FIRST HORIZON.
HOME LOANS

4000 Horizon Way
Irving, TX 75063

Letter of Comment No: 17
File Reference: 1200-001
Date Received: 07/31/03

July 31, 2003

Mr. Lawrence W. Smith
Director – Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merrit 7
Norwalk, CT 06856
director@fasb.org

File Reference No. 1200-001

We are pleased to have the opportunity to submit comments on the June 10, 2003, Exposure Draft of a Proposed Amendment, "Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140" (the ED). Our comments on key concepts and concerns are discussed below.

Overall

We support the two objectives of this proposed Statement as outlined in the ED. However, we have significant concerns about the proposal as currently drafted, and believe that unless the proposed Statement is clarified and additional implementation guidance is provided, the Statement will not improve current accounting and disclosure for Qualifying Special-Purpose Entities (QSPEs) and Isolation of Transferred Assets.

Basis for Conclusions

Our conclusions of the implications of the proposed statement is based on the belief that Fannie Mae, Ginnie Mae, Freddie Mac (hereby Agency or Agencies) securitizations and most private mortgage securitization transactions involve QSPEs, as that term is defined in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Unfortunately, it is not entirely clear what the definition of a Special Purpose Entity (SPE) really is, this is primarily the result of ambiguities in the use of the terms "SPEs,"[1] "QSPEs," "legal vehicles," and "securitization structures" in FAS 140 as well as the definition of "entity"[2] in FIN 46, *Consolidation of Variable Interest Entities.*

QSPEs are defined as "...a trust or other legal vehicle..." that meets the criteria of FAS 140, paragraph 35. We believe agency mortgage pools backing agency guaranteed securities meet the definition of a trust[3] because the agency has a fiduciary obligation to hold mortgages for the benefit of the securities

[1] We note that "Special Purpose Entity" is not a defined term in FAS 140. Consequently, in trying to distinguish between an "SPE" and a qualifying "SPE," we believe Company's have come to different conclusions with respect to the meaning of "SPE."

[2] Paragraph 3 of FIN 46 defines entity as follows: "For convenience, this Interpretation uses the term *entity* to refer to any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts. Portions of entities or aggregations of assets within an entity shall not be treated as separate entities for purposes of applying this Interpretation unless the entire entity is a variable interest entity. Some examples are divisions, departments, branches, and pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity. Majority-owned subsidiaries are entities separate from their parents that are subject to this Interpretation and may be variable interest entities."

[3] A trust is a fiduciary arrangement whereby title to property is held by one party for the benefit of another. American Heritage Dictionary (3rd ed. 1996).

holders.[4] Current industry practice leads us to believe the trusts involved in agency securitizations meet the additional criteria in paragraph 35.

Our comments and conclusions on the ED are primarily focused on its potential impact to Mortgage Bankers and indirectly, investors of agency and private label securities, if the QSPEs used in agency and private securitization transactions were determined to be "non-qualifying" as a result of the additional restrictions that are proposed on the permitted activities of transferors.

Specific Concerns

Paragraph 35 e) of the ED disallows a QSPE from "entering into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77 – 79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its Beneficial Interest Holders (BIHs). That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE as well as commitments to purchase outstanding beneficial interests directly or indirectly from the BIHs or to otherwise settle beneficial interests with their holders." Questions arise as to who the Transferor is in an Agency transaction. Some believe that the Agency is the transferor as the Lender transfers the pool of loans directly to the Agency, who then transfers the loans to an SPE or trust. If the Agency is deemed to be the Transferor, this provision would effectively prevent Agency securitizations from utilizing a QSPE as the Agency/Transferor provides a guarantee to the BIHs (in the case of agency securitizations, the BIHs would be the holder of the mortgage backed security or participation certificate) that they will receive the payment of interest and principal. Others believe that the Lender is the Transferor in an Agency transaction. The assumption here is that the Lender is transferring the pool of loans to QSPEs because the lender is required to convey all rights, title, or interest in the mortgages to the Agency, who act as their own trustee, constitutes a transfer to a trust. Further clarification on these guaranteed mortgage securitizations would ensure consistent application.

If the Agency is not the Transferor in an agency securitization, then this provision would still prevent the use of a QSPE. During the normal course of business, a Mortgage Banker (the Transferor) may be required to repurchase or replace individual loans that were placed in a pool or transferred to a QSPE pursuant to representations and warranties clauses outlined in the Agency Seller/Servicer guidelines. These reps and warranties are provided in virtually all sales of financial assets including those that do not involve a securitization transaction. Under FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, these guarantees are recorded at fair value in the financial statements of the Mortgage Banker. Additionally, under the ED, this would disallow an SPE from being a QSPE, and therefore prevent the Agency's from using a QSPE. We believe that repurchases under standard reps and warranties are operational in nature, and therefore represent operational risk, and not related to the ongoing performance or credit quality of the underlying loan. The operational risk is evident in the fact that loans are underwritten in conformity with identified standards as outlined by the agencies.

Once it has been determined that these pools of mortgages and/or SPEs are not QSPEs, then FIN 46 requires the BIHs to determine if they need to consolidate the pool or SPE. The pool or SPE would be considered a Variable Interest Entity (VIE) under Paragraph 5 a) of FIN 46 because "the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties," as evidenced by both the Agency Guarantee and the financial guarantee provided under the Agency Seller/Servicer guidelines. This determination gets very complex because the BIHs do not necessarily have access to the information required to determine if they are the primary beneficiary of the VIE. Also, Mortgage Backed Securities (MBS) are widely held securities, which make it even more difficult to determine the primary beneficiary. Another unforeseen consequence could result from the potential reduced liquidity in the market for MBS. If entities who invest in MBS are required to consolidate the VIE, they may be less likely to purchase these securities.

[4] Agency securitizations are treated as grantor trusts under subpart E, part I of subchapter J of the Internal Revenue Code.

The footnote in Paragraph 35 e) states that "Obligations to make servicing advances are not subject to the requirements related to other commitments if the servicer can choose not to make the advance if it believes recovery of the advance from collections on the assets of the SPE is in doubt." The ED does not provide a definition of servicing advances. Under a typical servicing agreement, the mortgage servicer can potentially advance funds to cover principal, interest, and escrow items such as taxes and insurance. Does the FASB consider all of these items to be servicing advances, or just principal and interest? Further clarification would ensure consistent application among mortgage servicers. This is particularly important due to the fact that Agencies typically do not service the loans; this function is generally retained by the lender.

Each Agency has different nuances to their securitization transactions, but generally, the servicer is contractually obligated to remit a full month of interest on each underlying loan, even if that loan prepaid during the month. This required additional remittance, the amount in excess of cash received, is generally accounted for as a reduction from the service fee. This is standard industry practice in MBS transactions and one which the MBS market has become accustomed too. This obligation is taken into account in the valuation of the mortgage servicing rights. Additionally, servicer advances may not be recoverable to the extent that a servicer has elected to assume some of the credit risk on the loans in return for a lower, negotiated guaranty fee.

Under Ginnie Mae securitization transactions, servicer advances may not be recoverable because servicers of VA guaranteed loans are required to incur costs in connection with foreclosures which may, or may not, be fully recoverable from the VA and/or the sale of the foreclosed property collateralizing the mortgage loan. Servicers may also forfeit the right to receive reimbursement for advances and or debenture interest if they fail to meet certain rules and timelines under the servicing contract.

Other

We propose that while the FASB is looking to amend Statement 140, that it consider allowing fair value accounting of Mortgage Servicing Rights (MSR) and Mortgage Loans classified as held for sale. Currently, the accounting model for these assets requires a lower of cost or market (LOCOM) method of accounting. Most financial institutions hedge these assets in order to reduce their exposure to interest rate risk. Statement 133 requires that changes in the fair value of derivative instruments be recognized currently in earnings. If certain criteria are met, changes in fair value of the hedged asset or liability being hedged are also recognized currently in earnings. As a result, financial institutions go to great length and expense to meticulously document the hedging relationship, designate and assess the effectiveness of each transaction. Requiring fair value accounting of the MSR and Mortgage Loans held for sale would simplify the process, reduce the required documentation, and result in more useful information for the user of the financial statements.

Conclusion

We believe that further clarification is required on the following items:

- In an Agency securitization, the Transferor should be defined as the Lender because the Agency, who functions as their own trustee, constitutes a transfer to a trust which is a QSPE.

- The proposed Statement should allow the Transferor in an Agency securitization to repurchase or replace individual loans placed in a pool pursuant to standard representations and warranties as outlined in the Agency Seller/Servicer guidelines as this represents operational and not credit risk.

- Further definition of servicing advances should be provided.

- Servicing advances under a guaranteed mortgage securitization program should not be considered a financial guarantee under the provisions of FAS 140.

We believe that the FASB should consider allowing fair value accounting of mortgage servicing rights and mortgage loans held for sale.

We appreciate the opportunity to comment on the ED. We would be pleased to discuss our comments with the Board members or staff.

Sincerely,

/s/ Allen Winmill

Allen Winmill
Vice President – Director of Accounting Policy