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May 7, 1996

Mr. Dennis Beresford
Chairman
Financial Accounting Standards Board
401 Merrit 7
Norwalk, Connecticut 06856-5116

Re: File Reference No. 154-E Additional Information on Mortgage Dollar Rolls

Dear Mr. Beresford:

The Public Securities Association ("PSA") is writing this letter to provide additional information to the Financial Accounting Standards Board ("FASB" or the "Board") in connection with the Board's tentative decision to treat all dollar rolls as financings. We hope that once FASB fully assesses the available information, it will come to the conclusion that the current accounting for dollar roll transactions in fact appropriately characterizes the nature of these transactions based on the purpose and results sought by counterparties, as well as on significant trading and operational concerns.

We would also like to take this opportunity to remind the Board of our concerns relating to the inclusion of "controlled" collateral on the balance sheet. PSA submitted a comment letter and participated at the public hearings in connection with the exposure draft on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. In addition, PSA has had continuing discussions with the FASB staff in an effort to provide business and operational information as the FASB deliberates the accounting for repurchase agreements, securities lending and "dollar roll" transactions.

I. Mortgage Dollar Rolls

In its comment letter and at the public hearings, PSA has taken the position that the current accounting treatment of dollar rolls has worked very well and should not be changed. The exposure draft would have changed current accounting treatment, in that all dollar rolls would have to be accounted for as sales, changing the way some investors treat dollar rolls. The Board's subsequent tentative decision would require all dollar rolls to be accounted for as financings, changing the way broker-dealers account for these transactions. PSA is mindful of FASB's goal to reach consistent accounting treatment for similar transactions across industries.

In this instance, however, we believe that the purpose and practical results sought by investors entering into dollar roll transactions is different than the purpose and practical results sought by broker-dealers entering into such transactions. Investors principally use dollar rolls for financing purposes, while broker-dealers use dollar rolls as trading or market making positions. Accordingly, the current accounting for dollar rolls as financings by most investors and as purchases and sales by broker dealers is conceptually appropriate and a better reflection of the purpose of the transactions than the Board's most recent tentative decision.

A. Different Types of Mortgage Dollar Rolls

The term "mortgage dollar roll" covers a variety of transactions that involve an agreement to transfer a mortgage pass-through security in exchange for cash, generally at some future date. Different types of dollar rolls have different characteristics. Some are similar to futures contracts traded on organized exchanges, while others are similar to financing transactions. The different purposes that various types of counterparties have for entering into these transactions are their primary distinguishing characteristics. Unfortunately, however, these characteristics become very confusing in their application to individual mortgage dollar roll transactions, and are extremely hard to isolate from a trading systems and operational stand point.

FASB's preliminary conclusion that all dollar rolls be accounted for as financings raises a number of substantive concerns. These concerns fall into two broad categories. One category of concerns relates to the definition of the dollar roll; the other category relates to operational and systems issues, particularly when dollar rolls are cleared through the Mortgage Backed Securities Clearing Corporation ("MBSCC").

While the term mortgage dollar roll is used generically, there are at least two different types of dollar roll transactions.

1. Roll

One type of dollar roll (sometimes referred to as a "roll") is simply a risk shifting mechanism pursuant to which an entity enters into a roll transaction rather than taking delivery of the security. This type of transaction is a commitment to deliver a security at a future date, much like a futures contract traded on an exchange. Typically, delivery of the security is not taken at any time. Rather, the entity's strategy is to keep rolling these transactions, thereby earning a trading spread from the price differential of transactions scheduled to settle in different months.

Example of a roll transaction - Today, entity A enters into a contract to buy a GNMA 8 pass-through security for June delivery. At any time prior to the June settlement, entity A decides that it does not want to have a forward position on GNMA 8 securities for June and transfers its risk in that position by rolling the transaction to July. The entity's decision to roll the transaction could be based on trading considerations, such as an attractive spread between the June and July prices, or operational concerns, such as not being willing or equipped to receive delivery of the security.

Mechanically, entity A sells a GNMA 8 for June delivery and purchases a GNMA 8 for July delivery. These transactions are typically paired-off. The only transfer that takes place is a money transfer representing the difference between the purchase price of the

GNMA 8 for July delivery and the sale price of the GNMA for June delivery. No transfer of securities occurs.

Issues for FASB - Is it clear whether the proposed accounting treatment of dollar rolls covers transactions that do not involve the delivery of a security? If they are covered, should they be treated as sales or financings? Since the only money that is settled relates to trading spreads between two securities, what is the financing element of such a transaction?

We understand that these types of transactions are not within the scope of this project and would continue to be accounted for as forward commitments.

2. Dollar Rolls

Another type of dollar roll transaction is a mechanism pursuant to which an entity that owns certain mortgage securities makes them available to the market place in order to obtain cheaper financing.

Example of a dollar roll transaction - Today, entity B has a GNMA 8 pass-through security in inventory, on its balance sheet, and lends that security to the marketplace in return for another GNMA 8 security. Mechanically, the entity sells the GNMA 8 from inventory and buys a GNMA 8 for future delivery. Typically, the GNMA 8 security held in entity B's inventory is transferred to the "borrower" and the "borrower" pays for that security. This type of dollar roll presumably allows entity B to obtain cheaper financing than other available alternatives.

It appears that this is the type of transaction that is being contemplated in FASB's discussions. PSA believes that the transaction described in the above example may be a financing from the seller/lender's perspective. It may seem reasonable in the abstract to require this transaction also to be viewed as a financing from the buyer/borrower's perspective. However, when the counterparty is a broker-dealer, which is typically the case, certain trading, operational, and system concerns prevent symmetric treatment of these transactions. These concerns are addressed below.

3. Dollar Rolls with Rolls

Let us take the dollar roll example a step forward. Assume that Entity B delivered the GNMA 8 security to its counterparty, Broker-Dealer X, for April settlement. At the same time, it entered into a forward commitment to purchase a GNMA 8 security for May settlement. Before the May settlement, Entity B and Broker-Dealer X agree to roll the transaction to June. The transaction may be rolled several times, before the second leg of the transactions is closed (i.e., Entity B takes delivery of the GNMA 8 security).

Broker-Dealer X enters into this transaction as part of its trading and market making activities seeking to achieve bid-offer or trading profits. Broker-Dealer X treats the GNMA 8 purchased from Entity B as part of its forward book with May price exposure.

These two trading positions with differing price exposures will then be traded and valued as proprietary trading positions along with other inventory, options and forward positions. This activity is conducted by the trading desk independent of the Financing Department.

For example, Broker-Dealer X can then enter into either:

- An offsetting dollar roll transaction with another counterparty, or
- A sale transaction for the GNMA 8 inventory with another Entity C and a forward May purchase commitment with a still different Entity D. As Entity B continues to roll its May settlement to future months, the broker-dealer will adjust its trading positions accordingly to achieve additional bid-offer or trading profits.

Again, as these examples illustrate, the profit achieved on these trading and market making activities is the goal of the trading desk. The goal is not to finance the broker-dealer's inventory.

B. Operational and Systems Concerns

Broker-dealers conduct all dollar roll activities from their mortgage trading desk, including transaction 2. described above, as opposed to the financing or repo area. Moreover, the mechanical process of trading rolls, dollar rolls, and outright to-be-announced ("TBA") transactions are indistinguishable from the dealer perspective. The commitment to return securities in the second leg of a dollar roll is treated as a forward sale commitment from the dealer's perspective. The mortgage trader will purchase securities forward from another counterparty to manage the risk of his forward position. The mortgage trader does not have the ability to segregate the second leg of a dollar roll as a financing from either a trading or operational perspective.

PSA estimates that there are over 20,000 trades per month in TBA transactions that are submitted for netting through the facilities of the MBSCC. Of those trades, approximately 30% are estimated to be dollar roll transactions. Broker-dealers have currently no system in place to distinguish between dollar roll and TBA transactions. The process of identifying and tracking the netting, clearance, and settlement of the securities through the ultimate close of the dollar roll is extremely complicated, because systems have been built to net out these transactions in order to reduce delivery risk, consistent with market-driven and regulatory concerns. The mortgage industry has always tried to pair off transactions to the extent possible and, in the mid-1980s, established MBSCC to help it achieve this goal.

***The Role of the Mortgage Backed Securities Clearing Corporation* ("MBSCC")**

The vast majority of broker-dealers and some investors clear their mortgage pass-through securities through MBSCC. The purpose of MBSCC is to improve operational efficiencies and reduce the costs and risks of the mortgage pass-through market by reducing the number of times securities need to be transferred to reach their ultimate purchasers. This netting process is very efficient in reducing operational burdens. However, it also makes it extremely difficult to track an entity's specific counterparty or the specific collateral associated with any transaction.

The MBSCC takes all transactions in the same product and coupon and nets these transactions regardless of counterparty. As such, the MBSCC's settlement balance order ("SBO") activity is analogous to the role played by futures exchanges. The SBO settlement system pairs-off like mortgage securities products, coupon rates, maturities, settlement dates, with like and unlike contra-sides through a netting process. Historically, the MBSCC SBO process has eliminated the need to settle in excess of 90% of all trades submitted for netting. Trades, either net buys or sells, which cannot be paired-off become SBO settlement obligations. In most cases, transactions are settled between non-original counterparties, at a price that represents the weighted average price for all counterparties in that particular product.

This netting level is achieved by including all dollar roll transactions. Through the netting of contractual obligations and amounts due, efficiencies of scale are achieved. The SBO that any MBSCC participants receives has very little to do with the security or the dollar amount of any specific trade or counterparty. No specific allowances are made for dollar roll transactions beginning with the actual delivery of a security. It would be impossible to track a dollar roll through the netting process or to reconstruct the deliveries that would have been made among counterparties had this netting process not taken place. Even assuming systems could be built to keep track of the specific transaction or collateral, it would be a costly exercise whose sole purpose would be bookkeeping.

There would also be great difficulty identifying dollar rolls versus purchase and sales which might appear to be rolls. For instance, a customer might enter into a transaction to sell securities to a dealer for a specific month and the dealer or customer might decide to defer delivery for a month -- thereby rolling the transaction a month. Therefore, in the sector of transactions which are not MBSCC eligible, there is a subset that should not be treated as financings because they truly are not financings. Instead, these transactions are simply a buy which is either paired off outright, or a buy which is paired off and rolled to a future delivery date.

C. Broker-Dealers Should Continue to Account for Dollar Rolls as Sales

PSA believes that the nature of the dollar roll market is such that in order to correctly account for those transactions, the purpose and practical results sought by the parties must be taken into account. As a result, entities that are financing their inventory by entering into dollar rolls should account for those transactions as financing; dealers and others that are trading positions or rolling their outright positions forward should account for those transactions as purchases and sales. This asymmetrical accounting treatment faithfully represents on balance sheets and income statements the nature of the transactions. Broker-dealers do not have any way of distinguishing their TBA transactions from their dollar roll transactions, nor any way to distinguish among dollar roll and roll transactions. Finally, trading activity that occurs through the MBSCC makes tracking specific counterparties and collateral impossible.

II. Collateral Issues

Separately and as described in our comment letter of January 19, 1996, and in subsequent conversations with the Board's staff, PSA is very concerned with the implications of reporting "controlled" collateral. The Board has preliminarily determined that if an entity is permitted to sell or repledge collateral it receives, that collateral must be reported as an additional asset. PSA believes that the proposed accounting does not represent an improvement over the current reporting systems and may even be misleading. Moreover, current providers of securities to the market place, either through repos or securities lending transactions, may withdraw from the market if they have to recognize assets previously unrecognized. Given its potential negative impact on market liquidity and lack of convincing evidence that the proposed accounting would benefit users of financial information, we believe that the Board should reconsider its decision to add collateral on balance sheets.

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PSA strongly believes that the different purposes, practical effects and operational issues support the current accounting model for dollar rolls. In addition, we do not believe that adding collateral on the balance sheet would be helpful to users of financial information. We hope these additional comments will assist the Board in reaching our recommended solutions to these issues. We would appreciate the opportunity to discuss the differing purposes and operational issues associated with dollar rolls as well as our concerns with the inclusion of collateral on balance sheet with the Board or its staff should the above comments require any clarification.

Sincerely yours,

Thomas K. Guba Daniel Minerva
Chairman, PSA Mortgage and Asset- Chairman, PSA Funding
Backed Division Division

cc: Mr. Halsey Bullen, FASB Project Manager