INTRODUCTION

The primary source of accounting guidance related to mortgage banking is Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 65, Accounting for Certain Mortgage Banking Activities. The Statement was issued in 1982 and, although the FASB is currently considering a project to amend it, SFAS No. 65 remains the most comprehensive accounting document pertaining to mortgage banking. SFAS No. 65 applies to all entities that engage in mortgage banking activities. Also, there are additional sources of guidance that are referenced throughout this discussion.

Why Accounting Impacts Mortgage Banking Strategies

As discussed in Section 572, Profitability, mortgage servicing is typically the most important source of long-term profits for mortgage banking entities. The rights to service mortgages are generally acquired in four ways: (1) the origination of mortgages by the thrift that are kept in the portfolio which is called portfolio servicing; (2) the origination of mortgages that are sold with servicing retained which is called retained servicing or originated mortgage servicing rights (OMSR); (3) the purchase of servicing rights from third parties called purchased mortgage servicing rights (PMSR); or (4) as a by-product in a purchase of mortgages and their servicing (servicing released purchase) where a definitive plan for the sale of the mortgages with the servicing rights retained exists at the time the mortgages are acquired, also called PMSR. Under current generally accepted accounting principles (GAAP), the accounting for mortgage servicing rights, at acquisition and thereafter, varies depending on the manner of acquisition.

Differences in the manner of accounting for servicing rights are primarily evident in three areas: (1) asset recognition criteria; (2) classification as tangible or intangible assets; and (3) potentially different methods of amortizing and measuring impairment of the assets. In addition, the treatment of servicing rights for regulatory capital purposes depends on their manner of acquisition. Appendix A summarizes the distinctions discussed in the following paragraphs.

Asset Recognition. Currently OMSR are not recognized on the balance sheet as an asset distinct from the mortgage. SFAS No. 65 also prohibits the recognition of a mortgage servicing asset representing the normal servicing fee when a thrift originates a mortgage loan and then sells it to a third party with the servicing rights retained by the seller; only the excess servicing fee, if any, may be recorded as an asset. However, SFAS No. 65 provides for the full capitalization of PMSR. SFAS No. 65 also requires thrifts to separately capitalize (and classify as PMSR) the portion of the purchase price representing the cost of acquiring the right to service mortgages when the thrift purchases mortgage loans with a definitive plan for the sale of the mortgages with servicing rights retained at the initiation of the transaction. Finally, it is possible for thrifts to record split servicing in connection with a purchase of servicing rights. Split servicing refers to: (1) recording the present value of the normal servicing fee acquired in a purchase as PMSR; and (2) recording the present value of the servicing fee in excess of the normal servicing fee.

Classification. Current GAAP applies differing classifications to servicing rights: (1) the normal servicing fee on mortgages originated and sold with servicing retained is not recognized on the balance sheet (OMSR); (2) ESFR are recorded on the balance sheet and classified as tangible assets; and (3) PMSR are given balance sheet recognition but are categorized as intangible assets.

Amortization/Impairment. ESFR are amortized using the level-yield method, but SFAS No. 65 specifies that PMSR should be amortized in proportion to, and over the period of, estimated net servicing income. In practice, the level-yield method is typically used and has been accepted as appropriate for PMSR amortization (discussed below). FASB Emerging Issues Task Force (EITF) Issue No. 86-38, Implications of Mortgage Prepayments on Amortization of Servicing Rights, requires that the impairment test for ESFR be performed on a discounted basis, whereas it allows for impairment of PMSR to be measured on either a discounted or undiscounted basis. However, both the OTS Regulatory Capital: Intangible Assets Regulation, and the FDIC's Capital Maintenance Rule, state that the book value of PMSR must be evaluated for impairment using a discounted cash flow approach if the asset is to be included in regulatory capital. Since the undiscounted approach is acceptable under GAAP, this would be an acceptable GAAP/RAP difference for financial statement purposes (with the appropriate adjustment reflected in the regulatory capital calculation).

Regulatory Capital Treatment. Because it is not recognized on the balance sheet, the normal servicing fee portion of OMSR is unaffected by regulatory capital guidelines. However, because the OTS Net Portfolio Value (NPV) model assigns a value to originated servicing rights, they are incorporated as part of the interest-rate-risk component of regulatory capital. ESFR are considered tangible assets under GAAP and are simply risk-weighted in the 100% category. However, due to their classification as intangible assets, PMSR are subject to special regulatory capital rules.

The OTS defines PMSR as qualifying intangible assets that are includable in regulatory capital, subject to certain limitations. Due to their complexity, these limitations are not discussed fully in this Section and the reader is advised to consult Section 576, Servicing, for a detailed review. The FDIC's Final Rule on Capital Maintenance and the OTS' Intangible Assets regulation require the book value of PMSR to be measured on a discounted cash flow basis. The discount rate used in the calculation should be no less than the original discount rate inherent in the asset at the time it was acquired, based upon the estimated net cash flow and price paid at the time of purchase.

The differences in book value recognition and regulatory capital values for servicing rights may result in transactions intended to obtain balance sheet recognition of OMSR. Current accounting practice encourages mortgage bankers to sell their off-balance sheet OMSR in order to recognize income immediately rather than on a cash basis over the life of the serviced mortgage. Mortgage bankers then can replace these rights through purchases of servicing originated by third parties that can be recorded on the balance sheet as purchased servicing assets. However, limitations such as the 10% regulatory capital haircut on PMSR tends to mitigate the impact of these transactions for thrifts.

Mortgage Loans Held for Investment or for Sale

Mortgages Held for Investment. These mortgages are carried at amortized cost, provided the thrift has the intent and ability to hold them for long-term investment purposes. The thrift's management should document its intent to originate the mortgages for a long-term investment. It is, however, the substance of a thrift's activities that determines whether mortgages reported as held for investment are, in reality, held for sale or trading. Thrift Bulletin No. 52, Supervisory Statement of Policy on Securities Activities, sets forth some of the factors to be considered in evaluating whether the classification of mortgages is consistent with management's intent. Mortgages that are moved from the held-for-investment to the held-for-sale category are transferred at amortized cost, but the lower of cost or market (LOCOM) method should be applied immediately with an allowance for loss established, if necessary.

Mortgages Held For Sale. Typically, mortgage banking entities originate or purchase mortgages for resale. SFAS No. 65 mandates that mortgages held for sale be reported at LOCOM. When the market value of mortgages held for sale is less than their amortized cost, the thrift records a charge to income and a valuation allowance that is shown on the balance sheet as a contra asset. If the market value of the mortgages subsequently improves, the valuation allowance is adjusted. However, the mortgages may never be shown on the balance sheet above the amortized cost, regardless of market value.

For example, assume that on July 1, 1993, Home Mortgage Inc. originated $2,000,000 in mortgages at par, intending to sell them in the secondary market at a later date. At July 30, 1993, the market value of the mortgages was 97% of par. At August 31, 1993, the market value had improved to 99% of par. At September 30, 1993, the market value was 104% of par. (For simplicity, this example does not consider paydowns or deferred fees/costs.)

The entry to record the funding of the mortgages should be:

7/1/93	Dr.	Loans Held For Sale	$2,000,000	
	Cr.	Cash		$2,000,000

The month-end entries to adjust the carrying amount of the mortgages should be:

7/30/93	Dr.	Unrealized Loss on Loan Held For Sale	$60,000	
	Cr.	Allowance For Loss Loans Held For Sale		$60,000
8/31/93	Dr.	Allowance For Loss Loans Held For Sale	$40,000	
	Cr.	Unrealized Gain on Loans Held For Sale		$40,000
9/30/93	Dr.	Allowance For Loss Loans Held For Sale	$20,000	
	Cr.	Unrealized Gain on Loans Held For Sale		$20,000

Note that the entry as of September 30, 1993 only increased the carrying value of the mortgages up to their amortized cost despite market value exceeding that cost.

In determining the market value of mortgages held for sale, the thrift should first segregate the mortgages by type (i.e., conventional [conforming and non-conforming to FNMA and FHLMC requirements], FHA, VA, FmHA, SBA, etc.). Next, they should be separated by property types (i.e., commercial, single-family, or multifamily); and then they should be separated by repayment types (i.e., ARMs, 30- and 15-year fixed-rates, and balloon mortgages). Once the mortgages have been separated, the LOCOM computation may be performed on either an individual mortgage basis or in the aggregate for the type of loan being valued. The adjustment to the valuation allowance is made for each type of mortgage identified. *While gains may be netted against losses within a particular type of mortgage, a net gain on one type of mortgage may not be used to offset a net loss on another type*. Unsalable, rejected, and repurchased mortgages should be valued separately and the loss should not be included as part of the overall LOCOM adjustment, depending on whether their impairment is permanent.

If a thrift has commitments in place to sell mortgages, the market value of those mortgages should be based on the commitment prices. If those commitments are representative of the market, they may also be used to estimate the market value of uncommitted mortgages. If not, the thrift should look to quoted market prices to determine market value.

Mortgages that are moved from the held-for-sale to the held-for-investment category are recorded at LOCOM as of the date of transfer. If market value is less than amortized cost, the market value becomes the new cost basis. The difference between the new cost basis and the contractual face amount of the mortgages is recorded as a contra asset on the balance sheet and, in accordance with SFAS No. 65 as amended by SFAS No. 91, amortized to income as a yield adjustment using the interest method over the remaining contractual life of the mortgages.

New FASB Pronouncement. The FASB has issued a new Statement, SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, that will affect mortgage banking entities. While the Statement does not specifically include loans within its scope, it does specify that mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in SFAS No. 65, shall be classified as trading securities. As trading securities, they are directly carried at market value without the cost basis ceiling inherent in LOCOM valuations, no balance sheet valuation allowance is employed, and unrealized holding gains and losses are included in earnings. The new Statement is effective for fiscal years beginning after December 15, 1993. However, it contains certain early adoption provisions. Readers should contact their regional accountants with any questions.

Transfers Among Affiliates

Mortgage banking entities often transfer mortgages to affiliates. For accounting purposes, the mortgages transferred must be adjusted to LOCOM as of the date management makes the decision to transfer them. However, if the mortgage banking entity is acting as an agent for an affiliate, the LOCOM adjustment is not necessary and the mortgages should be transferred at the originator's cost. As defined in SFAS No. 65, an agency relationship exists where the two entities agree that all mortgages of a particular type originated by the seller will be transferred to the buyer. A right of first refusal or other arrangement whereby the seller retains the risks associated with ownership of the mortgages does not qualify as an agency relationship and thus the mortgages must be carried at LOCOM on the originator's books. (See the Holding Company Handbook for additional limitations on transactions with affiliates.)

Table Funding Arrangements

Table funding refers to transactions in which a thrift provides the original funding for a mortgage loan at the table when a mortgage broker or correspondent and the borrower close the mortgage, despite the fact that the thrift had no direct part, besides funding, in the processing or closing of the mortgage. Immediately after the closing, the thrift pays a servicing release premium and acquires the mortgage and its related servicing rights from the originating correspondent. The arrangement raises the issue of whether the acquiring thrift should account for the table funding as a purchase or as an origination.

The issue is important because if the mortgage is deemed to have been purchased and a definitive plan for its sale with servicing retained exists at acquisition, then the cost of acquiring the servicing rights must be allocated and capitalized as a separate asset apart from the cost basis of the mortgage. This accounting treatment results in a lower cost basis being assigned to the mortgage and thus a reduction of any loss recognized upon its subsequent sale with the servicing rights retained. Conversely, if the arrangement is considered an origination, all direct origination costs must be capitalized as part of the cost basis of the mortgage (including costs that could theoretically be assigned to the servicing rights), resulting in a higher basis for the mortgage. Mortgage bankers often view the difference between purchased and originated servicing more simply. They view the difference as being whether the servicing asset is on or off the balance sheet.

For example, assume the correspondent originates a $100,000, 8% fixed-rate mortgage. The loan agreement calls for the borrower to pay a 1% origination fee plus 1 point at closing. Assume First Thrift (FT) will fund the mortgage at closing and pay the correspondent a 125bp servicing release premium ($100,000 x .0125 = $1,250). The correspondent will retain both the 1% origination fee ($1,000) and the loan fee of 1 point ($1,000) paid by the borrower at closing. Therefore, at closing FT will disburse $101,250 ($100,000 principal and $1,250 servicing release premium) and the correspondent will receive $3,250 ($2,000 in fees from the borrower and $1,250 from FSA).

<u>If Arrangement is Considered a Loan Origination</u>. FT would record its investment in the mortgage at $101,250, representing $100,000 in principal and $1,250 in deferred loan origination costs in accordance with SFAS No. 91. No servicing rights would be recorded. If the mortgage is intended for sale, the origination costs would be deferred but not amortized. Rather, they would be an adjustment to the gain or loss on the subsequent sale of the mortgage. If the mortgage were sold at par, FT would record a $1,250 loss equal to the excess of its net investment in the loan ($101,250) over the sales proceeds of $100,000.

<u>If Arrangement is Considered a Loan Purchase</u>. FT would record its investment as $100,000 in the mortgage and $1,250 in PMSR. If the mortgage were then sold at par, no gain or loss would be recognized and the servicing asset would remain on the balance sheet to be amortized in accordance with SFAS No. 65 over the estimated life of the mortgage.

<u>Table Funding Criteria</u>. EITF No. 92-10, Loan Acquisitions Involving Table Funding Arrangements, specifies that table funding arrangements should be accounted for as loan purchases if the mortgage is legally structured as an origination by the correspondent and if the correspondent is in-

dependent of the acquiring thrift. In making this determination, all of the following criteria must be satisfied:

- The correspondent is registered and licensed to originate and sell mortgages under the laws of the jurisdictions in which it does business;
- The correspondent originated, processed, and closed the mortgage in its own name and is the first titled owner of the mortgage with the thrift becoming a holder in due course;
- The correspondent is an independent third party and not an affiliate of the thrift, as defined in SFAS No. 65. The correspondent must bear all the costs of its place of business;
- The correspondent must sell mortgages to more than one thrift or mortgage banker and not have an exclusive relationship with the purchaser; and
- The correspondent may not be directly or indirectly indemnified by the purchaser for market or credit risk on mortgages originated by the correspondent. However, a purchase commitment is not considered an indemnification for purposes of this requirement.

If any of the above requirements are not met, the mortgage should be accounted for as an originated mortgage by the acquiring thrift.

Mortgage Sales

The primary focus in accounting for mortgage sales is to recognize the economic gain or loss at the time of the transaction and to avoid current recognition of income and expense attributable to future periods. In a simple mortgage sale, where the seller retains no recourse obligation or servicing rights, the gain or loss is generally based on the difference between the actual or stated yield of the mortgages and the yield to the investor. Complications arise in recording sales where the seller has not transferred all of the risks and rewards of ownership to the purchaser; this occurs when the seller retains recourse risk on the servicing rights.

<u>Mortgages Sold With Recourse</u>. Thrifts may sell mortgages to a government sponsored agency or private investor with terms that, under certain conditions, provide for recourse against the thrift. For example, the thrift may be required to advance its own funds to the investor to cover shortfalls if a borrower fails to make payments when due. In a transaction where the seller retains the risk of recourse or borrower default, a determination must be made as to whether it should be recorded as a sale or a financing.

SFAS No. 77, Reporting by Transferors for Transfers of Receivables with Recourse, specifies that a transfer of mortgages with recourse may qualify as a sale only if all the following criteria are satisfied:

- The transferor surrenders control of the future economic benefits embodied in the mortgages;
- The transferor's obligation under the recourse provisions can be reasonably estimated; and
- The transferee cannot require the transferor to repurchase the mortgages except pursuant to the recourse provisions.

The first condition generally means the seller cannot hold an option to repurchase (call) the mortgages. Conversely, the third criteria means that the buyer may not hold an option to put the mortgages back to the seller. The second requirement refers to measuring the extent of recourse. If the seller retains recourse, a liability must be recorded at the time of sale. The liability is recorded on the balance sheet and has the effect of reducing the gain or increasing the loss recognized on the sale. If the seller is unable to reasonably estimate the amount of recourse liability, the transaction does not qualify as a sale and the cash received from the transferee should be recorded as a secured financing.

EITF No. 92-2, Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse, specifies that the liability recorded at the sale date pertaining to the recourse provisions of the transfer must include all probable credit losses over the life of the transferred receivables and not only those measured and recorded in accordance with SFAS No. 5, Accounting for Contingencies.

The recourse obligation may be recognized on a present value basis if the timing of the estimated cash flow can be reasonably estimated. However, the Securities and Exchange Commission (SEC) has stated its position that the discount factor may be no less than the rate on monetary assets that are essentially risk free and that have maturities comparable to those of the recourse obligation. Moreover, the recourse obligation must be measured and reported separately as a liability and may not be netted against assets unless a legal right of offset exists between the seller and the purchaser. However, the recourse liability is not considered a general valuation allowance (GVA) and would not be included as such for capital purposes.

Mortgages Sold With Servicing Rights Retained. Thrifts that originate or purchase mortgages for subsequent sale in the secondary market often retain the rights and obligations of servicing the mortgages for the purchaser in exchange for a fee and related income. Typically, the servicing fee is stated as a percentage of the outstanding mortgage balance and is deducted by the servicer from the borrower's monthly mortgage payments before those payments are passed on to the owner of the mortgages.

When mortgages are sold with the servicing rights retained by the thrift, an ESFR asset may be recorded if the interest rate on the mortgages sold, minus the normal servicing fee rate and guarantee fees, if any, exceeds the rate passed through to the purchaser of the mortgages or mortgage-backed securities. Recording the present value of this future excess servicing fee results in an increase in the gain or reduction in the loss on the sale of the underlying mortgages. However, the amount of the adjustment is limited to the difference between the actual sales price of the mortgages and the estimated sales price that would have been obtained if only a normal servicing fee had been specified.

For example, assume a package of fixed-rate mortgages with a weighted average coupon rate of 9% is sold to an investor at par with a pass-through rate of 8% with the seller retaining the servicing rights. Assuming the normal servicing fee is 25bp and the guarantee fee is 18bp, this means the excess servicing fee is 57bp (9.00% - 8.00% - .25% - .18% = .57%). In determining the book value of the excess servicing fee receivable, the seller/servicer estimates the amount and timing of the cash flows and discounts them to arrive at the present value.

Excess Servicing Fee Receivable (ESFR)

SFAS No. 65 provides guidance on the appropriate methodology to be used in initially recording and amortizing ESFRs. The initial book value of the ESFR is primarily dependent on three factors: (1) the net interest spread between the mortgage coupon rate, minus the sum of the normal servicing fee rate and any guarantee fees, and the pass-through rate to investors; (2) the estimated prepayment rate on the underlying mortgages; and (3) the discount rate employed to compute the present value of the excess servicing fee. Generally, an estimate of prepayment speeds that is too slow or a discount rate that is too low will result in overstating the ESFR asset. The following guidelines should be used in recording ESFR.

Prepayment Speed. The prepayment speed estimate used in calculating the ESFR should be based on the same guidelines set forth in Section 576, Servicing, for the valuation of PMSR.

Discount Rate. On June 29, 1989, the EITF reached a consensus on Issue No. 88-11, Allocation of Recorded Investment When a Loan or Part of a Loan is Sold, that ESFR should be calculated using prepayment, default and interest-rate assumptions that market participants would use for similar financial instruments and should be discounted using an interest rate that a purchaser unrelated to the seller of such a financial instrument would demand. However, since the ESFR cannot be split off and sold separately from the normal servicing fee under FNMA or FHLMC regulations and since GNMAs usually have no ESFR, there is no significant market in ESFR, per se, upon which to establish a benchmark. With the absence of a true, market-derived ESFR discount rate, servicers must look to comparable financial instruments as a basis for deriving an appropriate ESFR discount rate.

Most apparently comparable financial instruments do not work well in establishing market discount rates for ESFR because each instrument has significant distinguishing features. For example, while cash flows associated with IO strips and ESFRs are both based on declining balance mortgages and both assets experience negative duration, ESFRs retain various distinct operational costs and risks. Similarly, an ESFR discount rate based on Treasury yields is inadequate because yields on mortgage servicing rights do not always track the U.S. Treasury securities yield curve.

Since the cash flow and operational risks associated with both ESFR and PMSR are identical and since there is a liquid market in PMSR, we believe that the best surrogate financial instrument in establishing ESFR market discount rates is PMSR. Typically, however, mortgage bankers and accountants have used discount rates for ESFR that are lower than for comparable PMSR. This is because of the cushioning or protective effects of the normal servicing fee, which is specifically deducted from the mortgage cash flow before computing ESFR. Conversely, when valuing PMSR, there is no stated normal servicing fee and all servicing costs and revenues are considered individually. *Because of these considerations, generally an ESFR discount rate of 100 basis points below the rate for comparable PMSR is reasonable.*

Comparable PMSR is generally meant to refer to the differences in the discount rates or yields demanded by investors for PMSR with perceived additional risks. High delinquency, nonagency, commercial, and recourse servicing are examples of servicing that traditionally have required significantly higher yields to attract buyers than single-family, agency servicing. Also, the terms, interest rates, and geographical locations of mortgages may be factors requiring higher yields to attract buyers.

In accordance with EITF No. 88-11, a discount rate equivalent to the pass-through rate to investors is not appropriate for ESFR recorded after June 29, 1989. Moreover, discount rates below the pass-through rate will generally not be accepted even if the ESFR was recorded prior to July, 1989. Such rates do not adequately reflect the true risks and rewards of the ESFR asset.

The OTS recognizes the difficulty in establishing reasonable and appropriate discount rates for ESFR. Each pool of ESFR should be evaluated based on its individual risks and a conservative, well-supported discount rate should be employed. Thrifts should remember that conservatively valued ESFR will not alter the actual underlying cash flows. If subsequent actual cash flows exceed those estimated in valuing the ESFR asset, the thrift will benefit from an asset providing a higher than anticipated yield. Conversely, the use of an aggressive or excessively low discount rate in valuing ESFR exposes the thrift’s capital to significant risk.

<u>Normal Servicing Fee</u>. The minimum servicing fees established by FNMA, FHLMC, and GNMA are intended to cover the cost of servicing plus an unspecified profit component to protect the market and encourage servicers to fulfill their servicing responsibilities. FASB Technical Bulletin No. 87-3, Accounting for Mortgage Servicing Fees and Rights (FTB No. 87-3), makes it clear that thrifts may not derive an individualized normal servicing fee rate based on their particular cost to service. FTB No. 87-3 states that the normal servicing fee must be no less than the minimum servicing fees specified by FNMA, FHLMC, and GNMA. Generally, these are 25bp for securitized fixed-rate mortgages, 37.5bp for ARMs and unsecuritized mortgages, and 44bp for FHA/VA mortgages in GNMA MBS pools. FNMA typically requires a minimum servicing fee of 50bp on servicing for second mortgages.

Recourse servicing generally should reflect significantly higher normal servicing fees than similar nonrecourse servicing in order to recognize the additional servicing costs from higher credit losses. Also, the normal servicing fee for Small Business Administration (SBA) loans must be a minimum of 100bp. For transactions requiring a minimum retained spread (such as ARM sales to FNMA, FHLMC and many private investors) the normal servicing fee must not be lower than the minimum retained spread.

For sales directly to private sector investors with servicing retained, FTB No. 87-3 requires the thrift to use the minimum servicing fee required by the federally sponsored organization whose servicing terms are most comparable to those being valued. If the thrift can show that FNMA, FHLMC, and GNMA do not purchase substantially similar mortgages, the thrift should use a normal servicing fee reflecting the predominant fee that is found in the private sector market for similar mortgages.

The normal servicing fees for second and wrap-around mortgages are more difficult to determine than for first mortgages. If prevailing market rates cannot be determined, the normal servicing fee should be calculated by considering the fully documented costs of servicing, a reasonable and adequate profit factor, and the costs related to protecting the second mortgages from foreclosure actions by the first mortgagee. The normal servicing fee for wrap-around mortgages should be a minimum of 100bp to adequately cover the large costs of servicing these mortgages.

Reasonableness Tests. As an overall reasonableness test, compare the prices paid by the FHLMC for mortgages with servicing released versus the price paid for mortgages with servicing retained. Also, the amount of ESFR recorded should not exceed the current servicing released premiums being paid for similar mortgages less the equivalent of a normal servicing fee.

Amortization and Impairment Analysis. ESFR should be amortized over its expected life so that net servicing income (servicing income less amortization) approximates the normal servicing fee plus interest earned on the ESFR asset. Therefore, if unanticipated mortgage prepayments occur, both the current book value of the ESFR and the rate of future amortization must be adjusted. Management must review its ESFR asset at least quarterly to determine if an adjustment is needed.

EITF No. 86-38 specifies that the ESFR asset must be written down to the present value of the currently estimated remaining cash flows applying the same discount factor used to initially record the asset. A cumulative adjustment should be made to the book value to reflect any decline in the present value. However, the book value of ESFR may not be increased as a result of slower than anticipated prepayments but, rather, the rate of amortization would be adjusted prospectively.

Preferably, the impairment analysis should be performed for each group or pool of serviced mortgages, but that is not always practical for very large ESFR assets. The OTS generally does not object to grouping similar types of mortgages, with very comparable interest rates and terms, into larger groups for purposes of measuring impairment. In these cases, a weighted average of the original discount rates should be used. For purposes of recording impairment these groups may then be aggregated. The OTS reserves the right to require less aggregation if the aggregation process appears to distort results.

Multifamily ESFR. Multifamily mortgages are secured by residential dwellings with five or more units. Unlike other types of commercial or income property mortgages, multifamily mortgages qualify for purchase by FNMA, FHLMC, and GNMA. Each of these organizations, however, has very different and complex programs. The minimum servicing fees and other requirements for these mortgages are defined by their purchase contracts and their respective sale and servicing guides. Minimum servicing fees are often as low as 12.5bp and even less for some multifamily mortgages over $10,000,000.

If ESFR is recorded, the normal servicing fee for multifamily mortgages should not be lower than 12.5bp (25bp if the mortgage is less than one million dollars) unless a lower rate is specified in the sale/servicing contract. The discount rate for multifamily ESFR should generally be at least 500bp over single-family ESFR rates. Prepayment estimates for multifamily servicing should generally be based on a Constant Prepayment Rate (CPR) speed that is closely analogous to fixed-rate single-family mortgages with similar interest rates and terms, adjusted for any required balloon payments.

Documentation and Recordkeeping. Thrifts should retain adequate records to support both the initial value of the ESFRs and the value as of the last four quarters. At a minimum, the following information should be maintained for each group or pool of mortgages with ESFR: (1) original and current principal balances; (2) original and current book values of related ESFRs; (3) original and current prepayment speed estimates, with documentation; (4) normal servicing fee rates, if obtained from other than a GSE then with supporting documentation; and (5) the original discount rate, with basis for its support. Thrifts should also maintain historical information regarding the actual prepayment experience for each pool. Records should substantiate the basis for and amounts of write-downs and other losses.

Purchased Mortgage Servicing Rights (PMSR)

Acquisition. PMSR may be acquired in two ways for accounting purposes: (1) through the purchase of the rights alone, where the seller retains the mortgages; and (2) by purchasing whole mortgages and allocating a portion of the acquisition costs to PMSR, as long as the purchaser has a definitive plan for the sale of the mortgages with servicing retained when they are acquired. SFAS No. 65 defines a definitive plan as follows: (1) the acquiror has obtained, before the purchase date, commitments from permanent investors to purchase the mortgages, or makes a commitment within a reasonable time (generally, within 30 days of the acquisition date) to sell the mortgages to permanent investors; and (2) the plan includes estimates of the purchase price and selling price.

In addition to the net interest spread between the mortgage coupon and the pass-through rate, the mortgage servicer usually obtains certain other unstated rights which have significant economic value. These rights include the opportunity to earn income by investing the float from collection of borrower payments (principal, interest, and escrows) before passing them through to the appropriate parties (investors who own the mortgage, taxing authorities, insurance companies, etc.). The servicer also receives ancillary income items such as late payment fees charged to borrowers and credit life insurance commissions. (Note that these rights may not be included in the determination of the book value of ESFR because ESFR is created via a credit to income rather than from an up-front payment to acquire the rights from an independent party, as is the case with PMSR. Income from these unstated rights is recognized on a cash basis as earned.)

When servicing rights are purchased, their cost is capitalized and classified as an intangible asset called PMSR. The purchase price represents the buyer's estimate of the present value of the future servicing fees net of servicing costs. The estimate encompasses such items as anticipated prepayment speeds, servicing costs, delinquency ratios, foreclosure costs, the cost of advances, escrow balances and the earnings thereon, ancillary income, and so on. The valuation of PMSR is thus far more complex and dependent on more assumptions than ESFR. Its recoverability should be closely monitored.

Amortization. SFAS No. 65 specifies that PMSR must be amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing costs). This proportional amortization requirement has generally been interpreted as allowing the use of either the level-yield (interest) method or the proportional cash flow approach. The proportional cash flow approach results in a slightly more rapid amortization.

When using the proportional cash flow approach, an amortization factor is computed each period by dividing the current period's net servicing income before amortization by the initial estimate of total net servicing income over the life of the asset. This ratio is then multiplied by the initial PMSR balance to arrive at the current period amortization expense.

In accordance with EITF No. 86-38A, the estimate of net servicing income must consider the effect of unanticipated prepayments. However, a write-down would not be required if estimated net servicing income exceeds the asset's carrying amount. The estimate of future net servicing income may be computed on a discounted or undiscounted basis. The effect of the unanticipated prepayments would result in an adjustment to the rate of amortization on a prospective basis consistent with the change in estimated future net servicing income. However, in order for PMSR to be included in regulatory capital, thrifts must measure impairment of PMSR using a discounted cash flow methodology for book value purposes, similar to that for ESFR.

Book Value. The FDIC's Final Rule on Capital Maintenance, and the OTS' Intangible Assets regulation, specify that a write-down of the book value of PMSR must be made to the extent that the discounted value of future net cash flows is less than current book value. The discount rate used for this impairment analysis must be no less than the rate inherent in the asset at the time of acquisition, based on estimated net cash flow and the price paid on the purchase date. Thus, in order for a thrift's PMSR to be includable in regulatory capital, the book value must be tested for impairment on a discounted basis utilizing, at a minimum, the thrift's original internal rate of return implicit in the purchase price.

Sales. The contractual right to service mortgages represents a significant economic asset to thrifts. The servicing rights related to a thrift's originated mortgage portfolio are not recognized on the balance sheet, nor is the normal servicing fee portion when mortgages are sold with the servicing retained (OMSR), however, PMSR are recognized for these same assets when these rights are, in effect, purchased from a third party. If a thrift sells the rights to service its mortgages but retains the underlying mortgages, immediate income recognition of the sales price is not appropriate.

There may be cases where a thrift has purchased mortgages with a definitive plan for their subsequent sale with the servicing rights retained, so that a portion of the purchase price is allocated as PMSR. EITF No. 86-39, Gains from the Sale of Mortgage Loans with Servicing Rights Retained, specifies that if the mortgages are then sold at a gain, the gain must be offset against the previously recorded PMSR before any income statement gain can be recognized.

Origination and Commitment Fees

SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, provides the guidance in this area. The Statement has been in effect for fiscal years beginning after December of 1987 and, due to its significant impact on the thrift industry, this discussion assumes the reader has a basic understanding of SFAS No. 91 and only focuses on those aspects applicable to mortgage banking.

On mortgages held for sale, origination fees and direct origination costs should be deferred until the related mortgage is sold. Commitment fees received should generally be deferred and amortized into income as a yield adjustment unless the commitment expires unused, at which time the remaining unamortized fee is taken into income. However, if the probability of a mortgage commitment being exercised is remote, the fees may be taken into income on a straight-line basis over the commitment period. If this approach is utilized but the commitment is then exercised, the remaining unamortized fees are recognized over the life of the mortgage (until it is sold) as an adjustment to the yield. For commitment fees paid to investors to ensure the sale of the mortgages, SFAS No. 91 requires the fees to be expensed when the mortgages are sold or it becomes evident the commitment will expire unused.

Conclusion

Accounting for mortgage banking activities is a complex and evolving area. The accounting principles involved are technical, detailed, and the theory discussed is often difficult to apply in practice. Aggressive valuation assumptions and accounting practices will result in placing a thrift's capital at risk. While applying conservative valuation and accounting principles will not eliminate the market risks associated with mortgage banking, such practices will mitigate the adverse impact of market fluctuations on a thrift's capital.

REFERENCES

Statements of Financial Accounting Standards Board (FASB)

Statements of Financial Accounting Standards

No. 65	Accounting for Certain Mortgage Banking Activities
No. 77	Reporting by Transferors for Transfers of Receivables with Recourse
No. 91	Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases

No. 115	Accounting for Certain Investments in Debt and Equity Securities

Emerging Issues Task Force (EITF) Consensuses

No. 84-21	Sale of Servicing, Loans Retained
No. 86-38	Implications of Mortgage Prepayments on Servicing Rights
No. 86-39	Gains from the Sale of Mortgage Loans With Servicing Rights Retained
No. 87-34	Subservicing Agreements
No. 88-11	Allocation of Recorded Investment When a Loan or Part of a Loan is Sold
No. 89-2	Maximum Maturity Guarantees on Transfers of Receivables with Recourse
No. 89-5	Sale of Mortgage Loan Servicing Rights
No. 92-2	Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse
No. 92-10	Loan Acquisitions Involving Table Funding Arrangements

Technical Bulletins

No. 87-3	Accounting for Mortgage Servicing Fees and Rights

American Institute of Certified Public Accountants (AICPA) Statement of Position

No. 90-3	Definition of the Term Substantially the Same for Holders of Debt
No. 90-3	Instruments, as Used in Certain Audit Guides and a Statement of Position

Office of Thrift Supervision Bulletins

TB 52	Supervisory Statement of Policy on Securities Activities