



October 2, 2006

LETTER OF COMMENT NO.

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

Dear Chairman Herz:

The Mortgage Bankers Association¹ is very concerned that some issuers, investors and others believe the guidance in FAS 133,² as amended by 155,³ requires "plain vanilla" pass-through mortgage-backed securities (hereby pass-through MBS) to be evaluated under paragraph 13.b. of that Statement. MBA believes application of that paragraph to certain discounted pass-through MBS would have an unexpected, chilling effect on the market by reducing the demand for MBS by investors that do not want to undertake the challenge of having to bifurcate a derivative in some inexplicable way or, alternatively, of recognizing the earnings volatility occasioned by temporary fluctuations in interest rates. MBA has reviewed FAS 133 and all related literature and believe it supports our position that pass-through MBS are not required to be evaluated under paragraph 13.b. for the reasons explained below.

I. Background

Under the guidance in paragraph 12 of FAS 133, financial instruments⁴ that contain embedded derivatives (i.e. hybrid instruments) which are *not* deemed to be "clearly and closely" related to the economic characteristics and risks of the host contract would have to be: (1) bifurcated and accounted for as two separate instruments (a host contract and a derivative contract); or, (2) measured in their entirety at fair value, with changes in fair value to be reported in earnings,

¹ 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.

² Statement of Financial Accounting Standards No. 133, *Accounting for Derivatives & Hedging Activities*.

³ Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of Statements No. 140 and 133*.

⁴ Other than certain interest-only (I/O) and principal-only (P/O) strips which are exempt from the Statement.

provided two additional conditions in that paragraph are also met. Paragraph 13 of FAS 133 provides additional guidance in the form of three quantitative tests that determine whether an embedded derivative in which the underlying is an interest-rate or interest-rate index is, in fact, "clearly and closely" related to its host contract under paragraph 12. Some people believe these tests would render the embedded prepayment option in many discounted pass-through MBS subject to bifurcation under the Statement, with attendant complexities and uncertainties regarding the proper valuation of the option.⁵ However, as the tests in paragraph 13.b. are required to be applied to different hybrid instruments depending on their various features and terms, the question at hand is whether they are applicable to evaluations of pass-through MBS.

II. MBA Position

MBA and others have looked to the guidance in FAS 133, as amended, and related FAS 133 Implementation Issues B39, "Application of 13(b) to Call Options That are Exercisable Only by the Debtor," and B16, "Calls and Puts in Debt Instruments", in an effort to answer this question. Although ambiguities in the authoritative guidance have led to legitimate differences of opinion regarding the correct answer, MBA believes that the guidance taken as a whole does not require paragraph 13.b. to be applied to evaluations of pass-through MBS. In reaching this conclusion, MBA also considered longstanding industry interpretation of the authoritative literature as reflected in industry practice in accounting for loans and MBS.

III. Basis for MBA's Position

MBA Observations about FAS 133

In drafting FAS 133, the Board cited "prepayable mortgages" as examples of compound instruments with embedded derivatives that are "clearly and closely related" to their mortgage host contracts.⁶ The fact that the Board singled out prepayable mortgages for identification and discussion to illustrate the "clearly and closely related" language in FAS 133 suggests that the relationship of the embedded prepayment option and the mortgages is so well established and understood that there would be no need to apply the quantitative tests in paragraph 13 to the instruments to prove the point. Consequently, MBA believes the guidance in paragraph 13, and 13.b. in particular, was developed by the Board with other hybrid instruments in mind; namely, structured finance transactions involving specifically negotiated terms and conditions designed to appeal to investors' objectives. By contrast, the prepayment option in mortgages is intended to accommodate borrowers' needs, rather than investors' desires.

MBA believes industry practice reflects a broad based understanding that the embedded prepayment options in loans and MBS meet the "clearly and closely" related test in paragraph 12 without the need to evaluate them under 13.b. This is because no lenders, to MBA's knowledge, have ever bifurcated those instruments, regardless of whether they believed they were subject to the exclusions provided for in FAS 133 Implementation Issue D1.⁷ Moreover,

⁵ MBA understands that there would be significant challenges to valuing the prepayment option separate from the prepayable mortgages under 13.b. and that the effects of doing so would likely produce nonsensical accounting results including gains on valuing the prepayment derivative in situations where the value of the overall security is declining because of interest rate fluctuations.

⁶ See paragraph 305 of FAS 133.

⁷ "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."

the guidance in FAS 134,⁸ which was released after FAS 133, appears to sanction this treatment by giving holders that are mortgage banking companies the opportunity to classify their MBS as other than "trading" securities, with no mention of the need for holders to evaluate them under 13.b. if they are not so classified.

MBA Observations on B39

MBA also considered the guidance in Issue B39 in considering whether pass-through MBS should be evaluated under paragraph 13.b. of FAS 133. In doing so, we noted that when the Issue was originally cleared by the Board in June 2005, it contained explicit guidance indicating that MBS were *not* subject to evaluation under paragraph 13.b. of FAS 133. According to the staff's response in that original guidance, paragraph 13.b. was not applicable to prepayable mortgages, whether securitized or not, because the investor did not have the unilateral right to exercise the prepayment option because the option was related to the mortgage note, not the MBS.

That guidance is still reflected in the first two paragraphs of the Staff Response in B39 as follows:

"The conditions in paragraph 13(b) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (issuer/borrower). This guidance does not affect the application of the condition in paragraph 13(a) or the application of the provisions of paragraph 61(d) as interpreted by Statement 133 Implementation Issue No. B16, "Calls and Puts in Debt Instruments." In addition, this guidance does not apply to other embedded derivative features that may be present in the same hybrid instrument.

The conditions in paragraph 13(b) were intended to apply only to situations that meet the two conditions specified in paragraphs 13(b)(1) and 13(b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs. When the embedded derivative is an option rather than a forward contract, it is important to analyze whether the investor is the holder of that option. For an embedded call option, the issuer or borrower (and not the investor) is the holder, and thus only the issuer (borrower) can exercise the option. Consequently, the investor does not have the unilateral ability to obtain the right to receive the high rate of return, which is contingent upon the issuer's exercise of the embedded call option."

Although this guidance seems unequivocal, Appendix B of FAS 155 introduced some ambiguity into B39 by changing the staff's comments in the table at the end of the issue in a manner that raised new questions about the applicability of 13.b. to MBS, and which effectively changes the guidance in the above paragraphs. The public was not given the opportunity to comment on these changes since they did not appear as proposals in the Exposure Draft and did not even appear in the fatal flaw draft.

The changes made to B39 by FAS 155 are shown in the table on the following page.

⁸ "Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise."

Example	Paragraph 13(b) Applicable to the Embedded Call Option?	Comments
<p>6. A mortgage-backed security (MBS) is issued, whereby cash flows associated with principal (including full or partial prepayments and related penalties) received on the related mortgage loans are passed through to the MBS investors.</p>	<p>No, <u>unless the impacts of the embedded call feature are disproportionately allocated to interest holders (see comments).</u></p>	<p>Although the related mortgage loans are prepayable, and thus each contain a separate embedded call option, the MBS itself does not contain an embedded call option. The MBS issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the MBS investors. <u>While the MBS itself does not contain an embedded call option, the Board decided as part of FASB Statement No. 155... that an interest in MBS with underlying assets containing an embedded call feature, for which all of the associated cash flows are proportionately passed through to all the interest holders, will not be subject to the conditions in paragraph 13(b) with respect to that embedded call feature. However, in situations in which the cash flows associated with the embedded call feature are disproportionately allocated to different classes of interest holders, all interests in that MBS would be subject to the conditions in paragraph 13(b) with respect to that embedded option.</u></p>

MBA understands that some people believe the staff's comments require pass-through MBS to be evaluated under paragraph 13.b. because some amount of the mortgage interest payments is used to pay a guarantee fee and/or servicing fee ("in excess of adequate compensation")⁹ which renders allocations of cash payments "disproportionate" as that word is described in paragraph 4.a. of FAS 155.¹⁰ MBA believes this interpretation, however, overlooks the specific wording of the staff's comments which refers to *cash flows associated with the embedded call feature only*, rather than to scheduled mortgage payments. Considered in the context of pass-through MBS, the accelerated principal payment under the call feature would be distributed proportionately because the repaid principal would be allocated to investors without reduction for any guarantee or servicing fees.

Consequently, MBA believes the guidance in B39 indicates that 13.b. is *not applicable* to pass-through MBS. MBA also believes that the guidance in B39 is internally inconsistent as it relates to MBS with disproportionate cash flows and that those inconsistencies should be resolved.

⁹ The level of servicing fees in agency MBS programs typically result in the seller/servicer recording a mortgage servicing rights asset.

¹⁰ Because the word "proportionate" as used in paragraph 4.a. defines I/Os and P/Os only, it is unclear why it should have any relevance to distinguishing between MBS that are subject to evaluation under paragraph 13.b. Stated differently, it is unclear why an embedded prepayment option in a mortgage note that is collateral for a pass-through MBS should be regarded as any less "clearly and closely related" to the note simply because some amount of the collected interest is not passed through to holders of the security.

MBA Observations of B16

MBA understands that some people also believe that pass-through MBS must be evaluated under paragraph 13.b. based on a four step decision sequence found in B16¹¹ for determining whether calls that can accelerate the settlement of the debt are "clearly and closely" related to the debt host contract. According to the sequence, pass-through MBS would be subject to evaluation under 13.b. simply because the embedded call option is not "contingently exercisable." Consequently, without further clarification of the intent of B16, they argue that paragraph 13.b. would apply to evaluations of pass-through MBS regardless of the guidance in B39.

MBA might agree except for the fact that the guidance in B39 was most recently amended in February of this year, a full six months after B16 was updated in June of last year. MBA can only assume, therefore, that the FASB members and staff were aware of differences in the guidance as they undertook to update B39 earlier this year and that they made a conscious decision that: (1) B16 was inapplicable to the types of instruments referred to in B39; or (2) B39 effectively supersedes the guidance in B16 for loans and MBS. This result only makes sense because the guidance in B16 and B39 could lead to opposite conclusions about whether pass-through MBS should be evaluated under 13.b.

As such, MBA believes B39 must be relied upon in evaluating prepayable mortgages and MBS because it contains guidance that is: (1) most relevant to those instruments; (2) most consistent with the Board's intent as described in the guidance in FAS 133 (and as reflected in industry practice with respect to accounting for pass-through MBS under FAS 134); and (3) the most current guidance regarding the relevance of 13.b. to the evaluation of MBS under FAS 133.

IV. Conclusion

In conclusion, MBA believes that the current FAS 133, as amended by FAS 155 and interpreted by B39 and B16, *does not* require pass-through MBS to be evaluated under paragraph 13.b. However, to ensure that issuers and holders have a common understanding of the requirements of the Statement, MBA recommends that the Board confirm *as soon as possible* that B39 does not require pass-through MBS to be evaluated under paragraph 13.b. because some companies that have already adopted FAS 155 are preparing to file their third quarter financial statements and need confirmation that MBA's interpretation, which is consistent with their interpretations, is correct. In the meantime, and until further notice, those issuers will assume that MBA's interpretation is correct.

MBA recommends also that the Board reconcile the inconsistencies in the guidance in B39. As previously stated, B39 provides an exemption from paragraph 13.b. for borrower held prepayment options while simultaneously requiring an interest in MBS to be evaluated under that paragraph if the cash flows from exercise of the prepayment option would be disproportionately allocated to investors. MBA believes this guidance should be reconciled by reinstating the previous exemption for all borrower held prepayment options as those options are "clearly and closely related" to all debt host contracts as indicated in FAS 133. MBA would expect that any changes would be subject to a public comment period, particularly as the changes to B39 in FAS 155 were not exposed for public comment.

¹¹ FAS 133 Implementation Issue: "Calls and Puts in Debt Instruments."

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As always, MBA greatly appreciates the opportunity to share our comments on important accounting matters with you. If you should have questions about MBA's comments, please contact Alison Utermohlen, Senior Director for Government Affairs, at (202) 557-2864 or autermohlen@mortgagebankers.org.

Most sincerely,

A handwritten signature in black ink, reading "Jonathan L. Kempner". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

Jonathan L. Kempner
President & Chief Executive Officer