



Via Electronic Mail

January 8, 2008

Ms. Holly Barker  
Project Manager  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856

Dear Holly:

Thank you for giving MBA the opportunity to provide more information regarding our December 5 letter to Chairman Herz recommending that lenders<sup>1</sup> be permitted to measure impairments of their residential mortgage loans that are troubled debt restructurings under FAS 5, *Accounting for Contingencies*, rather than FAS 114, *Accounting by Creditors for Impairment of a Loan*. I apologize again for the brevity of that letter which was intended primarily to alert the FASB to the issue. MBA has studied the questions the FASB staff sent after receiving our letter and has prepared the following responses:

- 1) Please clarify what loans are the subject of your request to waive the Statement 114 requirements for troubled debt restructurings - previously securitized residential mortgage loans that have been repurchased or newly originated residential mortgage loans that are being held in portfolio due to the current securitization market (if held in portfolio, should they be classified as held for sale loans and measured at the lower of cost or fair value?). Also what types of TDR's are you considering? All types of TDR's or only those which involve an interest rate concession?

**MBA Response:** MBA is seeking guidance from the FASB that 'modified residential mortgage loans that are TDRs' that are classified as held for investment pursuant to FAS 65 may be measured for impairment under FAS 5, rather than FAS 114. Those loans could include all loans that a lender holds for investment (regardless of whether they were originated or purchased or securitized in an on-balance sheet transaction) whose terms are changed to make them more affordable to borrowers. The types of changes may include, but would not be restricted to: (1) reducing the contractual interest rate;<sup>2</sup> (2) forgiving some amount of the original contractual interest and/or principal payments, including payments that are in arrears; (3) extending the life of the loan beyond its

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<sup>1</sup> References to lenders, companies and institutions are used interchangeably herein.

<sup>2</sup> This could include freezing the introductory interest rate on an adjustable rate mortgage for a period of time (e.g., three, five or more years) beyond the contractual initial, fixed rate period.

original contractual life; (4) modifying the terms of an adjustable rate mortgage to change the basis upon which future interest rate resets are calculated, and other changes. MBA believes that judgment would have to be exercised in determining whether the effect of any of these changes is more than "...An insignificant delay or insignificant shortfall in amount of payments..." such that the loan is subject to FAS 114 accounting (see par. 8 of FAS 114).

- 2) How pervasive is this issue? Is this issue concentrated with a few of the largest mortgage originators, or does it span the entire mortgage industry, regardless of size? Please provide relevant statistics that may be helpful in understanding the anticipated volumes of restructurings. Please specify what form of relief or clarification you would suggest.

**MBA Response:** MBA believes that potentially tens, and perhaps hundreds, of thousands of residential mortgage loans that are held for investment could be modified and therefore subject to the measurement guidance in FAS 114 initially *and on an ongoing basis* in the future. Consequently, MBA believes this issue is relevant to all companies that hold such loans for investment whose terms may be changed in the future to make them more affordable to borrowers. MBA also believes that the challenge of applying the guidance in FAS 114 would be comparable among large and small companies given their relative loan portfolios and systems capabilities.

For this reason, MBA believes the scope exception provided for smaller-balance, homogeneous pools of loans that are collectively evaluated for impairment under paragraph 6.a. of FAS 114 should apply to all such loans, including modified TDR loans. MBA believes the scope exception reflects an understanding by the Board that smaller-balance, homogeneous loans need to be evaluated differently than larger-balance, non-homogeneous loans. More specifically, our members believe the Board likely understood during the drafting of FAS 114 that mortgage lenders (and other lenders of smaller-balance homogenous loans) do not monitor the types of loans covered by 6.a. on an individual basis because it would be cost prohibitive to do so, and because they do not have access to the same type of real-time borrower and collateral specific information for smaller-balance loans that they generally do for larger-balance loans, particularly commercial loans.

Our members also believe that if both the mortgage lending industry and the Board had known during the drafting of FAS 114 that potentially tens, and perhaps hundreds, of thousands of smaller-balance, homogeneous loans that are collectively evaluated for impairment could one day be subject to FAS 114 initially *and on an ongoing basis* that the scope exception in 6.a. would have been written more broadly to include modified loans that are TDRs. Unfortunately, no one at that time, the MBA included, could have foreseen a day in which thousands of loans that are in default (or in reasonably foreseeable default) might be modified within the same reporting periods. Few residential mortgage loans have been modified so significantly in the past as to require FAS 114 accounting (i.e., the troubled debt restructurings were either immaterial to the financial statements or have been deemed insignificant under paragraph 8 of that Statement).

- 3) Please provide your views on whether your suggested approach to evaluate credit losses using a Statement 5 approach would likely result in a similar loan loss provision or impairment charge to a FAS 114 approach.

**MBA Response:** FAS 5 would capture the pure credit loss attributable to not receiving the carrying value of a loan based on an evaluation by the lender as of the reporting date of the probability that some amount of that value will not be recovered. This amount would likely differ from the loss amounts that would be produced under any of the three valuation approaches provided for under FAS 114 because they take into account factors beyond the probability of recovery of an asset's current carrying value.

For example, the discounted cash flow measurement approach under FAS 114 would capture the difference between the interest rate prior to and after modification that has been given up by the lender. However, the sacrifice of the potential future interest may have no bearing on the amount of a loan's carrying value that will not be recovered. It also may not be indicative of the market value of the loan.

The following hypothetical example helps to illustrate these points:

Assume a lender modifies an adjustable rate mortgage loan to convert it to a fixed rate loan bearing an 8% interest rate rather than to increase the rate to 13% at the next reset date per the original loan terms. Under a discounted cash flow measurement approach, FAS 114 would capture the net present value difference between the 13% and 8% interest rates. The resulting present value amount may produce a loss when compared to the carrying value of the loan that is not representative of the estimated future loss on the loan. Moreover, if the current market rate for such a loan were 8.5%, the lender would be required to report an impairment that would capture a 5% reduction in the interest cash flows that would likely produce a value for the loan that is much lower than its current market value.

Additionally, the alternatives to a discounted cash flow approach provided for in FAS 114 (i.e., value of the underlying collateral less cost to sell or quoted market price for the loan) are fair value measurements, as opposed to cost-based measurements, as acknowledged in paragraph C18 of FAS 157, *Fair Value Measurements*.<sup>3</sup> As such, they would produce values for the loans that would reflect changes in market factors, including changes in: (1) prevailing market rates for similar loans, (2) market supply and demand for similar loans, (3) the relative attractiveness of loans as investment vehicles (as compared to bonds, securities or other instruments), and other factors that may be irrelevant to the recoverability of the carrying values of the loans at a point in time.

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<sup>3</sup> "In the Exposure Draft, the Board decided to exclude FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, from the scope of this Statement. The Board clarified that the measurement for impaired loans, determined using a present value technique, is not a fair value measurement. Respondents agreed. However, they noted that the practical expedient in Statement 114 (observable market price or the fair value of collateral if the loan is collateral-dependent) is a fair value measurement. They said that when the practical expedient is used, the guidance in this Statement should apply. The Board agreed and decided to include Statement 114 in the scope of this Statement as it relates to the practical expedient."

Importantly also, the values derived from any of the three measurement approaches under FAS 114 could be subject to challenge and debate by management and auditors. Questions have already been raised, for example, with respect to the proper interpretation of the guidance in paragraph 12 of FAS 114; particularly, how the effective interest rate should be calculated for hybrid adjustable rate mortgages that generally were not anticipated to remain outstanding after the reset date. Values based on appraisals of the underlying collateral could be challenged also based on the qualifications of appraisers, the timeliness of the appraisals, differences between appraisals of comparable properties, etc. Likewise, quoted market prices of loans could be challenged if available quotes are difficult to obtain (particularly for great quantities of loans) or the range of quoted prices is very wide.

For all these reasons, MBA believes the measurement approach in FAS 5 and *each of the three* measurement approaches in FAS 114 would likely result in the recognition of different loss amounts initially and on an ongoing basis. On the other hand, MBA believes the measurement approach in FAS 5 is the superior approach because: (1) it is more consistent with the cost based guidance for measuring held for investment loans under FAS 65 (see question 13 below); (2) it would produce balances that could be substantiated and disclosed; and (3) lenders have the means currently to comply with it. Most importantly, MBA believes that a FAS 5 measurement would produce the most relevant information with respect to the amounts that lenders have at risk with respect to their held for investment modified smaller balance loans. The Board appears to have considered this in FAS 114 when it observed that creditors' formulas for estimating losses related to smaller-balance homogeneous loans are reasonable as they typically consider relevant factors (e.g., past loss experience, recent economic events etc.) which the Board concluded result "...in a measure of impairment that implicitly discounts expected future cash flows."<sup>4</sup>

- 4) Can you explain the systems constraints that the mortgage companies are experiencing? What difficulties would an institution encounter in capturing the relevant information from systems databases in a software package that would enable a discounted cash flow analysis to be completed? Do these systems constraints extend beyond Statement 114? In other words, do institutions' systems currently enable compliance with other accounting requirements such as Statement 91?

**MBA Response:** Most companies that have shared their views with MBA state they simply do not have the systems capability to measure impairments of modified smaller-balance residential mortgage loans using a discounted cash flow approach. They note that such an approach would involve considerations of the impact of changes to specific loan terms on probable future prepayments and defaults for the purpose of projecting future cash flows. For example, lenders' systems would have to consider and quantify for valuation purposes a variety of possible changes to borrowers' loan terms, including changes to the cash flows resulting from a modification where a borrower's initial interest rate is extended for a period of time as opposed to a modification where a borrower's principal and interest payments in arrears are forgiven. These changes would have significantly different affects on a loan's future cash flows and would require off-line efforts to calculate, which would be an enormous undertaking for small and large companies alike. Additionally, the systems do not capture the effective interest rates of

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<sup>4</sup> See paragraph 38 of FAS 114.

loans as that term is defined in FAS 114<sup>5</sup> (especially for hybrid ARMs), and thus, it would have to be calculated manually.

It is important to note that there is a distinction between estimating future cash flows under FAS 114 and estimating the probability of a loss under FAS 5. Under FAS 114, a lender would have to project all principal and interest cash flows in all future reporting periods whereas, under FAS 5, a lender would be responsible for estimating incurred losses at the reporting date as a result of expected defaults at that time. The effort involved in the first case would be far more detailed and subjective than in the second case for arguably less relevant information, as explained under question 3 above.

It is important to note also that there are key distinctions between the guidance in FAS 114 and FAS 91 which affect the degree of difficulty associated with the Statements.

For example, FAS 91 requires fees and costs to be recognized in income over the life of the loan using the interest method.<sup>6</sup> The interest method is easily calculated by comparing future **scheduled** payments to the face amount of the debt plus or minus any discount, premium or amortized fees at inception of the loan, without considering estimated defaults. The amortization of any fees and costs *would remain constant* until and unless: (1) the loan prepays or goes to foreclosure or (2) prepayments occur that were not anticipated in calculating the effective interest rate for a large number of similar loans (for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated).<sup>7</sup> Consequently, under FAS 91, **known** fees and costs are required to be amortized over the contractual life of a loan or the projected average life of a large number of similar loans for which prepayments are projected.

By contrast, FAS 114 requires principal and interest payments to be recast for loans depending upon the changes in their loan terms, which would involve estimating the effect of future prepayments and defaults (in terms of both amounts and timing of occurrence) on those payments. Because many loans are likely to be evaluated and then modified on a case-by-case basis, FAS 114 raises the prospect that lenders may be required to anticipate defaults and foreclosures in connection with projecting cash flows for individual loans under that Statement. MBA members have indicated they do not know how they would perform such a calculation since future prepayments are generally estimated on a pool basis.

Further, unlike FAS 91 which would require recalculations of the effective interest rate only in circumstances where anticipated prepayments occur for large pools of loans (see

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<sup>5</sup> Pursuant to FAS 114, the "effective interest rate" is the "...rate for a loan restructured in a troubled debt restructuring [which] is based on the original contractual rate, not the rate specified in the restructuring agreement." (see paragraph 14 of FAS 114). That rate is different than the interest rate (i.e. the level effective yield) which lenders must calculate for FAS 91 purposes through a comparison of future payments on loans (assuming no default) to their original balances (net of deferred fees and costs, premiums and discounts).

<sup>6</sup> Pursuant to ABP Omnibus Opinion 12, "The objective of the interest method is to arrive at a periodic interest cost (including amortization) which will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period."

<sup>7</sup> In the latter case, if "...a difference arises between the prepayments anticipated and actual prepayments received, the enterprise would recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loan shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans." (See paragraph 19 of FAS 91).

footnote 7), FAS 114 would require quarterly adjustments of required impairment charges, as well as adjustments of the impairment accretion rate, due to changes in projected cash flows or passage of time. This would be an enormous undertaking for all lenders.

- 5) What difficulties would an institution encounter in doing the discounted cash flow analysis in an excel spreadsheet or similar software?

**MBA Response:** Even if impairment for thousands of loans could be calculated “off-line,” the measured impairment would have to be manually fed into the loan accounting system and accounted for separately for subsequent accounting purposes, including accretion of the valuation allowance due to the passage of time. This would be extremely time-consuming and would likely involve additional staff dedicated to this purpose.

- 6) The FASB staff understands that financial institutions estimate cash inflows expected to be received through securitization transactions. These transactions generally encompass a significant amount of loans in a single transaction, for purposes of pricing the transaction and ascertaining the gain/loss on the transaction. What systems or other mechanisms are used in securitization transactions and what makes the cash flow estimation process different in securitization transactions when compared to a Statement 114 analysis? Consequently, is the asserted systems issue limited to smaller institutions or all financial institutions with the issue of mortgages expected to be restructured at rates less than the average effective rate stipulated in the original agreement?

**MBA Response:** Generally, this question is relevant only to large companies that model securitization cash flows internally in connection with their issuances of private label securities. Also, to the extent a company projects securitization cash flows in-house, they typically project them based on representative collateral characteristics of the pool, by type of loan within the pool (rather than on a loan-by-loan basis). Those projections are intended to provide prospective investors with a range of possible yields on investments (rather than one, single 'best' estimate) assuming a variety of different prepayment and loss curves, and interest and discount rates. By contrast, FAS 114 would require companies to calculate best estimates on a loan-by-loan basis if the loans are modified differently and therefore not evaluated as part of a pool. Accordingly, the loan-by-loan systems limitations exist at institutions both large and small, and regardless of whether they securitize or not.

- 7) How do mortgage companies that have historically held residential mortgages in portfolio comply with Statement 114's requirements when a residential mortgage loan is modified in a manner that qualifies as a TDR? How do these entities apply FAS 114 to other types of loans which do not qualify for the scope exception in FAS 114?

**MBA response:** Few residential mortgage loans have been modified so significantly since the issuance of FAS 114 (i.e., the trouble debt restructurings were either immaterial to the financial statements or have been deemed insignificant under paragraph 8 of that Statement) as to require the prescribed accounting under the Statement. Events of the past few months, however, have radically changed the prospect that companies with significant holdings of on-balance sheet loans will not

apply FAS 114 accounting on the basis of materiality. There has been a growing realization of this fact throughout the mortgage banking industry since August of this year, when the market for "subprime" loans, particularly adjustable rate loans with low, initial market rates, diminished dramatically almost overnight.

By contrast, commercial mortgage loans that are impaired have always been accounted for under FAS 114 because lenders have always been better equipped to measure impairments of larger-balance, non-homogeneous loans for impairment under that Statement.

- 8) Please explain how the concessions will be executed. Specifically, will lenders provide concessions on a pooled basis or a loan-by-loan basis? Would a pooled analysis under Statement 114 rather than a loan-by-loan analysis be feasible?

**MBA Response:** Many MBA members are considering the feasibility of streamlined modifications for categories of loans at this time. They are conferring with all interested parties and knowledgeable advisors in assessing the accounting, legal and other considerations involved in making the same, or similar, modifications to large groups of loans. In the event such modifications occur, pools of similarly modified loans presumably could be grouped for the purpose of evaluation under FAS 114.

Nevertheless, our members note that FAS 114 would still be onerous to apply because of the requirement that future cash flows be estimated at every reporting period for the remaining life of a loan, or pool of loans. Moreover, loans that could not be grouped together (for reasons relating to the nature of a particular modification) would still have to be evaluated separately. Thus, lenders would still be burdened with projecting cash flows for some individual loans, as well – potentially – as some large pools of loans. The burden of complying with FAS 114 going forward would, therefore, still be great for most lenders.

Most importantly, MBA members believe that the financial results of measuring impairments under FAS 114 would not produce better information to readers of financial statements. As mentioned earlier in this letter, a discounted cash flow analysis would reflect lost interest that may be irrelevant to the recoverability of the carrying value of a loan. MBA believes it would be more difficult for this reason to explain and disclose the calculation of impairment charges under FAS 114, than the calculation of loss reserves under FAS 5, for held for investment loans.

- 9) How are the large institutions currently applying Statement 5 to these loans? How are factors to calculate an adequate loan loss reserve derived (a) if historically they have not held these loans in portfolio and (b) given recent market events? The FASB staff understands that a Statement 5 approach typically is based on undiscounted cash flows. Is this understanding accurate and generally applied across the industry?

**MBA Response:** Although companies measure losses on their loans under Statement 5 using a variety of methodologies, the common objective of all methodologies is to recognize loan losses that are estimable and are probable of occurring as of the reporting date. A near universal feature of those methodologies is that they take into consideration historical loss amounts on similar loans. MBA members believe they have

the means to estimate losses on loans that may be modified in the future under FAS 5, which likely will include comparing historical default rates on pre-existing and existing loans with terms and borrowers that are comparable to the newly modified loans.

- 10) In your letter, you assert that “the values of the underlying collateral and observable market prices would be unobtainable or unavailable timely”. In addition, you state that evaluating TDRs in accordance with SFAS 114 would be costly to a lender “for arguably no benefit in terms of improved financial information”. Please elaborate on those assertions.

**MBA Response:** Our members report that it would be costly to obtain appraisals of thousands of single family homes, or quoted market prices for modified smaller-balance loans, initially *and on an ongoing basis* as an alternative to measuring impairments under FAS 114 using discounted cash flow analyses. It would also be difficult to obtain the information on a timely basis and, once obtained, it could be subject to challenge - particularly in the case of quoted market prices which can vary widely depending upon the sources of bids. The requirement to obtain appraisals or quoted market prices initially and at the end of every period for which financial data is reported would likely involve the hiring of additional staff for this purpose alone.

- 11) Would the modified loans be deemed collateral-dependent loans subject to banking regulators’ requirements that such loans be analyzed under SFAS 114 using collateral fair values?

**MBA Response:** MBA understands that companies that are subject to the FFIEC’s rules have been measuring impairments of loans that are 180 days past due based on the value of the underlying collateral less costs to sell. However, unlike the FFIEC rules which impose a requirement to measure impairments of loans for a limited period of time because the loans are probable of being foreclosed, the FAS 114 guidance would impose an ongoing burden on lenders to measure impairments of loans that – as a result of a modification – are less likely of being foreclosed than they were prior to the modification. Consequently, the costs of applying FAS 114 to modified loans that are TDRs would be far greater than the costs of applying the FFIEC rules to loans that are 180 days past due in return for arguably less relevant information about the modified loans.

- 12) If institutions were permitted to perform credit loss analyses under SFAS 5 for impaired loans that are TDRs, would those companies be able to provide impaired loan disclosures specific to loans that have been restructured? Said differently, would lenders be able to bifurcate loans analyzed that are TDRs from the rest of their loan portfolio, and provide adequate information around the restructuring so that users of financial statements can adequately understand the concessions granted to the subset of borrowers whose loans are restructured?

**MBA Response:** MBA members assert that they would be able to provide information under FAS 5 that would allow users to understand the concessions granted to borrowers, including subsets of borrowers, as a result of loan restructurings. In fact, our members maintain that it would be far easier for them to explain recognized losses related to loan carrying amounts (under FAS 5) as opposed to recognized losses related

to foregone future interest (under FAS 114) that (1) the lender may never have anticipated receiving because the loan was expected to prepay prior to an interest rate reset date and (2) would likely not be received absent the restructuring because the loan would likely go into foreclosure. MBA members acknowledge, however, that it would be onerous to disclose loss amounts for each type of TDR (e.g., interest rate reduction, maturity extension, etc.) under FAS 5 without systems enhancements.

- 13) Please elaborate on your statement that SFAS 5 would produce loan balances using a methodology consistent with the cost basis under SFAS 65.

**MBA Response:** As explained in MBA's response to question 3 above, a FAS 5 measurement would capture the extent to which the carrying value of a loan would not be recovered which is a cost-based measurement, similar to the requirement to carry loans held for investment at cost under FAS 65. By contrast, a discounted cash flow approach under FAS 114 would capture the effect of not receiving interest that *might* have been received absent the modification despite the greater likelihood that the loan would have gone into foreclosure (i.e. resulting in a loss of *any and all* future interest), which is neither a cost-based nor a market-based measurement. The expedient alternatives of relying on the value of the collateral less costs to sell or quoted market prices of the loan are market-based, rather than cost-based, measurements.

Thank you again for giving MBA the opportunity to address your questions. If you still have questions about our request, please let me know.

Sincerely,



Alison B. Utermohlen

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