



September 8, 2009

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
First Floor  
London, EC4M 6XH  
United Kingdom

Dear Sir:

The Mortgage Bankers Association<sup>1</sup> (MBA) appreciates the opportunity to comment on ED/2009/7, *Financial Instruments: Classification and Measurement* (proposed IFRS). As a result of the proposed convergence of U.S. accounting standards with international accounting standards, the proposed IFRS will likely have a significant impact on MBA's members.

The purpose of the proposed IFRS is to establish principles for the classification and measurement of financial assets and financial liabilities that will present relevant and decision-useful information to users of financial statements for the assessment of the amounts, timing and uncertainty of future cash flows.

The following are MBA's general and specific comments.

### **MBA's General Comments**

**Piecemeal Amendment Process:** Paragraphs 13 and 14 point to applying impairment and hedge accounting requirements in accordance with existing standards of the International Accounting Standards Board (IASB). The G20 recommendation and IASB current agenda include revisions to those pronouncements being released soon. MBA acknowledges that some, including

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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 2,400 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](http://www.mortgagebankers.org).

the European Union, may be encouraging the IASB to divide the financial instruments accounting amendment project into multiple projects and exposure drafts. However, MBA believes that it would be preferable to expose for comment the entire “quilt” of proposed accounting principles for financial instruments as opposed to individual pieces. This would enable respondents to exposure drafts to assess the impact of the financial instrument accounting proposals taken as a whole.

**Interest Rate Lock Commitments:** Paragraphs 16 and 17 of the proposed IFRS prescribe rules for accounting for commitments to provide a loan. Mortgage bankers frequently make commitments to make a loan at a specified interest rate (IRLCs), and many of those IRLCs meet the definition of a derivative under Financial Accounting Standards Board (FASB) Statement of Financial Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), because the resulting loans will be held for sale. Assuming the definition of a derivative does not ultimately change in the converged accounting standards, which guidance should reporting entities follow, paragraph 16 and 17 of the proposed IFRS or the prescribed accounting for derivatives? MBA recommends that paragraphs 16 and 17 should be re-worded to carve out special accounting treatment for loan commitments that meet the definition of derivatives.

**Held for Trading Definition:** Appendix A on page 24 of the proposed IFRS contains the definition of held for trading. Item (b) in the definition states “...on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking” (tainting rules). What constitutes a pattern? Frequently, financial institutions sell securities like mortgage-backed securities (MBS) to adjust the duration of their portfolio as rates or the shape of the yield curve change. Further, sales are made from time to time for credit risk management purposes as well. Also, sales may be made from time to time to shrink the balance sheet for regulatory capital ratio purposes. Under present U.S. Generally Accepted Accounting Principles (GAAP) there is an available for sale (AFS) classification that accommodates those instruments on a bank’s balance sheet that are occasionally used by management for managing interest rate, credit risk, regulatory capital and other key asset/liability management functions. MBA recommends that the proposed IFRS provide tainting rules that permit sales that are not for short-term profit-taking.

**Definition of Transaction Costs:** Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91) allows for the capitalization in the basis of the loan of certain direct origination fees and costs. MBA believes that the proposed IFRS is inconsistent on the

deferral of origination fees on loans. The definition of transaction costs on page 25 of the proposed IFRS does not include direct origination fees. Paragraph 11 appears to require the capitalization of transaction costs on loans not measured at fair value through profit or loss, but is silent on direct origination fees. In contrast, the definition of effective interest rate on page 24 of the proposed IFRS appears to include fees as integral to the calculation of the effective interest rate. MBA believes that such fees should be capitalized and amortized over the lives of the respective loans as an adjustment to the yield on the loans, and MBA requests IASB to clarify this in the final pronouncement.

**Identification of Tranches Providing Credit Protection:** Paragraph B8 on page 28 of the proposed IFRS provides that any tranche that provides credit protection to other tranches in any situation does not have basic loan features, thus would not be eligible for amortized cost classification. MBA believes that this provision does not fully take into account the purpose and function of providing tranches of cash flows in a multiple tranche security. Many MBS have multiple tranches that allow investors to choose from a variety of duration options. Credit losses are only deemed probable for the lowest tranches. Other tranches are positioned in the waterfall of cash flows to provide for differentiation in the duration of cash flows. The longer the duration, the higher the interest rate, depending on the shape of the yield curve at the time of issuance. MBA recommends that the proposed IFRS be changed to allow all tranches that have sufficient subordination below it to absorb expected credit losses to be eligible for amortized cost classification.

**Financial Assets Acquired at a Discount:** Paragraph B13(b) on page 24 of the proposed IFRS indicates that a financial asset that is acquired at a discount that reflects incurred credit losses is deemed to be not managed on a contractual yield basis and not eligible for amortized cost classification. MBA notes that few financial assets acquired after the asset is originated are acquired at exactly par. A discount inherent in the sale price can reflect changes in interest rates and the yield curve since the instrument was originated as well as changes in incurred credit losses. Determining whether a discount or premium relates to changes in interest rates or the shape of the yield curve or whether it relates to credit risk assumption changes is difficult. MBA believes that loans acquired at a discount, even with discounts related to incurred credit losses, frequently are held for and managed on a contractual yield basis. Accordingly, MBA recommends that loans acquired at a discount be accorded the same accounting treatment as loans acquired at par.

### **MBA's Specific Comments**

**Question 1:** Does amortized cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

**MBA Response:** Generally MBA believes that amortized cost provides decision-useful information for a financial asset or financial liability that has basis loan features and is managed on a contractual yield basis. However, see MBA's general comments above about tranches providing credit protection and financial assets acquired at a discount.

**Question 2:** Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

**MBA Response:** See MBA's general comments for identification of tranches providing credit protection and financial assets acquired at a discount.

**Question 3:** Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortized cost? If so,

(a) what alternative conditions would you propose? Why are those conditions more appropriate?

(b) if additional financial assets or financial liabilities would be measured at amortized cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortized cost result in information that is more decision-useful than measurement at fair value?

(c) if financial assets or financial liabilities that the exposure draft would measure at amortized cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

**MBA Response:** (a) See MBA's general comment above about the held for trading definition. MBA believes the IASB should have a carve-out from tainting rules to accommodate those instruments on a financial institution's balance sheet that are occasionally used by management for managing interest rate risk, credit risk, regulatory capital and other key asset/liability management functions. Those should be allowed to be carried at amortized cost.

(b) Not applicable.

(c) Presently, the fair value election in the proposed IFRS is only available when there is an accounting mismatch between assets carried at amortized cost and a supporting liability carried at fair value. There could be situations where a financial asset is carried at amortized cost and a related derivative is carried at fair value. MBA recommends that fair value election be allowed in those situations.

**Question 4:** (a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

**MBA Response:** (a) MBA believes that this is a complex issue and represents a significant departure from U.S. GAAP, where bifurcation of the embedded derivative from its financial instrument host is grounded in practice. MBA members do not have a consensus on this issue and need more time to consider its implications.

(b) MBA disagrees with the proposed approach to contractually subordinated interests. See general comment above related to identification of tranches providing credit protection.

**Question 5:** Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

**MBA Response:** MBA agrees.

**Question 6:** Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

**MBA Response:** MBA recommends that the fair value option be allowed for assets that are hedged by derivatives carried at fair value.

**Question 7:** Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

**MBA Response:** See MBA's general comment above about the held for trading definition.

**Question 8:** Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

**MBA Response:** MBA generally supports the proposed IFRS requiring equity securities to be carried at fair value in the statement of financial position. MBA also supports the one-time election to present changes in fair value of equity securities not held for trading to be reported in Other Comprehensive Income (OCI). MBA cautions that measuring equity instruments that are not publicly traded is a costly and arduous process that would include evaluating a company's tangible and intangible values or projecting a value based upon projected earnings and an unknown earnings multiple. Accordingly, MBA recommends that equity securities not broadly held or publicly traded be exempt from fair value.

**Question 9:** Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

**MBA Response:** If the primary assets owned by a reporting entity are equity securities that are not publicly traded, requiring those securities to be carried at fair value would provide decision-useful information in certain circumstances. This may apply to reporting entities like venture capital funds.

**Question 10:** Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

**MBA Response:** MBA believes that presenting fair value changes for particular investments in equity securities provides decision-useful information because MBA believes the results of operations should not be impacted by the volatility of the markets for securities it does not hold for trading, but rather for other strategic purposes.

**Question 11:** Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

**MBA Response:** MBA agrees that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition.

**Question 12:** Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

**MBA Response:** MBA agrees with the additional disclosures required if a reporting entity applies the proposed IFRS before its mandated effective date.

**Question 13:** Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

**MBA Response:** MBA believes that retrospective treatment for the accounting changes under the proposed IFRS will be time-consuming and costly especially for entities currently reporting under U.S. accounting standards where many financial institutions have elected fair value accounting for a number of assets that, under the proposed standards, will have to be accounted for at amortized cost. MBA asks that IASB consider allowing entities to re-classify and measure financial assets and liabilities as of the beginning of the period in which the proposed IFRS is effective, with a cumulative effect adjustment to retained earnings for the after-tax impact of the change in accounting.

**Question 14:** Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortized cost, specifically:

- (a) in the statement of financial position?
- (b) in the statement of comprehensive income? If so, why?

**MBA Response:** The alternative approach basically would limit loans carried at amortized cost to loans for which there is no active market. Other financial assets that have basic loan features and are managed on a contractual yield basis would be carried in the statement of financial position at fair value. Changes in value determined on an amortized cost basis would be reported in the income statement, while the difference between amortized cost and fair value would be reported through OCI. This would seem to satisfy users' desire for fair value information on loans traded in active markets. It would also exclude from earnings temporary changes in fair value for financial assets not to be sold in the foreseeable future. MBA believes that this alternative approach may be a good compromise to the FASB's proposal to account for all financial instruments at fair value. MBA notes that the primary problem with the proposed IFRS and the proposed FASB model is the focus on the characteristics of the individual financial instrument as opposed to the reporting entity's business model for the intended use of the financial instrument. In arriving at a converged standard, MBA hopes that the focus will shift to the business model and intended use to drive the classification and appropriate measurement.

**Question 15:** Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

**MBA Response:** The first variation would require all financial assets and liabilities, except those that are not traded in an active market, to be valued at fair value with changes going through the income statement. MBA believes that this is improper accounting for financial institutions that hold financial assets for the long-term contractual yield. MBA also believes that such accounting would result in extreme fluctuations in reported earnings, resulting in a pro-cyclical impact.

The second variation would require all financial instruments to be accounted for at fair value in the statement of financial position. The change in value determined on an amortized cost basis for financial instruments with basic loan features that are managed on a contractual yield basis would be recorded in the income statement, while the remaining change in fair value would be recorded in OCI. MBA notes that much of this information is already available under U.S. accounting principles in a note to financial statements comparing amortized cost

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with fair value at period end. The proposed IFRS would require dual accounting for most financial assets and liabilities—amortized cost and fair value. This dual accounting would be costly and time-consuming.

MBA appreciates the opportunity to share these comments with the IASB. 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](mailto:jgross@mortgagebankers.org).

Sincerely,

A handwritten signature in cursive script that reads "John A. Courson".

John A. Courson  
President and Chief Executive Officer  
Mortgage Bankers Association