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March 1, 2011

Sir David Tweedie
Chairman
International Accounting Standards Board (IASB)
30 Cannon Street
London, EC4M 6XH
United Kingdom

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Dear Sir David:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the International Accounting Standards Board's (IASB) exposure draft, *Hedge Accounting* (Proposed Standard). The exposure draft *Hedge Accounting* is the third phase of the International Accounting Standards Board's project to replace IAS 39 Financial Instruments: *Recognition and Measurement* (IAS 39). The first two phases related to classification and measurement of financial instruments and impairment of financial instruments. In contrast, during 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft that covered classification and measurement of financial instruments, impairment of financial instruments, and hedging activities. The stated goal of IASB and FASB is to finalize a converged accounting standard for financial instruments by the end of 2011.

¹ 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 2,200 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.

Background

The stated objectives of the Proposed Standard are:

- (a) to align hedge accounting more closely with risk management and hence result in more useful information,
- (b) to establish a more objective-based approach to hedge accounting, and
- (c) to address inconsistencies and weaknesses in the existing hedge accounting model.

MBA is especially concerned with hedging relationships typically used within the mortgage industry such as hedges of loans held-for-sale and mortgage servicing rights (MSRs). MBA believes it is vital that hedge accounting guidance allow for these hedging relationships to continue. The following are MBA's general comments on the Proposed Standard. Appendix A contains MBA's responses to IASB's specific questions.

General Comments

International Accounting Standards Convergence

MBA is concerned that the Proposed Standard contains many principles that diverge from the FASB's proposed hedge accounting model. This is especially disappointing since the FASB's model was proposed in May 2010 and the IASB Proposed Standard offers little explanation of how this model is better than the FASB's. MBA believes that FASB's hedge effectiveness model, whereby effectiveness is determined using a qualitative test with an effectiveness threshold of "reasonably effective", is consistent with the IASB's stated objectives of better aligning hedge accounting with risk management practices. As discussed further below, MBA believes certain criteria of the IASB's model introduce undue complexity and may lead to unintended consequences that would not meet IASB's objectives.

MBA acknowledges that the FASB recently issued a Supplementary Document requesting comments on some of the facets of the IASB's proposed model. MBA intends to respond to FASB's Supplementary Document indicating that MBA opposes many of the principles in the Proposed Standard especially related to IASB's proposed hedge effectiveness testing model.

Hedge Effectiveness Criteria

MBA observes that FASB's recent exposure draft for accounting for financial instruments would call for hedge effectiveness testing to generally require only qualitative, rather than quantitative analysis, and the effectiveness measurement would

be reduced to “reasonably effective” from the present “highly effective” yardstick. In its comment letter to FASB, MBA supported these changes and continues to support these changes today.

MBA notes that in practice, existing standards which call for a “highly effective” threshold have resulted in ever-evolving interpretations by the accounting firms and the SEC which, in turn, have resulted in hundreds of restatements and a “form over substance” practice.

The Proposed Standard states that the effectiveness threshold would be based on a hedging relationship that produces an “unbiased result”, leads to “other than accidental offsetting”, and would minimize expected ineffectiveness. The concept of a relationship that leads to an “unbiased result” is counterintuitive to the objective of aligning hedge accounting with the company’s risk management objectives because the use of hedge accounting is primarily in place to allow a company to mitigate certain risks based on its overall strategies. Included in those strategies could be a bias toward an expected change in certain risk components, such as an expected movement in interest rates. As such, companies would consider hedge accounting as a means to address their interest rate risk exposures to be in line with their expectations about those interest rate movements. Further, the concept of minimizing expected ineffectiveness may not make sense in certain circumstances. If the cost of hedging a specific exposure is high, a reporting entity will often hedge less than 100 percent of the risk.

MBA is also concerned that requiring re-balancing of the hedge ratios in conjunction with the requirement to maintain an “unbiased result” on a prospective basis, could lead companies to re-balance certain hedge strategies on a frequent basis, perhaps even quarterly. This re-balancing could require additional costs (by adjusting the actual hedging instrument) and will certainly increase the operational difficulties already present in maintaining hedge accounting compliance. Additional unintended consequences may result from the use of the “unbiased result” requirement, such as more frequent failures which have led to significant restatements in the past. MBA would support voluntary rebalancing of a portfolio and would further support a requirement that a hedge relationship be reasonably effective.

While “other than accidental offsetting” is clearly lower than the “reasonably effective” and “highly effective” thresholds presented or previously applied, MBA believes that the “unbiased result” threshold is too complex and could lead to significant operational difficulties and potential unintended consequences. As such, MBA still supports FASB’s proposed “reasonably effective” criteria.

IASB’s Proposed Standard also indicates that an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge effectiveness. Paragraph B34 more specifically states, “For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to

conclude on the basis of a qualitative assessment of those critical terms that the hedging relationship will probably achieve systematic offset and that the hedge ineffectiveness, if any, would not be expected to produce a biased result. This qualitative assessment might also allow the entity to determine an appropriate hedge ratio (e.g. 1:1 or as determined by simple ratio calculation) and also support an expectation that the hedge ratio would minimize any hedge ineffectiveness.” This appears to indicate that qualitative testing should generally be limited to those situations where critical term matching can be used. Thus, the IASB’s model would often call for quantitative testing. MBA believes that entities should be required to monitor hedging relationships and must take action when circumstances indicate that the hedge relationship is no longer reasonably effective. However, MBA does not believe ongoing testing, particularly quantitative testing, should be required for hedging relationships. MBA further notes that if IASB were to retain the “other than accidental offsetting” criterion, MBA does not understand what scenarios could result in ongoing testing whereby this criterion would not be met unless circumstances indicate that the hedge relationship has changed significantly, due to, for instance, changes to the critical terms of either the hedged item or the hedging instrument.

Pursuant to the objective of international accounting standards convergence, MBA recommends that the IASB adopt the model proposed by FASB that calls for qualitative effectiveness testing and a measurement threshold of “reasonably effective.” MBA believes this approach is much simpler than the Proposed Standard due to the reduced focus on quantitative testing and elimination of periodic (at least quarterly) prospective testing. Further, it is easier to understand and does not present the potential for significant operational difficulties and unintended consequences that would be contrary to the overall objectives of the Proposed Standard. MBA believes that this will solve many of the practice issues associated with hedge accounting to date and evolve into a “substance over form” application of principles.

Eligibility of a Dynamic Hedge

In MBA’s response to FASB’s proposed amendments to hedge accounting, MBA expressed its disagreement with the prohibition of voluntary de-designations. MBA continues to believe that voluntary de-designations should be permitted to allow companies to appropriately adjust hedge accounting relationships in accordance with their risk management objectives and consistent with certain dynamic hedging relationships, where such de-designations are necessary to apply hedge accounting. Without the ability to de-designate and then re-designate, a reporting entity’s accounting would not match its risk management practices--- a key goal of the Proposed Standard.

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 a hedged loan portfolio, its derivative holdings could be correspondingly very

large. The constantly changing portfolios of commitments and loans necessitates an '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.

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 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 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. 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. It is economically better to dynamically hedge in these circumstances.

Paragraph IN7 of the Proposed Standard states: "The Board decided not to address open portfolios or macro hedging as part of this exposure draft. The Board considered hedge accounting only in the context of groups of items that constitute a gross position or a net position in closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and re-designating the hedging relationship)." MBA is not certain what is meant by an "open portfolio" in this context. However, it appears that the phrase, "in which hedged items and hedging instruments can be added or removed by de-designating and re-designating the hedging relationship" anticipates the dynamic hedge situation for loans held for sale highlighted above. MBA would like IASB to confirm this understanding.

Clarification Needed on the Ineligibility of Prepayment Option Instruments

Generally, MSRs for residential mortgage-backed securities (MBS) contain prepayment risk because the underlying mortgage loans may be prepaid by the borrower at any time. Prepayment risk is primarily driven by changes in interest rates because as rates rise, prepayment speeds decrease. Conversely, as rates fall, prepayment speeds rise. In addition, MSR values are impacted to a lesser extent by the number of loans going into default and other, non-interest factors. This combination of factors makes hedging

the entire fair value of MSRs very difficult and costly. Thus, most mortgage companies bifurcate risk (as per proposed paragraph IN18) and hedge the MSR for changes in fair value related to changes in interest rates. MBA members believe that MSRs should continue to be eligible for hedging due to changes in interest rates under any proposed standard.

Further, some entities hedge mortgage loans held-for-investment and MBS, which are subject to prepayment risk, in a similar fashion by hedging changes in fair value relative to changes in a benchmark interest rate. Allowing hedge accounting for these instruments would serve one of IASB's key goals of aligning hedge accounting more closely with risk management.

Because the MSR and loans held-for-investment balance varies and is not precisely predictable, entities typically hedge MSRs and loans held-for-investment by designating a portion of the asset as the hedged item. This technique is equivalent to the layering approach described in paragraph IN20 of the Proposed Standard. Paragraph IN20 states: "The exposure draft proposes that a layer component of the nominal amount of an item should be eligible for designation as a hedged item. However, a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk."

MBA believes it is essential that preparers have the ability to hedge MSRs and loans held-for-investment via the layering technique. We, therefore, request that the Proposed Standard be revised to remove the prohibition against hedging a layer when the hedged item includes a prepayment option.

Ineligibility of Credit Derivatives

Page 19, paragraphs IN46 and IN47 of the Proposed Standard indicate that a reporting entity cannot use hedge accounting treatment for credit derivatives. The Proposed Standard states the reason for this is that it is "operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item as a component that meets eligibility criteria for hedged items." MBA notes that IASB's exposure draft ED/2009/12, *Financial Instruments: Amortized Cost and Impairment* (Impairment ED) would require reporting entities to estimate the credit risk component (i.e. impairment) on all debt instruments on an expected basis. Thus, the Proposed Standard would appear to contradict the Impairment ED. MBA believes that if it is appropriate to measure impairment on an expected loss basis, then it is operationally possible to isolate and measure the credit risk component of a financial item hedged by a credit instrument.

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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.

Sincerely,

A handwritten signature in black ink that reads "John A. Courson". The signature is written in a cursive, flowing style.

John A. Courson

President and CEO

Mortgage Bankers Association

Responses to IASB's Specific Questions

Appendix A

Question 1: Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

MBA's Response: Yes. The concept of aligning hedge accounting with risk management strategies is an improvement over existing standards which are rules-based and tend to be more form over substance.

Question 2: Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

MBA's Response: Yes.

Question 3: Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

MBA's Response: Yes.

Question 4: Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA agrees. MBA points out that the concept of hedging a risk component that is "separately identifiable and reliably measureable" should be an overarching principle in the Proposed Standard. As such, per our general comments above, credit risk and prepayment risk should be considered as eligible hedged risk under such principle.

Question 5:

- (a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

MBA's Response:

- (a) MBA agrees that an entity should be allowed to designate a layer of the nominal amount as the hedged item if such designation is consistent with management's hedge objectives for the item.
- (b) MBA believes that a layer component of a contract that includes a prepayment option should be eligible for hedge accounting treatment. See MBA's general comment, *Clarification Needed on the Ineligibility of Prepayment Option Instruments*, above.

Question 6: Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

MBA's Response: MBA believes that IASB's proposed hedge effectiveness requirements contain complexities and could lead to operational difficulties and unintended consequences. Therefore, MBA does not support this approach; rather, MBA supports the FASB's proposed hedge effectiveness requirements, specifically, the use of qualitative effectiveness testing whenever possible. MBA believes qualitative effectiveness testing will reduce practice issues related to the "bright lines" which exist in meeting the highly effective standard and the use of quantitative methods.

Question 7:

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

MBA's Response:

- (a) MBA does not believe that such re-balancing should be required and supports the ability to voluntarily de-designate a hedging relationship as an entity's risk management objectives and strategies change. MBA believes that if the hedging relationship fails to meet a reasonably effective threshold, an entity should be allowed to rebalance the hedging relationship provided the objective for the hedging relationship remains the same. This simplification would allow entities to proactively rebalance their relationships as the environment changes, rather than

suffering a retrospective hit. See MBA general comment, *Eligibility of a Dynamic Hedge*, above.

(b) MBA agrees.

Question 8:

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA believes entities should retain the ability to dedesignate a hedging relationship in order to have the flexibility to manage hedging relationships consistent with changes in risk management objectives or risk management techniques. See MBA general comment, *Hedge Effectiveness Criteria*, above.

Question 9:

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

MBA's Response:

- (a) The Proposed Standard would require for fair value hedges that the gain or loss on the hedging instrument and the hedged item be recognized in Other Comprehensive Income (OCI) and the ineffective portion be recognized in profit or loss. The Proposed Standard would also require that gains or losses on the hedged item be presented as a separate line item in the balance sheet. MBA

believes that these requirements will serve only to further clutter the balance sheet, income statement and statements of changes in shareholders' equity without adding any significant value to users of financial statements. Further, MBA does not understand what the separate line item in the balance sheet would represent. It does not appear to meet the criteria of a stand-alone asset or liability. Is it a valuation reserve? In addition, the mandate for a separate line item would appear to require disclosure of an item even if it is not material. MBA recommends that IASB retain its existing reporting (which would also be generally consistent with FASB guidance), whereby OCI accounts are not utilized for fair value hedges.

(b) See (a) above.

(c) If IASB were to proceed with its proposal to require the effects of fair value hedge accounting to be reported in OCI, MBA believes that linked presentation would be beneficial to a user of financial instruments to understand the direct impacts of hedge accounting.

Question 10:

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalized into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA theoretically agrees with the separation of the time value and the intrinsic value in the Proposed Standard. However, for smaller, less sophisticated entities, the proposed measurement and accounting may prove to be quite cumbersome from an operational perspective.

Question 11: Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA generally agrees with the criteria for the eligibility of groups of items.

Question 12: Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognized in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA generally agrees but is concerned that the proposed accounting may serve only to further clutter the income statement.

Question 13:

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

MBA's Response:

- (a) MBA believes that the proposed disclosures are overly prescriptive. For example, paragraph 46 of the Proposed Standard would require:

“An entity shall provide a breakdown that discloses, for each subsequent period that the hedging relationship is expected to affect profit or loss, the following:
(a) the monetary amount or other quantity (e.g. tons, cubic meters) to which the entity is exposed for each particular risk (for hedges of groups of items, an entity shall explain the risk exposure in the context of a group or net position);
(b) the amount or quantity of the risk exposure being hedged; and
(c) in quantitative terms, how hedging changes the exposure (i.e. the exposure profile after hedging such as the average rate at which the entity has hedged that exposure).”

MBA believes that the above disclosure would not provide useful information to investors. MBA recommends that the IASB cite the principles and objectives for disclosure and allow the preparers to determine the detailed disclosures necessary to fulfill those principles and objectives.

- (b) MBA has no additional disclosure recommendations.

Question 14: Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA agrees.

Question 15:

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

MBA's Response: MBA believes that credit derivatives should be eligible for hedge accounting treatment. See MBA general comment above entitled *Ineligibility of Credit Derivatives*. IASB should continue to evaluate alternatives and work toward developing an accounting model for the eligibility of a credit risk hedge.

Question 16: Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

MBA's Response: MBA believes that a longer transition period will be required unless the IASB fixes some operational issues like the aforementioned shortcomings of the hedge effectiveness model in the Proposed Standard.