

MINUTES



Financial Accounting
Standards Board

To: Board Members
From: Servicing Rights Team (Bergstrom, ext. 296)
Subject: Minutes of the November 16, 2005 Board Meeting (Servicing Rights) **Date:** November 22, 2005
cc: Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Vincent, Sutay, Gabriele, Swift, Polley, Getz, Carney (e-mail), FASB Intranet (e-mail)

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Issues for Redeliberation: Servicing of Financial Assets, a Proposed Amendment to Statement 140: Comment Letter Analysis, Disclosures, Transition and Effective Date Provisions

Basis for Discussion: Servicing Rights Memorandums 10, 11, and 12

Length of Discussion: 11:25 am to 12:30 pm

Attendance:

Board members present: Herz, Batavick, Schipper, Seidman, Trott, and Young (by phone)

Board members absent: Crooch

Staff in charge of topic: Donoghue, Barker, and Lusniak

Other staff at Board table: L. Smith, Wilkins, E. Smith, and Bergstrom

Outside participants: None

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Summary of Decisions Reached:

At today's meeting, the Board addressed issues raised by respondents on the Exposure Draft, *Accounting for Servicing of Financial Assets*. The Board decided:

1. Under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, an entity that undertakes an obligation to service financial assets should recognize a servicing asset or a servicing liability for that servicing contract if the servicing obligation is a result of:
 - a. A transfer of the servicer's financial assets that meets the requirements for sale accounting.
 - b. An acquisition or assumption of a servicing contract that does not relate to financial assets that have been transferred by the servicer.

The Board stated that if a servicer transfers financial assets and the transfer does not meet the requirements for sale accounting, a separate servicing right should not be recognized.

2. To permit a one-time reclassification of available-for-sale (AFS) securities to trading securities, without calling into question the treatment of those securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. This reclassification would be permitted upon initial application of the Statement as of the beginning of the fiscal year of application.
 - a. This reclassification is restricted to AFS securities identified as economic hedges of servicing rights that a servicer elects to subsequently measure at fair value.
 - b. Any gains and losses that are carried in accumulated other comprehensive income at the time of the reclassification should be

included in the cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of the adoption of the amendment to Statement 140.

- c. A reclassification should be disclosed along with the notional amounts of the reclassified securities and the effect of the reclassification on retained earnings.
3. To allow a risk management approach for identifying the classes of servicing rights to apply the fair value election based on the different valuation and risk characteristics of the underlying assets and the way that the economic risks are managed.
4. Not to readdress initial measurement of separately recognized servicing rights.
5. To adopt the disclosure requirements proposed in the Exposure Draft with the following changes:
 - a. Delete the basis for management's decision to subsequently measure servicing assets and servicing liabilities at either fair value or amortized cost but require a disclosure that describes the characteristics that management is using to identify its asset classes under the risk management approach.
 - b. Modify the requirement to provide contractual servicing fees as a component of the roll forward and report it separately instead as well as include an illustrative example of roll forward in the final Statement.
 - c. Delete the requirement to provide a sensitivity analysis or stress test separately for each class of servicing rights.

- d. Add the requirement from FASB Statement No. 154, *Accounting Changes and Error Corrections*, to disclose the effect of the change in accounting principle on income from continuing operations.
 - e. Require that an election to reclassify securities from AFS to trading be disclosed along with the amount reclassified and the impact of that reclassification on the cumulative-effect adjustment to retained earnings.
6. To make the final Statement effective for fiscal years beginning after September 15, 2006, and to allow early application as of the beginning of a fiscal year for which the entity has not previously issued interim financial statements. This is consistent with the Board's decision on the hybrid financial instruments project.
7. For transition provisions—
- a. To clarify when the new disclosure requirements are effective.
 - b. To clarify that (1) the initial measurement of servicing rights at fair value should be applied prospectively and (2) servicing rights transactions should be initially measured at fair value as of the beginning of the fiscal year.
 - c. To revise the language in paragraphs 6 and 7 to state that the cumulative-effect adjustment should be the difference between the fair value and the carrying amount of the servicing rights that exist as of the beginning of the fiscal year, not as of the date of the entity's election.
 - d. To clarify that subsequent measurement at fair value should be a policy decision that is (1) irrevocable, (2) made as of the beginning of the fiscal year, and (3) effective as of the first day of the fiscal year of the election.

Objective of Meeting:

The objective of the meeting was to redeliberate issues raised by respondents in response to the Exposure Draft on servicing rights. The objective of the meeting was accomplished.

Matters Discussed and Decisions Reached:

1. Ms. Donoghue introduced the issues to be discussed at today's meeting, noting that the issues arose through comment letters submitted to the FASB in response to the Exposure Draft, *Accounting for Servicing of Financial Assets*. Ms. Donoghue stated that the vast majority of respondents supported the proposed amendments, but she acknowledged that respondents suggested a number of improvements and clarifications to the proposed Statement.
2. The first issue presented to the Board was the scope of the servicing rights provisions in Statement 140. Ms. Donoghue noted that respondents questioned under what circumstances a servicing right should be accounted for under the guidance in Statement 140. Specifically, Ms. Donoghue noted that paragraphs 10, 11, and 13 of the proposed Statement have led some readers to believe that the scope of Statement 140 had changed. Further, she commented that both the staff as well as the EITF have dealt with questions regarding the scope of Statement 140 related to separately recognized servicing rights, for example, servicing rights that arise without a transfer of financial assets and servicing rights that arise in a transfer that does not meet the requirements for sale accounting. Ms. Donoghue noted that generally the staff has responded to such inquiries by stating that it believes that all servicing rights that result from a transfer of financial assets, regardless of the servicer's involvement in that transfer, create a servicing right that would be accounted for under Statement 140.

3. Mr. Trott stated that transfers that do not qualify for sale accounting that would be considered a secured borrowing do not give rise to a separately recognized servicing right under Statement 140 if the transferor acts as the servicer.
4. Ms. Seidman commented that much of the confusion on this issue has resulted from the words that describe the servicing rights that should be separately recognized under Statement 140. Ms. Seidman specifically noted the word *purchase*, stating that it implies that if an entity acquires a servicing right other than by paying cash for it, the right falls outside the scope of Statement 140. She noted further that she did not believe that was consistent with the Board's intent. Ms. Seidman stated that she believes that servicing rights within the scope of Statement 140 are those generated by:
 - a. A transfer of financial assets that meets the requirements for sale accounting
 - b. An acquisition or assumption of an existing servicing contract, absent a transfer of financial assets.
5. Mr. L. Smith summarized Ms. Seidman's and Mr. Trott's comments by stating that if a servicer obtains the right to service assets other than its own and the compensation was either more or less than adequate compensation to service that asset, then a separately recognized servicing asset or liability would be recorded under Statement 140. Further, in cases where a Statement 140 transaction takes place that is not accounted for as a sale but, rather, as a financing, a borrower who has an obligation to service the underlying assets should not recognize a servicing asset or liability. The Board unanimously agreed with Mr. L. Smith's comments. Mr. Batavick noted that several respondents had requested that examples be included in the final Statement showing when a servicing right would be separately recognized and when it would not. The staff agreed to include such examples in the final Statement.

6. Ms. Donoghue then introduced the next issue for discussion stating that the Board had originally deferred its decision on whether to permit entities that use AFS securities to offset the risks inherent in servicing rights to reclassify those securities as trading securities without calling into question an entity's treatment of such securities under Statement 115. Ms. Donoghue stated that the majority of respondents to the Exposure Draft requested that such a transfer be permitted without restriction and noted that the entities that use AFS securities as economic hedges for their servicing rights typically know which securities are being used for those activities.
7. Ms. Donoghue stated that the staff recommends that the Board allow a one-time reclassification of AFS securities to trading securities to encourage and facilitate the fair value election provided in the proposed Statement. Ms. Donoghue noted that the staff considered allowing such a reclassification each time an entity elects a class of servicing rights to be carried at fair value but explained that, in the past, entities classified securities acquired to offset risks inherent in servicing rights as AFS because the option to carry servicing rights at fair value did not exist. Those entities would be able to carry both the servicing rights and the securities used to economically hedge them at fair value upon adoption of the proposed statement.
8. Additionally, Ms. Donoghue stated that the staff recommends that the impact on earnings associated with this reclassification be included in the cumulative-effect adjustment to retained earnings and that disclosures be required that describe the amount and effects of the reclassification on the cumulative-effect adjustment.
9. Ms. Schipper stated that reclassification should be permitted but restricted to a one-time reclassification that is only available upon initial adoption of the fair value election of AFS securities that can be identified as economic hedges of servicing rights and those servicing rights should be carried at

fair value. The result of the transfer should include the cumulative-effect adjustment to retained earnings and the magnitude should be separately disclosed with the decision to reclassify the AFS securities to trading securities.

10. Messrs. Batavick, Herz, and Young voiced their agreement with Ms. Schipper's comments and the staff recommendation. Mr. Batavick stated that such an allowance would be important to encourage the use of the fair value election. Mr. Batavick was concerned with being overly prescriptive in the restrictions for the reclassification of AFS securities to trading securities, but he noted that the comment letters generally indicated that entities would be able to specifically link the AFS securities that are being reclassified with the servicing rights that they are associated with. Ms. Donoghue noted that entities may not have adequate documentation that support which AFS securities were previously designated to economically hedge specific servicing rights, but at the time the election is made, entities should be able to identify and adequately document those securities linked to servicing rights.

11. Mr. Herz commented that he did not believe that it was appropriate to give permanent optionality that allows entities to pick and choose when they want to move something through retained earnings as opposed to the income statement. He noted that an unrestricted ability to transfer AFS securities to trading with the effect of the reclassification going through retained earnings would permit an entity to move an under water AFS portfolio to trading without requiring that the associated losses be recorded in earnings. Additionally, Mr. Herz stated that entities that utilize this option should have to show some kind of linkage between the securities that are being reclassified and the servicing rights that they are supposed to economically hedge.

12. Mr. Trott disagreed with portions of the staff's recommendations. Specifically, Mr. Trott stated that an unrestricted transfer from AFS to

trading should be allowed each time an entity elects to carry a new category of servicing rights at fair value and should be accounted for as a cumulative-effect adjustment. Mr. Trott stated that he was originally concerned about the potential for abuse that an unrestricted transfer allowance might present, but he believed accounting for the reclassification as a cumulative-effect adjustment to retained earnings rather than income would dissuade entities from moving all AFS securities to trading. Mr. Trott noted that the restrictions on the fair value election that only allow the election to be made at the beginning of a fiscal period and require that the effects run through retained earnings would also act to prevent abuse of this option. Mr. Trott stated that such an approach would be simpler to implement. Ms. Seidman agreed with Mr. Trott's recommendation, based upon the reasoning that none of the securities used in the economic hedges of servicing rights are designated as hedges or documented as such and will not be required to be after the reclassification. Ms. Seidman stated that the most important aspect of allowing the reclassification is to provide transparency to users by disclosing the magnitude of the amount of securities that are being transferred and the effect that is being recognized. Further, Ms. Seidman added that the ongoing requirement to record the reclassified securities at their market value would also act to deter abuse of the option.

13. Ms. Barker introduced the third issue. Ms. Barker stated that regarding the class-by-class fair value election, more than half of the respondents, including all of the Big 4 accounting firms, requested that the definition of classes be defined at a more granular level than major asset type. Their concerns included: (a) the availability of market-observable inputs used in determining the fair value of servicing rights can vary significantly within a broad asset class, (b) entities managing assets differently within the stated broad categories due to differing risk characteristics, (c) broad asset classes that are inconsistent with the current stratification guidance in Statement 140 used to evaluate and measure impairment of servicing

assets, and (d) broad asset classes that are inconsistent with the Board's recent discussions on the hybrid financial instruments and fair value option project, which may permit entities to elect fair value on an instrument-by-instrument basis.

14. Based on these concerns, Ms. Barker presented the Board with several alternatives to the broad asset classes specified in the Exposure Draft:

- a. Loan categories listed in either the Call Report Instructions or SEC Regulation S-X.
- b. Risk management approach whereby management would identify the various classes based on the different valuation and risk characteristics of the underlying assets and the way the economic risks are managed.
- c. Stratification approach in which categories would be determined in a manner consistent with the current stratification guidance used to evaluate and measure impairment of servicing rights accounted for under the amortization method.

15. Ms. Barker stated that the staff recommends the risk management approach, as it would expand the number of asset classes beyond major asset type to reflect the predominant factors used in determining the fair value of servicing rights and an entity's methods for risk managing those assets. Further, Ms. Barker noted that the additional comprehensive disclosures included in the Exposure Draft on servicing, which require roll-forwards of each class of servicing rights, should limit the number of servicing classes used by an entity. In addition, she questioned how an entity that changes its class structure subsequent to initial adoption would report the change and whether a restatement would be required.

16. Ms. Seidman noted her support for the staff's recommendation and stated that she also supported additional disclosures that would require

management to describe the characteristics that an entity is using to identify its asset classes. Further, Ms. Seidman stated that the changes to asset class structure after initial adoption should be dealt with as a cumulative-effect adjustment. Messers. Herz, Batavick, Trott, and Young also supported the staff's recommendations and Ms. Seidman's comments. Ms. Schipper noted that she would dissent from the entire document but agreed with the staff's recommendation on this issue.

17. Ms. Donoghue introduced the fourth issue. She stated that several respondents to the Exposure Draft objected to initial measurement of servicing rights at fair value but would recommend requiring them to be initially measured by the amortization method. Ms. Donoghue acknowledged that the Board has already carefully deliberated this issue and that no significant new information had become available through the comment letters. A possible alternative to the proposed amendments would be to allow an election for initial measurement, but then require entities to continue to use the same measurement attribute that had been elected through the life of the servicing asset or liability. Ms. Donoghue stated that the staff does not recommend changing the proposed amendments and asked the Board if they wanted to re-address the issue of initial measurement at fair value for all new separately recognized servicing rights.

18. In regard to her previous objections to requiring initial fair value measurement of servicing rights, Ms. Seidman stated that she objected to the idea that servicing rights represent new assets and therefore recommends that they be carried at fair value. However, Ms. Seidman noted that she did not object to initial fair value measurement in this Statement primarily because it is a simplification. Ms. Seidman asked that the Board clarify whether the basis for requiring that servicing rights be measured at fair value is because they consider them new assets and liabilities or to simplify the accounting for servicing assets and liabilities. Ms. Seidman noted that the reasoning behind the change affects the way

that Statement 140 should be amended. Further, she stated that the changes currently proposed for the accounting for servicing rights are not clear and leave the impression that they are retained interests.

19. Mr. Trott stated that from both a practical standpoint as well as his view that a “fresh start event” or a “new basis event” has occurred, servicing rights should be required to be initially measured at fair value. Mr. Trott stated that he did not see any benefit to redeliberating this issue. The rest of the Board present (Herz, Batavick, Schipper, and Young) except Ms. Seidman supported Mr. Trott’s comments. Ms. Donoghue stated that Ms. Seidman’s concerns could be alleviated through drafting changes to the final Statement.

20. Ms. Lusniak introduced the next topic. She stated that the reaction of most of the respondents to the new disclosure requirements was favorable. However, the staff received some suggestions for improvements in the disclosures that it believes would be helpful. The suggestions included:

- a. Deleting the basis for management’s decision to subsequently measure servicing assets and servicing liabilities at either fair value or amortized cost but requiring a disclosure that describes the characteristics that management is using to identify its asset classes under the risk management approach.
- b. Modifying the requirement to provide contractual servicing fees as a component of the roll forward and reporting them separately instead, as well as including an illustrative example of a roll forward in the final Statement.
- c. Deleting the requirement to provide a sensitivity analysis or stress test separately for each class of servicing rights.

- d. Adding the requirement from Statement 154 to disclose the effect of the change in accounting principle on income from continuing operations.
 - e. Requiring that an election to reclassify securities from AFS to trading be disclosed along with amount reclassified and the impact of that reclassification on the cumulative-effect adjustment to retained earnings.
21. Mr. Trott stated that he agreed with the staff's recommended changes to the disclosure requirements. Messrs. Batavick and Herz and Ms. Schipper supported Mr. Trott's comments.
22. Ms. Seidman reiterated that she would like to see disclosures related to the transfer of AFS securities to trading securities include a description of the characteristics that management is using to identify its asset classes under the risk management approach. Ms. Seidman stated that because the fair value option must be elected at the beginning of a fiscal year, interim disclosures from Statement 154 would be irrelevant.
23. Mr. Young disagreed with removing the requirement that management disclose the basis for its decision to subsequently measure servicing rights at fair value or amortized cost. He stated that he believes such information is necessary for users to determine how management manages its risks.
24. Mr. L. Smith discussed the effective date provisions. He stated that the staff believes that both the servicing rights project and the hybrid financial instruments project would be completed before the end of the first quarter of 2006. In an attempt to be consistent with the other Statement 140 Exposure Drafts, he proposed that the final Statements be effective for fiscal years beginning after September 15, 2006, and to allow early application as of the beginning of a fiscal year for which the entity has not previously issued interim financial statements. This would be consistent

with the Board's decision on the hybrid financial instruments project and would allow entities with fiscal years to utilize the fair value elections as of the first quarter of 2006. Mr. L Smith stated that in the hybrid financial instruments project, at initial application, an entity may elect the fair value option for existing bifurcated instruments and may elect the fair value option on an instrument-by-instrument basis.

25. The staff recommended the following modifications to the transition provisions

- a. Clarify when the new disclosure requirements are effective.
- b. Clarify that (1) the initial measurement of servicing rights at fair value should be applied prospectively and (2) servicing rights transactions should be initially measured at fair value as of the beginning of the fiscal year.
- c. Revise the language in paragraphs 6 and 7 to state that the cumulative-effect adjustment should be the difference between the fair value and the carrying amount of the servicing rights that exist as of the beginning of the fiscal year, not as of the date of the entity's election.
- d. Clarify that subsequent measurement at fair value should be a policy decision that is (1) irrevocable, (2) made as of the beginning of the fiscal year, and (3) effective as of the first day of the fiscal year of the election.

26. The Board unanimously supported the staff's recommendations to the effective date and transition provisions.

Follow-up Items:

None.

General Announcements:

None.