March 31, 2015

Mr. Matthew Esposito
Assistant Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
mesposito@fasb.org

Reference: Suggested Technical Correction Language for Return of Accounts Provision

Dear Mr. Esposito:

The Mortgage Bankers Association[1] (MBA) appreciates the clarification you provided us on the return of accounts provision (ROAP) related to delinquent loans in Ginnie Mae MBS. In January, we promised to provide language for the next technical correction bulletin that would help clarify this issue and hopefully eliminate the diversity in practice on this issue. The following contains the background on the issue followed by MBA's recommended language changes in the accounting standards codification (ASC).

Background

If a servicer services Ginnie Mae MBS, it must continue to pass through scheduled principal and interest to the pool investor whether the borrower pays his or her monthly payment on time or not. This holds true until foreclosure sale. FHA, VA, and the USDA back the underlying loans in Ginnie Mae pools, and they each have separate policies on how much of the interest advanced by the servicer the servicer may ultimately recover, but the servicer does in fact get reimbursed at a lesser rate or amount than the amount the servicer passes through to the pool investor. Ginnie Mae allows servicers to repurchase loans from a pool if the loan becomes 90 days or more delinquent since this

[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, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

allows a servicer with a low cost of funds to reduce its interest lost on seriously delinquent loans. Otherwise, the lost interest is deemed to be a cost of servicing Ginnie Mae MBS. In fact, Ginnie Mae allows a servicing fee of up to 44 bps for servicing compared with 25 bps for Fannie Mae and Freddie Mac, partly because of this partial loss of interest on foreclosures.

The Financial Accounting Standards Board's Statement of Accounting Standards No. 166, *Accounting for Transfers of Financial Assets* (FAS 166), an amendment of FAS 140, provides the current authoritative guidance for transfers of financial assets. There are criteria in FAS 166 that preclude sale treatment. One such criterion is that the transferor may not have the unilateral right to repurchase an asset from the transferee. The ability to repurchase a loan from a Ginnie Mae pool if it becomes 90 days delinquent does not preclude initial sales treatment because that ability to repurchase is dependent on a third party doing something in the future – in this case a borrower must become 90 days or more delinquent. So, a transferor gets sale treatment when it originates loans and issues a Ginnie Mae MBS. However, if the transferor is still servicing the loan when the loan becomes 90 days delinquent, that servicer then has the unilateral ability to repurchase the loan. Many believe that the servicer must then reverse the balance sheet side of the original sales treatment and put an asset and a liability on its balance sheet equal to the outstanding principal balance of the loan. They believe this is true whether or not that servicer has a past practice or present intention to buy such loans out of Ginnie Mae pools.

The applicable guidance is contained in ASC 860-20-25-11:

> Whether the removal-of-accounts provision is exercised or not, the transferor shall recognize any financial assets subject to the removal-of-accounts provision if all of the following conditions are met:
> a. A third party's action (such as default or cancellation) or decision not to act (expiration) occurs.
>
> b. The occurrence allows removal of assets to be initiated solely by the transferor.
>
> c. The provision provides a more-than-trivial benefit to the transferor.
>
> For example, once a contingency is met (such as when a given loan goes into default), the call option on that asset (loan) is no longer contingent.

In its guidance to MBA in January 2015, FASB confirmed that the decision whether to put the defaulted loans and an associated liability back on the seller/servicer's books involves two steps: 1. determination that a default has occurred allowing the seller/servicer to repurchase the defaulted loan and 2.determination that there is more-than-a-trivial benefit to the transferor.

Conflicting Guidance

The January guidance from FASB should eliminate the uncertainty that conflicting SEC and EITF guidance (below) provide which make it a foregone conclusion that the existence of the triggering event (default) automatically provides a more- than-a-trivial benefit to the transferor. However, FASB may wish to discuss the following with the SEC and the EITF to eliminate any confusion that remains from their respective guidance.

In the post-FAS 166 version of EITF 02-9, right after the original paragraph 3, there is a note:

> **[Note: After the adoption of Statement 166, paragraph 3 should read as follows:]**
>
> Under Statement 140, rights held by the transferor (typically in the form of purchase options or forward purchase contracts) preclude sale accounting under paragraph 9(c) if they provide the transferor with (a) the *unilateral* right to cause the holder to return *specific* transferred financial assets and (b) more-than-a-trivial benefit… Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA and other governmental and quasi-governmental agencies. Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset (loan) is no longer contingent. **At that point, the transfer fails the criterion in paragraph 9(c) of Statement 140 because the transferor has the unilateral right to purchase a specific transferred financial asset and obtains more-than-a-trivial benefit from that right.** Under the requirements of paragraph 55, when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the "re-purchase" of a *specific subset* of the financial assets transferred to and held by the entity. The transferor must do so *regardless of whether it intends to exercise its call option.*[Emphasis added]

The SEC staff's specific guidance is noted in a Current Issues and Rulemaking Projects (CIRP) dated November 30, 2006[2]:

> The terms of sale of loans or other receivables, including but not limited to, those securitized through the Government National Mortgage Association or another GSE, may either require or allow for the transferor's repurchase of such loans or receivables upon event of default.
>
> The guidance beginning in paragraph 860-20-25-8 must be applied when such a call option becomes exercisable on the event of borrower default. Specifically, the transferor recognizes in its financial statements [assets regained] together with liabilities to the former transferees or beneficial holders in those assets at fair value on the date that the call option becomes exercisable, regardless of whether it intends to exercise the call.

Since our original white paper and subsequent phone conversations with you, we noted one additional source of confusion on this issue. The Office of the Comptroller of Currency's (OCC) *Mortgage Banking Handbook* contains the following guidance which appears to point to a one step test:

> Ginnie Mae mortgage-backed securities are backed by residential mortgage loans that are insured or guaranteed by the FHA, the VA, or the Farmers Home Administration. Ginnie Mae

[2] SEC, Current Issues and Rulemaking

> programs allow banks to buy back individual delinquent mortgage loans that meet certain criteria from the securitized loan pool for which the bank provides servicing. At the servicer's option, and without Ginnie Mae's prior authorization, the servicer may repurchase such a delinquent loan for an amount equal to 100 percent of the remaining principal balance of the loan. Under ASC 860, this buyback option is considered a conditional option until the delinquency criteria are met, at which time the option becomes unconditional.
>
> When the loans backing a Ginnie Mae security are initially securitized, ASC 860 does not preclude the transferor of the loans from treating the transaction as a sale for accounting purposes, because the conditional nature of the buyback option means that the transferor (seller) does not maintain effective control over the loans. If the transfer meets all the criteria for sales accounting, the loans are removed from the seller's balance sheet. When individual loans later meet Ginnie Mae's specified delinquency criteria and are eligible for repurchase, the seller (provided the seller is also the servicer) is deemed to have regained effective control over these loans, and, under ASC 860, the loans can no longer be reported as sold. The delinquent Ginnie Mae loans must be brought back onto the seller-servicer's books as assets and initially recorded at fair value, regardless of whether the seller intends to exercise the buyback option. An offsetting liability also would be recorded. Whether or not these rebooked delinquent loans are repurchased, the seller-servicer should report them as loans on the call report balance sheet and related schedules. These loans should be reported as held for sale or held for investment, based on facts and circumstances, in accordance with GAAP. These loans should not be reported as "other assets." As required per the call report instructions, the offsetting liability should be reported as "other borrowed money."[3]

MBA notes that, notwithstanding the OCC's references to Topic 860 which implies that the OCC intends for regulatory reporting to align with GAAP on this issue, the statement "When individual loans later meet Ginnie Mae's specified delinquency criteria and are eligible for repurchase, the seller (provided the seller is also the servicer) is deemed to have regained effective control over these loans, and, under ASC 860, the loans can no longer be reported as sold. The delinquent Ginnie Mae loans must be brought back onto the seller-servicer's books as assets and initially recorded at fair value, regardless of whether the seller intends to exercise the buyback option." is inconsistent with GAAP. MBA would appreciate if FASB would support MBA drafting a letter to the OCC identifying the inconsistency in interpretation.

MBA's Proposed ASC Technical Corrections

MBA is hearing that some large accounting firms still believe that since the more-than-a-trivial benefit is such a low threshold, that defaulted assets in Ginnie Mae pools should be placed on the balance sheet automatically. MBA agrees that it is a low threshold, but one that many servicers can get under given their unique facts and circumstances. One of the problems that MBA believes the FASB should fix is to provide some definition of more-than-a- trivial benefit in ASC 860-20-25-11.

ASC 860-10-40-28a provides some specific guidance related to ROAPs at sale or securitization. It states, "A call option or other right conveys more-than-a-trivial benefit (that is, fails the condition in paragraph 860-10-40-5(c)(2)(ii)) if the price to be paid is

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[3] Office of the Comptroller of the Currency, *Comptroller's Handbook – Mortgage Banking*, February 2014, page 184.

fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it."

ASC 860-10-40-28c provides some additional clarity, "A call option on readily obtainable assets at fair value may not provide the transferor with more-than-a-trivial benefit."

FASB should add similar language to ASC 860-20-25-11.

A further suggestion is to make it absolutely clear in ASC 860-20-25-11 that the determination of more-than-a-trivial benefit is based upon the reporting entity's own, unique facts and circumstances. MBA notes that this is supported by ASC 860-10-40-28a, "… or for other reasons it is probable when the option is written that the transferor will not exercise it."

Putting these concepts together for a technical correction, MBA suggests the following for ASC 860-20-25-11(added language is italicized below):

"Whether the removal-of-accounts provision is exercised or not, the transferor shall recognize any financial assets subject to the removal-of-accounts provision if all of the following conditions are met:

> **a. A third party's action (such as default or cancellation) or decision not to act (expiration) occurs.**
>
> **b. The occurrence allows removal of assets to be initiated solely by the transferor.**
>
> **c. The provision provides a more-than-trivial benefit to the transferor.**

For example, once a contingency is met (such as when a given loan goes into default), the call option on that asset (loan) is no longer contingent.

A call option on readily obtainable assets at fair value may not provide the transferor with more-than-a-trivial benefit. Likewise, a call option or other right conveys more-than-a-trivial benefit if the price to be paid is potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option becomes exercisable that the transferor will not exercise it. The more-than-trivial benefit is a determination to be made by the reporting entity based on its own facts and circumstances, and this decision is made at the unit of account level."

MBA thanks you again for you assistance in dealing with the inconsistency in practice that has evolved with respect to the ROAP provisions related to servicing Ginnie Mae MBS. Any questions about the information provided herein should be directed to me at (202) 557-2860 or jgross@MBA.org. Likewise, if you would like to have a telephone call with our working group on this technical correction proposal, I would be happy to arrange that.

Sincerely,

James P. Gross
Vice President of Financial Accounting & Public Policy