



May 14, 2013

Ms. Susan M. Cospers  
Technical Director  
Financial Accounting Standards Board  
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**File Reference No. 2013-220, *Recognition and Measurement of Financial Assets and Liabilities***

Dear Ms. Cospers:

The Mortgage Bankers Association<sup>1</sup> (MBA) appreciates the opportunity to comment on Exposure Draft, *Recognition and Measurement of Financial Assets and Liabilities* (Proposed Update). MBA's response is driven by the overarching premise that accounting and reporting for financial instruments should reflect both a reporting entity's business strategy and the characteristics of the financial instruments. The following presents a series of concerns about the proposed treatment of securities with multiple credit tranches, MBA's other general comments, and our response to certain of FASB's questions.

**Background**

The Proposed Update is part of the overall financial instruments project undertaken by FASB jointly with the International Accounting Standards Board (IASB) several years ago. The project encompasses three areas: 1) classification and measurement of

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<sup>1</sup> 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](http://www.mortgagebankers.org).

financial assets (subject of the Proposed Update); 2) measuring and reporting credit impairment; and 3) accounting for hedging activities. The Proposed Update would affect all reporting entities that hold financial assets or owe financial liabilities. For the mortgage banking industry, it would be applicable to Ginnie Mae, Fannie Mae, Freddie Mac and private label mortgage-backed securities (MBS), commercial/multifamily MBS, residential mortgage loans, and commercial real estate loans. The Proposed Update would retain some of what is in existing Generally Accepted Accounting Principles (GAAP), including three classifications. Under the Proposed Update, the reporting entity would first look to see if the contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. An entity would be required to measure financial assets that do not meet this contractual cash flow characteristics criterion at fair value with changes in fair value going through net income. If an entity meets the cash flow criterion, it would then consider the business model in which the asset is managed. If an entity holds the asset for contractual cash flows then it must account for the asset at amortized cost. If an entity holds the asset for contractual cash flow or sale, then the entity would record the asset at fair value with changes in fair value recorded in the other comprehensive income (OCI) in the equity section of the balance sheet. Financial assets that do not qualify for either of these two categories would be measured at fair value through net income.

MBA generally supports this three classification approach, but has significant concerns about some of the attributes in the contractual cash flow criterion and the business purpose criterion. These concerns rise to the level of importance such that **MBA requests FASB withdraw the Proposed Update and reconsider these unwarranted attributes. If FASB adopts the Proposed Update as is, the result will be for many assets to be misclassified resulting in user confusion as assets held for cash flows or assets held for cash flows or sale are misclassified as assets held for trading.**

## General Comments

### Concentration of Credit Risk

Reporting entities from time to time will dispose of assets held for contractual cash flows because of geographic concentration, industry concentration, or counterparty concentration. Page 220, ASC 825-10-55-31, states that such portfolio restructuring is not consistent with amortized cost classification:

As part of the business activity for managing financial assets for collection of contractual cash flows, an entity would focus on managing the credit risk of the assets to maximize the collection of contractual cash flows. Sales of financial assets as a result of a significant deterioration in the issuer's creditworthiness would not be inconsistent with the objective of amortized cost classification if the purpose of those sales is to maximize the collection of contractual cash flows through sales rather than through cash collection. However, sales of financial assets that result from managing the credit exposure because of concentrations of credit risk would not be consistent with the objective of amortized cost classification.

MBA agrees with FASB that for amortized cost assets, the focus should be on managing the credit risk of the assets to maximize the collection of contractual cash flows. MBA disagrees, however, with FASB's assertion that managing concentrations of credit risk is not consistent with the objective of amortized cost classification. We see no underlying principles or reasons that support the assertion and request FASB to eliminate this restriction in the final rule.

### **Treatment of Tranched Securities Under the Contractual Cash Flow Criterion**

MBA supports the introduction of a contractual cash flow criterion in the Proposed Update. However, MBA has significant concerns with respect to the interpretation of the contractual cash flow criteria as it relates to structured securities that contain multiple credit tranches. Page 47 of the ED (ASC 825-10-55-26c.) states:

The exposure to credit risk in the underlying pool of financial instruments that are inherent in the tranche of beneficial interest is equal to or lower than the exposure to credit risk of the underlying pool of instruments. For example, this condition would be met if the underlying pool of instruments were to lose 50 percent as a result of credit losses and under all circumstances the tranche would lose 50 percent or less in value.

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. MBA notes that this would force all but the most senior tranche in multi-tranche mortgage-backed securities (MBS) to be accounted for at fair value through net income even though the securities are managed both in order to collect contractual cash flows and for possible sale. MBA believes that the following comments and observations present a compelling case for changing this criterion.

- **Inconsistent With Principle of Accounting Following Business Model:** MBA acknowledges that the Proposed Update would require application of the contractual cash flow criterion before applying the business model criterion. However, MBA believes the primary criterion for determining classification and measurement should be an entity's business model. If an entity does not intend to sell a debt financial instrument, it should not be required to be accounted for as if it were held for trading. That instrument 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.
- **Payments to Each Tranche Holder Represent Principal and Interest:** MBA could not find any reasons in the Proposed Update for the proposed treatment of

lower tranches in a securitization. But, there are compelling reasons for applying the same accounting model for all securitization tranches. In a multiple-tranche security, the payments represent contractual payments of principal and interest to each tranche not just the most senior tranche, and those payments come from the contractual cash flows of the underlying pool of mortgages. The highest rated tranche generally is paid sooner in the cash flow waterfall and accepts a lower effective interest rate for shorter duration and resulting reduced credit risk. Lower tranches are paid subsequent to the senior tranche in the cash flow waterfall (still from principal and interest of the underlying pool of mortgages). These lower tranches receive a higher effective yield because of a longer duration and resulting increase in credit risk. All tranche holders are paid solely from principal and interest and should be deemed to meet the cash flow characteristics under IFRS 9. MBA believes these tranches meet the cash flow characteristics, and the distinction made in the Proposed Update for lower tranches is arbitrary and lacking accounting principles support.

- **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 contractual cash flows.
- **Existence of Credit Risk Is Not Relevant to Classification and Measurement:** Single tranche securitizations and multiple tranche securitizations all have credit risk as do whole loans. 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 investors expect losses at purchase, they do not buy the securities at par. On an ongoing basis investors will evaluate for impairment and take subsequent impairment charges through net income, as appropriate. Both the IASB and the FASB believe that there should be one accounting model for debt instruments acquired in whole loan or security form. However, 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 separate model for impairment measurement.

- **Proposed Accounting for Lower Tranches Would Be Less Transparent:** Fair value through profit and loss should be used for financial assets that are held for sale. Lower tranches that a reporting entity holds for the collection of principal and interest or for sale should be carried at fair value through OCI. To do otherwise will result in less transparent, if not confusing, accounting and reporting to investors by obfuscating the business purpose for holding the asset.
- **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. When an entity intends to hold the security for collection of cash flows, we believe fair value through net income accounting results in unnecessary volatility and produces misleading financial statement results as it indicates the security is intended to be sold when that is not the case.
- **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.

### **Matching Timeframes for Variable Interest Resets**

The proposed ASC 825-10-55-18 states:

... the economic relationship between principal and the consideration for the time value of money and the credit risk in a financial asset may be modified by an interest rate reset feature in which the frequency of the reset does not match the period of time covered by the interest rate. For example, the interest rate may be reset monthly to a three-month rate. In those cases and in the case of leverage (collectively referred to as modified economic relationship), an entity is required to assess the modification to the economic relationship to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. If the modification to the economic relationship could result in cash flows that are more than insignificantly different from the benchmark cash flows, the financial asset does not meet the contractual flow criterion ...

MBA notes that frequently financial assets are priced at a variable rate in which the index of reset may not match the period of time covered by the interest rate. This does not mean the interest received under that regime is anything other than interest. Such a criterion is not principles-driven, is inconsistent with the contractual cash flows principle, and may result in a narrowing of pricing choices available to investors and consumers in the market. MBA recommends that FASB remove this criterion. Guidance already exists which requires examination of instruments for embedded derivatives. That existing guidance would address any circumstances where a feature in an instrument should be bifurcated for accounting. That guidance already requires fair value accounting in circumstances where an embedded derivative cannot be bifurcated. MBA

believes that existing guidance already addresses potential issues such as interest rate mismatch.

### **Prepayment Options**

ASC 825-10-55-21 states that prepayment options represent solely payment of principal and interest as long as prepayment is not contingent on certain future events and as long as “The prepayment amount substantially represents unpaid amounts of principal outstanding, which may include reasonable additional compensation for the early termination of the contract.”

Many commercial real estate mortgages include yield maintenance or “make whole” provisions if the borrower desires to prepay. The lender has committed the loan for a specified period of time at a stated interest rate. If the borrower prepays the loan, the lender will need to find a new asset to invest in. This prepayment provision is there to compensate the lender for needing to invest in another asset at a lower rate than the current loan.

Likewise, some residential mortgage loans contain a prepayment penalty if the borrower prepays during the first few years after the loan was originated. Again, the intent here is to encourage borrowers not to prepay unless they are moving to a new location.

MBA believes that such prepayment penalties should not preclude accounting for such financial assets at fair value through OCI since they represent legitimate, contractual fees to compensate the lender or investor for all or part of the loss incurred upon prepayment. The proposed required analysis could be subjective and burdensome to preparers and result in assets held for contractual cash flows or for contractual cash flows or sale to account for such assets erroneously as if they were trading account assets.

### **Ancillary Income**

Page 215, ASC 825-10-55-16, states:

If the contractual cash flows include payments that are unrelated to principal, the time value of money, and the credit risk, the contractual cash flows do not represent solely payments of principal and interest. Paragraphs 825-10-55-17 through 55-27 provide guidance for applying the contractual cash flows characteristics criterion.

MBA notes that many financial assets contain provisions that may give rise to payments that are other than payments of principal and interest. For example, residential and commercial mortgage loans generally allow the servicer or mortgagee to collect late charges when a borrower is delinquent, a fee for assumptions, and other ancillary fees. Likewise, lenders collect origination fees to recover the costs incurred in underwriting and processing loan applications. In addition, some mortgages contractually require the mortgagor to pay monthly amounts into escrow to pay property insurance and taxes.

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MBA believes these fees, although not directly part of principal and interest revenues, are essential to the transaction and should not result in the accounting classification of fair value through net income when the financial assets are held for the collection of contractual cash flows or for the collection of contractual cash flows or sale. MBA believes that ASC 825-10-55-16 will have significant unintended consequences and should be removed from the Proposed Update.

### **Business Model Too Macro Level**

Page 220, ASC 825-10-55-28, suggest how a reporting entity evidences the business model's intentions with regard to financial assets. It states:

The determination of the business model for managing financial assets is not driven by a single factor; rather, all objective evidence that is relevant to assessing the entity's business model should be considered, including the following:

- a. How the performance of the business is reported to the entity's key management personnel
- b. How management is compensated, for example, whether the compensation is based on fair value of the assets managed
- c. The frequency and volume of sales in prior periods, why sales have occurred in the past, and expectations about the sales activity in the future.

Frequently, especially with respect to large and complex banks, the attributes above would not capture the reporting entities' intentions with respect to all classes of financial assets. The attributes above are just too macro. MBA recommends that the business model test should be performed at the level at which an entity makes decisions regarding its financial instruments to include minutes of asset liability committees, internal memos that document changes in strategy, and other such documentation so that all strategies and strategy changes fit within the definition of documentation.

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

Sincerely,



James P. Gross  
Vice President of Financial Accounting and Public Policy

## Appendix A – Responses to Select FASB Questions

**Question 1:** Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?

**MBA's Response:** MBA agrees with the scope.

**Question 2:** Do you agree with the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9? If not, why? What would you propose instead?

**MBA's Response:** MBA agrees with the industry-specific scope guidance.

**Question 4:** Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?

**MBA's Response:** MBA strongly disagrees with the characteristics and attributes in the Proposed Update with respect to contractual flow characteristics assessment. See general comments above entitled, *Treatment of Tranched Securities Under the Contractual Cash Flow Criterion, Matching Timeframes for Variable Interest Resets, Prepayment Options, and Ancillary Income*.

**Question 5:** The proposed amendments define *principal* as the amount transferred by the holder at initial recognition. Should the definition of *principal* be expanded to include repayment of the principal amount at maturity or other settlement? If so, what instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?

**MBA's Response:** MBA believes that *principal* should be expanded to include subsequent disbursements of principal from creditor to debtor after initial recognition date, interest accrued and capitalized as additional principal (if allowed under contractual terms) and principal that remains at maturity, including unpaid amounts at the end of the term of a balloon mortgage.

**Question 6:** Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?

**MBA's Response:** MBA believes the application guidance is generally sufficient in the circumstances.

**Question 7:** Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could

not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

**MBA's Response:** MBA finds the use of the term "leverage" in 825-10-55-18 to be nebulous and totally lacking definition and clarity. Also, see general comment above entitled *Matching Timeframes for Variable Interest Resets*.

**Question 8:** Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?

**MBA's Response:** See MBA's response to Question 7 above.

**Question 9:** For beneficial interests in securitized financial assets, the proposed amendments would require an entity to look through to the underlying pool of instruments in determining whether the tranche contains payments of solely principal and interest. Do you agree with this look-through approach? If not, why? What would you propose instead?

**MBA's Response:** MBA believes that the guidance for beneficial interests in securitized financial assets is **fatally flawed**. See general comment above entitled *Treatment of Tranched Securities Under the Contractual Cash Flow Criterion* above for further details.

**Question 10:** Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?

**MBA's Response:** MBA believes that the guidance for the business model assessment is **fatally flawed**. See MBA's general comments above entitled *Business Model Too Macro Level* and *Concentration of Credit Risk*.

**Question 11:** Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?

**MBA's Response:** See MBA's response to Question 10 above.

**Question 12:** Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?

**MBA's Response:** MBA believes in principles-based as opposed to rules-based accounting standards. Accordingly, we believe that the final rule should not contain an

explicit tainting notion and should rely on the principle and the exercise of professional judgment.

**Question 13:** The proposed amendments would require loan commitments, a revolving line of credit, or a commercial letter of credit (the potential creditor) to be measured on the basis of the likelihood of exercise of the commitment and the classification of the underlying loan that would be made upon exercise of the commitment. Do you agree with the proposed classification of loan commitments? If not, why? What would you propose instead?

**MBA's Response:** MBA agrees with the proposed guidance for loan commitments and agrees that existing guidance for interest rate lock commitments should be continued.

**Question 14:** Do you agree with the initial measurement principles for financial instruments? If not, why?

**MBA's Response:** MBA generally agrees with the initial measurement principles for financial instruments.

**Question 16:** Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?

**MBA's Response:** MBA generally agrees with the proposed measurement of financial liabilities.

**Question 17:** The proposed amendments would require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets (see paragraph 825-10-35-11) to be measured on the same basis as those assets. Do you agree with the proposed amendments? If not, why? What would you propose instead?

**MBA's Response:** MBA agrees with the proposed amendments but remains consistent in its opposition to reporting separately in consolidated financial statements FAS 167 assets that it does not own and liabilities it does not owe. We believe that such assets and liabilities should be presented as linked on one side of the balance sheet resulting in a net position that reflects the variable interest the reporting entity owns.

**Question 18:** The proposed amendments would require financial assets measured at amortized cost that are subsequently identified for sale to continue to be classified and measured at amortized cost less impairment and would prohibit recognition of the gain, until the sale is complete. Do you agree with the proposed classification and measurement requirements? If not, why?

**MBA's Response:** MBA generally agrees with FASB on financial instruments carried at amortized cost and subsequently identified for sale.

**Question 21:** Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?

**MBA's Response:** MBA sees no theoretical basis for reporting hybrid financial assets on a different basis than hybrid financial liabilities. Accordingly, we support the option to carry hybrid financial assets at fair value or to bifurcate the derivative from the financial asset.

**Question 22:** The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?

**MBA's Response:** MBA generally agrees with the proposed guidance.

**Question 29:** Do you agree with the proposed disclosure requirements? If not, which disclosure requirement would you change and why?

**MBA's Response:** MBA has several concerns about the proposed disclosures. First, the Proposed Update (ASC 825-10-50-34) would increase disclosures of financial instruments carried at amortized cost by requiring parenthetical disclosures of fair value on the face of the balance sheet and additional disclosures in the notes to financial statements that are akin to Level 3 disclosures. Further, for core deposit liabilities a depository would be required to calculate an "all-in cost to service" core deposits. Such a calculation would be based upon a significant amount of judgment and would likely not be consistent from one reporting entity to another.

**Question 30:** Should an entity be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for hybrid financial liabilities that would qualify for the fair value option under the proposed requirements? If not, why?

**MBA's Response:** MBA has no objections.

**Question 31:** Should the effective date be the same for both public entities and nonpublic entities?

**MBA's Response:** MBA generally believes that small, non-public entities should be allowed more time to implement the Proposed Update, when finalized.

**Question 32:** How much time is needed to implement the proposed guidance?

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**MBA's Response:** The analysis of “solely payments of principal and interest” would have to be done on an individual asset level. For financial institutions this would be a huge, time-consuming and labor-intensive process since it would affect almost all of the reporting entity's assets. Likewise, there are several other inter-related pronouncements in FASB's pipeline requiring attention of the same employees. Accordingly, MBA believes that the transition period should be at least three years.

**Question 33:** Are the transition provisions in this proposed Update operable? If not, why?

**MBA's Response:** Transition via cumulative effect adjustment as of the beginning of the reporting period in which the guidance is effective is appropriate in the circumstances.