default is not expected to cure. Default is 'reasonably foreseeable' if there has been actual contact with the borrower, an assessment of ability to continue to pay, and a reasonable basis for concluding that the borrower will be unable to continue to make their mortgage payment in the foreseeable future.[13]

Because a servicer (on behalf of a QSPE) would be taking action only in response to an event (i.e. default or reasonably foreseeable default) that is contemplated by the pooling and servicing agreement, significantly limited discretion would be involved in identifying loans that are subject to restructuring.

Question #3: If these troubled loan restructurings *are* TDRs, would the decisions involved in restructuring the loans, including contacting borrowers to assess probability of default and to initiate conversations regarding restructuring of their loans, be considered 'decisions inherent in servicing,' consistent with the limits on the types of assets a QSPE may hold?

MBA Response: Yes. MBA reasoned that because loan restructurings that are TDRs are permitted activities of a QSPE, and because TDRs involve decision-making (e.g. to lower the *rate on a loan rather than extend the term of the loan), then the decision-making involved in the* loan restructurings must be decisions inherent in servicing the loans.

MBA considered and rejected suggestions that servicer activities in performing cash flow projections in connection with evaluating loans that are in default or for which default is reasonably foreseeable in judging the probability of foreclosure are inconsistent with the activities of a QSPE because those activities must be undertaken to confirm that a borrower is experiencing financial difficulty, pursuant to the first box in the 02-4 model (see page 4). Those activities are necessary also to determine the type of concession to grant a borrower experiencing financial difficulty, pursuant to the second box in the model. Consequently, those activities involve decision-making that is inherent in a TDR which, as noted above, is a permitted activity of a QSPE.

[13] MBA believes this description is consistent with the general interpretation of the term "reasonably foreseeable default" in the tax law relating to Real Estate Mortgage Investment Conduits (REMICs).

Indeed, the only real distinction between a loan restructuring that is initiated before or after default is timing because restructurings can be triggered by borrower initiated contact with the servicer (or vice versa) *prior to* or after default, and the same decision-making is involved in both circumstances. For example, defaulted loans must be assessed in the same manner as loans for which default is reasonably foreseeable to determine whether a restructuring is necessary to avoid foreclosure of the loan. As mortgage servicers are responsible for making these determinations based on consultations with borrowers, reviews of the relevant evidence, and their obligations under the legal documents, there is no substantive difference between the decision-making involved in restructurings before or after default, or between servicer initiated conversations with the borrower or vice versa.

VI. Conclusion

In summary, MBA believes restructurings of troubled loans that involve granting concessions to debtors experiencing financial difficulty that creditors would not otherwise consider are 'troubled debt restructurings' (TDRs) pursuant to the authoritative accounting literature and therefore are 'restructures or workouts of loans' which are permitted activities of a QSPE. MBA believes these TDRs involve activities that are 'significantly limited' and decisions that are 'inherent in servicing' consistent with the limitations imposed on the activities of QSPEs. Consequently, MBA believes restructurings of certain securitized residential mortgage loans that are widely anticipated to go into default will not cause QSPEs holding the restructured loans to be disqualifying, thereby forcing transferors to record repurchases of the loans.

APPENDIX

The following guidance in FAS 140 elaborates on the conditions in paragraph 35:

"Limits on Permitted Activities
37. The powers of the SPE must be limited to those activities allowed by paragraph 35 for it to be a qualifying SPE..."

"Limits on What a Qualifying SPE May Hold
39. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing..."

Limits on Sales or Other Dispositions of Assets
42. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE –*because they respond automatically to the occurrence of an event or circumstance that (a) is* specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes or is expected to cause the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them – include requirements to dispose of transferred assets in response to..."

Additional guidance on restructurings of loans is found in "A Special Report: A Guide to Implementation of Statement 140:"

28B. Q--When a loan becomes delinquent or defaults, the servicer typically attempts to restructure or "work out" the loan in lieu of foreclosing on the collateral. Is the discretion permitted a servicer to work out a loan consistent with the limited powers permitted a qualifying SPE?

A--Yes. A servicer may have discretion in restructuring or working out a loan as long as that discretion is significantly limited and the parameters of that discretion are fully described in the legal documents that established the qualifying SPE or that created the beneficial interests in the transferred assets. However, the servicer may not initiate new lending to the borrower through the qualifying SPE as a result of the workout. (Refer to paragraph 185 of Statement 140.) Examples of activities that are not new lending are:

* Payments made by a servicer after a debtor fails to pay them (for example, to pay delinquent property taxes, to ensure required property and casualty insurance coverage is maintained, and so forth) that are contemplated in the lending agreement prior to its transfer to the qualifying SPE.

* Advances of funds by servicers (whether required or discretionary) to facilitate timely payments to the beneficial interest holders, after which the servicer has a priority right to recoup its advances from future cash inflows. That activity does not represent new lending activity to the borrower because it does not increase the indebtedness of the borrower.

* Extension of further credit by a transferor in a credit card securitization or revolving-period securitization and the subsequent transfer of the resulting loan by the transferor to qualifying SPE, pursuant to agreements in the legal documents that established the qualifying SPE. That is not a new lending activity by a qualifying SPE because the loan is originated by the transferor, not through the qualifying SPE. [Added 9/01.]