VIA Electronic Mail (director@fasb.org)

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Technical Director
Financial Accounting Standards Board
401 Merritt 7, P. O. Box 5116
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Dear Board Members and FASB Staff:

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to comment on the proposed Statement, *Accounting for Hedging Activities,* an amendment of FASB Statement No. 133. The primary objectives for the proposed Statement are to simplify accounting for hedging activities and to resolve major practice issues related to hedge accounting that have arisen under Statement 133.

Our members primarily use derivatives to hedge the price risk associated with producing loans for delivery to investors in the secondary market and for hedging the interest rate risk inherent in the ownership of mortgage servicing rights (MSRs). Derivatives are also used by many of our members in hedging the interest rate risk, cash flows or fair market value of various debt instruments.

MBA POSITION

General Comments:

The MBA supports the Board's efforts to simplify accounting for hedging activities. The MBA also supports the movement away from the "rules-based" accounting that has lead to many of the practice issues under Statement 133.

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 370,000 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 2,400 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.

However, the MBA has several major concerns with the proposed Statement as discussed on the following pages:

Elimination of Bifurcation-by-Risk

Statement No. 133, as presently amended, provides for the ability to bifurcate-by-risk. Paragraph 21 f. of Statement No 133 states:

> "If the hedged item is a financial asset or liability, a recognized loan servicing right, or a non-financial firm commitment with financial components, the designated risk being hedged is:
>
> (1) The risk of changes in the overall fair value of the entire hedged item,
> (2) The risk of changes in its fair value attributable to changes in the **designated benchmark interest rate** (referred to as interest rate risk),
> (3) The risk of changes in its fair value attributable to changes in related foreign currency exchange rates (referred to as foreign exchange risk), or
> (4) The risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk)."

With two exceptions,[2] the proposed Statement would limit an entity's ability to designate the risk being hedged to the risk of changes in the overall fair value of the entire hedged item.

Over the last 20 years, financial instruments and the bi-products of securitization such as MSRs have become extremely complex. Such assets and liabilities can contain multiple interest, credit, operational, regulatory and other risks. Some of these risks can be effectively hedged, while others cannot be hedged on a cost-efficient basis. For example, the overall fair value of an MSR is influenced by many factors, some affecting interest rate risk, some affecting credit risk, and some affecting the cost to service the underlying loans. Changes in laws and regulations can also impact the value of servicing rights. Because entities do not and cannot hedge all risks in MSRs, mortgage banking companies have generally elected to hedge the interest rate risk only, identifying changes in a benchmark interest rate as the specified hedged risk. They elect not to attempt to hedge the risks associated with changes in delinquency of the underlying loans and other risks that may impact fair value from time to time. The MBA believes that the ability to bifurcate-by-risk allows for an accounting recognition that mirrors the way companies manage the risks inherent in these complex assets and liabilities.

Many of the problems associated with FAS 133 have resulted from the long-term migration from a "cost" approach to full fair value accounting. The long transition period has resulted in a hybrid accounting model whereby some assets and liabilities are accounted for at cost and others at fair market value. In fact, recently issued accounting

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[2] The proposed Statement would permit designation of interest rate risk with respect to an entity's own debt and foreign currency risk as the risk being hedged.

pronouncements continue to allow a fair value option for servicing assets and financial instruments. The MBA believes that moving from a risk component approach to hedging the entire fair value of an asset or liability at this juncture in time is premature. The MBA recommends that the existing bifurcation-by-risk continue to be allowed until the migration to fair value accounting is complete. At that juncture, the bifurcation-by-risk issue will be moot.

International Accounting Standards Convergence

MBA appreciates the FASB's interest in seeking to reduce complexity in the application of Statement 133 by developing more principles-based guidance. On the other hand, MBA believes that the proposed Statement is unlikely to be beneficial to preparers and users of financial statements if any or all changes could be overturned as part of the international convergence effort. In essence, the MBA does not think that it makes sense for entities to first implement the proposed changes to FAS 133, then adopt IAS 39 under the accounting standards convergence project, and then to adopt and implement any subsequent changes to IAS 39. Readers of financial statements will be confused by the frequency of change, and individual entities will incur significant cost to make back-to-back changes in accounting for the same types of transactions. The MBA strongly recommends that the FASB postpone the proposed changes to hedge accounting until after the convergence to international accounting standards, at which time U.S. public companies will be required to follow IAS 39, as amended.

Proposed Prohibition of De-designation of Hedging Relationship

The proposed accounting pronouncement would prohibit the de-designation of an effective hedging relationship after it has been established. The MBA believes that the proposed accounting may preclude many of its members from electing hedge accounting for loans held-for-sale that are accounted for at the lower of cost or fair value under FAS 65, *Accounting for Certain Mortgage Banking Activities*, as amended. The following describes the economic hedging process for interest rate lock commitments (IRLCs), purchase loan commitments and loans held-for-sale.

Mortgage banking companies by necessity employ highly dynamic hedging practices to protect themselves from the risk of delivering loans to investors in the secondary market at a loss. Because a mortgage company on any given day may have tens of thousands of (1) interest rate lock commitments (IRLC), (2) purchase loan commitments, and (3) loans in its hedged loan portfolio, its derivative holdings would be correspondingly very large. The combination of large volumes of derivatives, and hedged IRLCs, purchase commitments, and loans necessitates an extremely 'hands-on' hedging process involving near constant monitoring of risk exposures, and frequent rebalancing of hedge relationships to ensure that a company is effectively protected against loss at all times because the population of loans and IRLCs and purchase commitments is changing constantly.

This hedging process involves frequent allocations of derivatives or groups of derivatives to IRLCs, purchase commitments, and loans (with derivatives allocated to loans designated as Statement 133 hedge instruments). Although the frequency with which companies' hedge positions are rebalanced varies by company, it is fairly common practice among the largest mortgage companies for this allocation process to occur on a daily basis using highly sophisticated methods. Smaller companies may employ similar rebalancing techniques but on a less frequent basis using their own, internally developed procedures.

Nevertheless, under all scenarios, a derivative, or a portion of a derivative, that may be economically hedging an IRLC or purchase commitment on one day may be designated as a Statement 133 fair value hedge (or cash flow hedge of the forecasted sale) of a loan on another day during the same reporting period. On any given day, a single derivative may be allocated between a fair value hedge of a loan and an economic hedge of an IRLC or a purchase commitment. Additionally, derivatives that are assets one day can convert to liabilities the next day, such that any distinction between derivative assets and derivative liabilities within the context of a mortgage company's hedging operations is very transient, and therefore not meaningful. Also, designated hedged items at the end of a reporting period may have been designated as of that date, whereas the related derivative could have been a designated hedging instrument throughout the reporting period.

As IRLC's become closed loans, correspondents and brokers deliver loans under purchase loan commitments, and loans previously held-for-sale are delivered to investors under forward loan commitments, the dynamic hedging process described above, requires, from an accounting standpoint, a frequent (often daily) de-designation and simultaneous re-designation of hedges assigned to loans held-for-sale

The MBA believes that the proposed prohibition against removing the designation of an effective hedging relationship after it has been established does not recognize the dynamics of the hedging process itself. MBA therefore strongly recommends that the proposed Statement continue to allow the frequent de-designation and re-designation with respect to hedge relationships like hedges for loans held-for-sale that, of necessity, need to be managed dynamically.

<u>Specific Comments:</u>

The MBA's position on the proposed Statement is further described below in response to specific questions for which the Board solicited responses. The MBA did not respond to issues or portions of issues requesting a projection of the impact on specific entities (e.g., Issue 4, third paragraph).

Issue 1: For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship.

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?

MBA Response: For the reasons cited in the MBA's General Comments above, the MBA objects to the proposed elimination of the ability of an entity to designate individual risks as the hedged risk. The MBA believes that allowing bifurcation-by-risk is consistent with the current hybrid accounting model and better portrays, from an accounting standpoint, the actual methodologies used to choose hedge instruments and strategies. We recommend that the existing bifurcation-by-risk continue to be allowed.

The proposed Statement should be changed to require more explicit disclosure in the notes to financial statements of the risks that management chooses to hedge and not to hedge and other qualitative and quantitative information that provides the user a better understanding of the hedge and fair value dynamics.

Issue 2: For the reasons stated in paragraphs A18 – A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for borrowed funds), if hedged at inception, and (b) foreign currency risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.

Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

MBA Response: For the reasons cited in the MBA's General Comments above, the MBA objects to the proposed elimination of the ability of an entity to designate individual risks as the hedged risk. We are pleased that the proposed Statement would continue the designation of specific risks for an entity's own issued debt and for foreign currency risk. However, we believe that the language "if hedged at inception" severely limits the carve-out for the entity's own issued debt. Entities often put on a specific hedge after inception of the underlying debt or otherwise dynamically manage the hedge position over time as circumstances change.

Issue 3: This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, the entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected cash flows on the hedged transaction.

Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

MBA Response: Misuse of the shortcut method historically resulted in many entities having to restate prior results. Such practice issues seem to be a problem of the past as most entities now fully understand the process and documentation required. The MBA believes that the removal of the short-cut method is inconsistent with one of the primary objectives of this project -- to simplify accounting for hedging activities.

Issue 4: This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from *highly effective* to *reasonably effective* at offsetting changes in fair value or variability in cash flows.

Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

MBA Response: The MBA believes that the proposed qualitative standard, "reasonably effective," would eliminate a large number of practice issues under the current Statement 133 and is an enlightened departure from the trend towards "rules-based" accounting principles. The practice under Statement 133 has evolved into iterative processes requiring statisticians and mathematicians, not accountants, to apply. The use of qualitative judgment, supplemented as necessary, with quantitative analysis will enable practitioners to get back to "substance over form" accounting.

With that said, the MBA believes that its members have already invested millions of dollars in infrastructure costs to comply with Statement 133 as it relates to hedge effectiveness testing for MSRs and loans held-for-sale. With this costly infrastructure already in place, the net impact of moving to a simpler model is not as appealing as it would have been years ago.

The MBA has one additional concern with respect to the proposed modification of the effectiveness threshold from highly effective to reasonably effective. Since the original issuance of Statement 133, accounting firms, bank regulators and the SEC have frequently changed the interpretation of the qualitative tests for "highly effective." This "evolution" has resulted in frequent re-statements of financial statements and the incurrence of millions of dollars of incremental costs to change software and infrastructure to the latest "interpretation." The MBA believes that the proposed accounting rules should provide some specific examples of what constitutes competent and relevant qualitative evidence supporting the assertion of reasonably effective to hopefully preclude a lapse back to ever-evolving interpretations by accountants and regulators.

Issue 5: This proposed Statement would always require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?

MBA Response: As noted in the General Comments above, the MBA believes that the proposed prohibition against removing the designation of an effective hedging relationship after it has been established does not recognize the dynamics of the hedging process itself. If the FASB modifies the proposed accounting to allow for de-designation and re-designation of hedges in a dynamic hedge situation, we would recommend that guidance also be provided on the timing and frequency of hedge effectiveness evaluations related thereto. The MBA does not foresee any other significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective. Entities will need to re-visit the qualitative and, as applicable, quantitative analyses that were used in the original analysis and incorporate any relevant, new factors not considered in the original analyses as they arise.

Issue 6: The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That "in" and "out" of hedge accounting would make it more difficult for users to interpret financial statements.

Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected term?

MBA Response: For the reasons cited in the MBA's General Comments above, the MBA objects to the proposed elimination of the ability of an entity to designate individual risks as the hedged risk. Because entities do not and cannot hedge all risks in complex financial transactions, the MBA suspects that more hedges will fail the effectiveness tests over time. The MBA recommends that the proposed Statement be modified to allow the continuation of the bifurcation-by-risk that is currently allowed under FAS 133. Then, the effectiveness evaluation should be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

Item 10: The Board decided to permit an entity a one-time fair value option election under FASB Statements 156, *Accounting for Servicing of Financial Assets,* and No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement.

Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of the proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?

MBA Response: The MBA believes that allowing a fair value option at initial adoption of the proposed Statement makes sense since the proposed Statement would require judging hedge effectiveness based upon changes in the entire fair value, not separate risk components.

Issue 11: The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations by the Board are provided in paragraphs A43 – A50 in Appendix B of the proposed Statement.

Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If no, what additional benefits or costs should the Board consider?

MBA Response: The MBA believes that the cost-benefit analysis incorporated in Appendix B of the proposed Statement should have considered the following additional factors:

- Many entities have spent millions of dollars building an infrastructure around the existing hedge effectiveness and documentation requirements under the existing Statement 133. Although the costs of compliance with the proposed Statement would be much less significant, those costs represent an addition to the sums of money already expended.
- As noted in the MBA's General Comments, the FASB is currently working on an international accounting standards convergence project. This may require additional changes to the current hedging and proposed hedging guidelines. MBA's members do not want to go through the cost and disruption of dealing with two or three potential changes in the same accounting pronouncement in a period of several years.

Conclusion

The MBA lauds the FASB's efforts to simplify accounting for hedging activities and to resolve major practice issues related to hedge accounting that have arisen under Statement 133. However, MBA believes that the existing bifurcation-by-risk carve-outs in Statement 133 should be allowed to stand.

The MBA is in favor of the proposed movement from *highly effective* to *reasonably effective* at offsetting changes in fair value or variability in cash flows. MBA would recommend, however, that a final Statement include some examples of the types of evidence that could be relied upon to demonstrate that a relationship is reasonably effective.

MBA also recommends that the FASB assess the possible impact of the current international accounting standards convergence project on the guidance proposed in the exposure draft to ascertain that adoption of the proposed changes to Statement no. 133 and then subsequent convergence with international accounting standards will not result in entities having to go through the cost and disruption of dealing with several changes in the same accounting pronouncement in a period of several years.

Finally, the MBA recommends that the proposed accounting be modified to allow for hedge de-designations and re-designations in the dynamic hedge situation described in the General Comments above related to the hedge of loans held-for-sale.

The MBA appreciates the opportunity to share these comments with the Board. Any questions about MBA's comments should be directed to Jim Gross, Associate Vice President and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Most sincerely,

Kieran P. Quinn, CMB
Chairman