Statement of Financial Accounting Standards No. 122

Note: This Statement has been completely superseded

FAS122 Status Page
FAS122 Summary

Accounting for Mortgage Servicing Rights

(an amendment of FASB Statement No. 65)

May 1995

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 122

Accounting for Mortgage Servicing Rights

an amendment of FASB Statement No. 65

May 1995

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Paragraph Numbers

FAS 122: Accounting for Mortgage Servicing Rights

an amendment of FASB Statement No. 65

FAS 122 Summary

This Statement amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, to require that a mortgage banking enterprise recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired. A mortgage banking enterprise that acquires mortgage servicing rights through either the purchase or origination of mortgage loans and sells or securitizes those loans with servicing rights retained should allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

This Statement requires that a mortgage banking enterprise assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. A mortgage banking enterprise should stratify its mortgage servicing rights that are capitalized after the adoption of this Statement based on one or more of the predominant risk characteristics of the underlying loans. Impairment should be recognized through a valuation allowance for each impaired stratum.

This Statement applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased before the adoption of this Statement. Earlier application is encouraged. Retroactive capitalization of mortgage servicing rights retained in transactions in which a mortgage banking enterprise originates mortgage loans and sells or securitizes those loans before the adoption of this Statement is prohibited.

INTRODUCTION AND BACKGROUND

1. Prior to the issuance of this Statement, FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, required separate capitalization of the cost of the rights to service mortgage loans for others when those rights were acquired through a purchase transaction but prohibited separate capitalization when those rights were acquired through loan origination activities. As a result, mortgage banking enterprises and enterprises such as commercial banks and thrift institutions that conduct operations that are substantially similar to the primary operations of a mortgage banking enterprise (hereafter collectively referred to as a mortgage banking enterprise) often reported losses on the sale of mortgage loans with servicing rights retained that were acquired through loan origination activities. That was because, in determining the gain or loss on the sale, the cost deducted from the sales price included the cost associated with both the mortgage servicing rights and the loans themselves. However, if the same mortgage loans had been acquired in a purchase transaction, the cost of the mortgage servicing rights would have been capitalized separately as an asset and would not have been deducted from the sales price of the mortgage loans.

2. This Statement amends certain provisions of Statement 65 to eliminate the accounting distinction between rights to service mortgage loans for others that are acquired through loan origination activities and those acquired through purchase transactions. When a mortgage banking enterprise purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related mortgage servicing rights. If the mortgage banking enterprise sells or securitizes the loans and retains the mortgage servicing rights, the enterprise should allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the entire cost of acquiring the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights. Any cost allocated to mortgage servicing rights should be recognized as a separate asset. Mortgage servicing rights should be amortized in proportion to and over the period of estimated net servicing income and should be evaluated for impairment based on their fair value.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Existing Pronouncements

3. Statement 65 is amended as follows:

a. In the first sentence of paragraph 1, *origination or acquisition* is replaced by *purchase or origination.*

b. In the first sentence of paragraph 10, *of existing* is replaced by *or origination of.*

c. In paragraph 15, the reference to paragraph 18 is replaced by a reference to paragraph 19 and the following is added to the end of the paragraph:

> The rate used to determine the present value shall be an appropriate long-term interest rate.

d. Paragraph 16 is replaced by the following:

> A mortgage banking enterprise may purchase mortgage servicing rights separately or it may acquire mortgage servicing rights by purchasing or originating mortgage loans and selling or securitizing those loans with servicing rights retained. When a mortgage banking enterprise purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related mortgage servicing rights. If the mortgage banking enterprise sells or securitizes the loans and retains the mortgage servicing rights, the enterprise shall allocate the total cost of the mortgage loans (the recorded investment in the mortgage loans including net deferred loan fees or costs and any purchase premium or discount) to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values (refer to paragraph 18) as follows:
>
> a. A mortgage banking enterprise that purchases or originates mortgage loans with a definitive plan to sell or securitize those loans and retain the mortgage servicing rights shall allocate the cost of the mortgage loans based on the relative fair values at the date of purchase or origination.* The allocation shall be based on the assumption that a normal servicing fee will be received and that the rights to the remaining cash flows from the underlying mortgage loans will be sold or securitized. A definitive plan exists if (1) the mortgage banking enterprise has obtained, before the purchase or origination date, commitments from permanent investors to purchase the mortgage loans or related mortgage-backed securities, makes a commitment within a reasonable period (usually not more than 30 days after the purchase or origination date) to sell the mortgage loans or related mortgage-backed securities to a permanent investor or underwriter, or has made, before the purchase or origination date, commitments to deliver the mortgage loans for securitization and (2) estimates of the selling price have been made.
>
> b. A mortgage banking enterprise that does not have a definitive plan at the purchase or origination date and later sells or securitizes the mortgage loans and retains the mortgage servicing rights shall allocate the amortized cost of the mortgage loans as described in paragraph 16(a) based on the relative fair values at the date of sale or securitization.
>
> If it is not practicable to estimate the fair values of the mortgage servicing rights and the

mortgage loans (without the mortgage servicing rights), the entire cost of purchasing or originating the mortgage loans shall be allocated to the mortgage loans (without the mortgage servicing rights) and no cost shall be allocated to the mortgage servicing rights.

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* In the absence of a definitive plan for the sale or securitization of the related mortgage loans, the cost of purchasing or originating the right to service mortgage loans is included as part of the cost of the loans for purposes of determining the lower of cost or market value.

e. Paragraph 17 (as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*) and footnote 6 are replaced by the following three paragraphs and related footnote:

For the purpose of evaluating and measuring impairment of capitalized mortgage servicing rights, a mortgage banking enterprise shall stratify those rights based on one or more of the predominant risk characteristics of the underlying loans. Those characteristics may include loan type,* size, note rate, date of origination, term, and geographic location.

Impairment shall be recognized through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the capitalized mortgage servicing rights for a stratum exceed their fair value (refer to paragraph 18). The fair value of mortgage servicing rights that have not been capitalized shall not be used in the evaluation of impairment.

Subsequent to the initial measurement of impairment, the mortgage banking enterprise shall adjust the valuation allowance to reflect changes in the measurement of impairment. Fair value in excess of the amount capitalized as mortgage servicing rights (net of amortization), however, shall not be recognized. This Statement does not address when a mortgage banking enterprise should record a direct write-down of capitalized mortgage servicing rights.

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* Loan type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

f. Paragraph 18 is replaced by the following:

The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring mortgage servicing rights should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates.

g. In paragraph 19, (*net of any valuation allowances*) is added after *the right to service mortgage loans*. The following is added to the end of the paragraph:

> For this purpose, estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental cost basis.

h. In paragraph 30, *acquiring* is replaced by *purchasing or originating.*

i. The following three paragraphs are added after paragraph 30:

> The fair value of capitalized mortgage servicing rights and the methods and significant assumptions used to estimate that fair value shall be disclosed. If no cost is allocated to certain mortgage servicing rights in accordance with the last sentence of paragraph 16 of this Statement, the mortgage banking enterprise shall describe those mortgage servicing rights and shall disclose the reasons why it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights).
>
> The risk characteristics of the underlying loans used to stratify capitalized mortgage servicing rights for purposes of measuring impairment shall be disclosed.
>
> For each period for which results of operations are presented, the activity in the valuation allowances for capitalized mortgage servicing rights, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances shall be disclosed.

4. Paragraph 9 of FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*, is replaced by the following:

> An enterprise may acquire mortgage servicing rights by purchasing or originating mortgage loans and selling those loans with servicing rights retained or by purchasing the servicing rights separately. Mortgage servicing rights are amortized in proportion to, and over the period of, estimated net servicing income.

Effective Date and Transition

5. The provisions of this Statement shall be applied prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased before the adoption of this Statement. Earlier application is encouraged in fiscal years or interim periods for which financial statements or information has not been issued. Retroactive capitalization of mortgage servicing rights retained in transactions in which a mortgage banking enterprise originates mortgage loans and sells or securitizes those loans before the adoption of this Statement is prohibited.

6. Paragraph 17 of Statement 65, as amended by this Statement, applies to impairment evaluations of all capitalized mortgage servicing rights. However, a mortgage banking enterprise may continue to apply its previous accounting policies for stratifying mortgage servicing rights to those mortgage servicing rights that were capitalized prior to the adoption of this Statement.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board.

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
James J. Leisenring
Robert H. Northcutt
Robert J. Swieringa

Appendix A

BASIS FOR CONCLUSIONS

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Appendix A: BASIS FOR CONCLUSIONS

Introduction

7. This appendix summarizes considerations that were deemed significant by Board members in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

8. The Board was asked in November 1992 by the Mortgage Bankers Association of America to reconsider the accounting for originated mortgage servicing rights. A Prospectus was issued in December 1992 to obtain comments from interested parties about a potential project that would amend Statement 65 to address several practice problems in accounting for mortgage servicing rights. The Board received 48 letters of comment on the Prospectus. Most respondents recommended that the Board add the project to its agenda.

9. In October 1993, after considering the comments received on the Prospectus, the Board added the project on mortgage servicing rights to its agenda. The project had three objectives: (a) to determine whether the accounting distinction between originated and purchased mortgage servicing rights should be retained, (b) to determine how mortgage servicing rights should be evaluated for impairment, and (c) to consider how the accounting for mortgage servicing rights could be simplified.

10. An FASB Exposure Draft, *Accounting for Mortgage Servicing Rights and Excess Servicing Receivables and for Securitization of Mortgage Loans*, was issued in June 1994. That Exposure Draft proposed to eliminate the accounting distinction between mortgage servicing rights that are acquired through loan origination activities and those that are acquired through purchase transactions by requiring that a mortgage banking enterprise allocate some of the cost of an originated mortgage loan to the mortgage servicing rights. It proposed that securitizations of mortgage loans be accounted for as sales of mortgage loans and acquisitions of mortgage-backed securities. It also proposed that a mortgage banking enterprise measure impairment of mortgage servicing rights based on fair value. The Board received 89 letters of comment on the Exposure Draft. In addition, nine mortgage banking enterprises participated in a limited field test of the provisions of the Exposure Draft. The test results were useful to the Board during its deliberations of the issues addressed by this Statement. The Board decided that it could reach an informed decision on the project without holding a public hearing.

11. After considering the responses to the Exposure Draft and the results of the limited field

test, the Board decided to limit the scope of the amendment of Statement 65 to recognition of mortgage servicing rights and measurement of impairment of those rights. As a result, the Board decided not to address the provisions in paragraph 11 of Statement 65 that require that a mortgage banking enterprise recognize the fair value of excess servicing receivables as an addition to the sales price of the mortgage loans. This Statement does not modify the provisions in Emerging Issues Task Force Issue No. 86-38, "Implications of Mortgage Prepayments on Amortization of Servicing Rights," that require that the excess service fee receivable . . . should be written down to the present value of the estimated remaining future excess service fee revenue. The same discount factor used to calculate the original excess service fee receivable . . . should be used to calculate the change. The excess service fee receivable would not be increased as a result of favorable prepayment experience; however, amortization would be adjusted prospectively."

12. In addition, this Statement does not change the provisions in paragraph 11 of Statement 65 that require that a mortgage banking enterprise (a) accrue a loss if estimated servicing costs are expected to exceed normal servicing revenue and (b) recognize a liability if it will receive less than a normal servicing fee and amortize that liability to provide for a normal servicing fee in each subsequent period. This Statement also does not change the requirement in paragraph 19 of Statement 65 to amortize mortgage servicing rights in proportion to and over the period of estimated net servicing income.

13. With respect to mortgage servicing rights, Statement 65, as amended by this Statement, does not apply to the right to service loans other than mortgage loans. It does not apply to a mortgage banking enterprise that retains mortgage loans and sells the right to service those loans. It does not apply to transactions in which a mortgage banking enterprise sells partial interests in mortgage loans with servicing rights retained other than those in which the interests retained by the mortgage banking enterprise represent excess servicing receivables (paragraph 11 of Statement 65). Currently, EITF Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold," requires that an enterprise allocate the recorded investment between the portion of the loan sold and the portion retained based on the relative fair values of those portions on the date that the loan was acquired, if practicable, adjusted for payments and other activity from the date of acquisition to the date of sale. If not practicable, the allocation is based on relative fair values at the date of sale. Under Issue 88-11, the Board anticipates that a mortgage banking enterprise generally would allocate a portion of the recorded investment in a mortgage loan to mortgage servicing rights.

Benefits and Costs

14. The Board's mission statement charges the Board to determine that a proposed standard will fill a significant need and that the cost it imposes, compared with possible alternatives, will be justified in relation to the overall benefits.

15. Issues about the accounting for mortgage servicing rights have persisted since the issuance

of Statement 65, and the Board and the EITF addressed various implementation questions. This Statement eliminates the accounting distinction between mortgage servicing rights acquired through purchase and those acquired through loan origination activities. It also eliminates an incentive to engage in the sale of mortgage servicing rights that were acquired through loan origination activities to achieve an accounting result. This Statement also specifies how mortgage servicing rights should be evaluated for impairment.

16. Practical decisions were made to reduce the cost and complexity of applying this Statement. Those decisions include limiting the scope of the amendment to mortgage servicing rights for which it is practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans and requiring that a mortgage banking enterprise allocate the cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on the relative fair values at the date of sale or securitization if the enterprise does not have a definitive plan at the purchase or origination date to sell or securitize the mortgage loans. The Board believes that the benefits to be derived from the accounting required by this Statement will outweigh the costs of implementation.

Separate Recognition of Mortgage Servicing Rights

17. Statement 65 prohibited a mortgage banking enterprise from separately capitalizing the cost of mortgage servicing rights when the rights were acquired through loan origination activities. The Board believes that the accounting required by Statement 65 for those originated mortgage servicing rights was inconsistent with the underlying rights and benefits associated with mortgage servicing rights. Mortgage banking enterprises often reported losses for accounting purposes on the sale of mortgage loans with servicing rights retained that were acquired through loan origination activities because the cost deducted from the sales price included the cost associated with both the mortgage servicing rights and the loans themselves. As a result, net servicing income in future periods was overstated because the cost of acquiring the mortgage servicing rights was not amortized against servicing revenue. However, if the same mortgage loans had been acquired in a purchase transaction, the cost of the mortgage servicing rights would have been capitalized separately as an asset and would not have been deducted from the sales price.

18. The Board concluded that the distinction in Statement 65 between mortgage servicing rights acquired through an origination of mortgage loans and those acquired through a purchase transaction is inappropriate. Most respondents to the Exposure Draft agreed that the Board should eliminate that distinction because mortgage loans that are acquired through origination activities and mortgage loans that are acquired through purchase transactions are identical.

Reference to Intangible Assets

19. This Statement eliminates the reference in paragraph 16 of Statement 65 to mortgage servicing rights as intangible assets. The Board decided that it was not necessary to characterize

mortgage servicing rights as either intangible assets or tangible assets when similar characterizations have not been made for most other assets. The elimination of the reference does not imply that mortgage servicing rights are tangible assets or intangible assets.

Measurement of Mortgage Servicing Rights

20. This Statement requires that a mortgage banking enterprise measure mortgage servicing rights at cost by allocating the cost of mortgage loans between the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights) based on their relative fair values if it sells or securitizes mortgage loans and retains the mortgage servicing rights and if it is practicable to estimate those fair values. The cost of purchasing or originating the mortgage loans should be deducted from the loan sale proceeds to determine gain or loss on the sale of those loans. The cost of the mortgage servicing rights should be amortized in proportion to and over the period of estimated net servicing income.

21. The Board concluded that the relative fair value approach is consistent with the objectives of accounting allocations as described in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Paragraph 142 of Concepts Statement 6 discusses the objective of accounting allocations and cites some common examples:

> Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. . . . Common examples of allocations include assigning manufacturing costs to production departments or cost centers and thence to units of product to determine "product cost," *apportioning the cost of a "basket purchase" to the individual assets acquired on the basis of their relative market values*, and spreading the cost of an insurance policy or a building to two or more accounting periods. [Emphasis added.]

22. The Board also considered an allocation approach that would require a mortgage banking enterprise to measure the mortgage loans without servicing rights at fair value and allocate the remaining cost to the mortgage servicing rights. However, the Board concluded that that approach would not accurately reflect the transaction to sell mortgage loans. Gains should be recognized when the sales price of an asset exceeds the cost of that asset. In a loan purchase or origination, the mortgage banking enterprise acquires a mortgage loan, including the right to service that loan. The Board believes that mortgage loans (without the mortgage servicing rights) and the related servicing rights generally have separately determinable fair values. The cost of the mortgage loans (without the mortgage servicing rights) and the cost of the right to service those loans can be assigned by allocating the original cost of the loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values.

23. The Exposure Draft proposed that the fair value of mortgage servicing rights should be based on observable market prices if available. In the absence of observable market prices, it

proposed that fair value could be based on the present value of expected future cash flows. Respondents questioned whether the results of present-value-based measurements could be used if prices for similar assets existed. Further, some respondents indicated that selling prices for similar assets are sometimes included in valuation techniques that consider expected future cash flows.

24. The Board decided to include an approach for measuring the fair value of an asset that would be broadly applicable to other assets in addition to mortgage servicing rights. The Board concluded that quoted market prices in active markets are the most objective and relevant measure of fair value and should be used, if available. If quoted market prices are not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring mortgage servicing rights should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates.

25. The Exposure Draft proposed that the cost of all mortgage loans should be allocated to the mortgage servicing rights and the loans (without the mortgage servicing rights) if a mortgage banking enterprise sells or securitizes the loans and retains the mortgage servicing rights. Some respondents indicated that the fair value of some mortgage servicing rights would be difficult to obtain. Some of those respondents suggested that the scope of the amendment should be limited to servicing rights for residential mortgage loans. Others suggested that enterprises with small or illiquid mortgage servicing portfolios should be excluded from the scope of the amendment of Statement 65 because fair value for those portfolios would be difficult to obtain.

26. The Board decided that a mortgage banking enterprise should allocate cost to mortgage servicing rights if it is practicable to estimate the fair value of those rights and the related mortgage loans. If it is not practicable to estimate the fair values of the mortgage servicing rights and the related mortgage loans, the mortgage servicing rights should be recorded at zero and the mortgage banking enterprise should describe in its financial statements those mortgage servicing rights and disclose the reasons why it is not practicable to estimate those fair values.

Allocation Date

27. Some have suggested that the original cost of all mortgage loans should be allocated to the mortgage servicing rights and the mortgage loans (without mortgage servicing rights) based on their relative fair values as of the date the loans are acquired. However, the Board noted that not all mortgage loans are sold with servicing rights retained and that such a requirement would be burdensome. Some respondents said that when mortgage loans are sold with the servicing rights

retained, the original cost of the mortgage loans should be allocated based on the relative fair values as of the date the loans are acquired. They believe that because the cost of purchasing or originating a mortgage loan is a "basket purchase" of two assets, the mortgage loan (without the mortgage servicing rights) and the mortgage servicing rights, cost should be assigned to each of those assets as of the purchase or origination date. The Board noted that allocation based on the purchase or origination date would require that a mortgage banking enterprise calculate the allocation that should have been made at purchase or origination and adjust those amounts for amortization, payments, and prepayments since purchase or origination if the mortgage banking enterprise sold mortgage loans after the purchase or origination of those loans.

28. Some respondents said that the sale of mortgage loans is the event that should result in the cost allocation to the mortgage servicing rights and the mortgage loans. They said that the cost allocation to the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights) should reflect the decisions made by the mortgage banking enterprise to sell the loans. Subsequent to the purchase or origination of the loans, changes in market conditions, mortgage prepayments, servicing costs, and the creditworthiness of borrowers will affect the values of the mortgage loans and the mortgage servicing rights differently. As a result, those respondents believe that an allocation based on the relative fair values at purchase or origination may not reflect the economics of the sale transaction.

29. The Board noted that prior to the issuance of this Statement, paragraph 17 of Statement 65 required a mortgage banking enterprise to allocate the costs of purchased mortgage loans to the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights) at acquisition if a definitive plan for sale exists when the purchase transaction is initiated. The Board decided to retain that requirement. The Board decided that a mortgage banking enterprise that does not have a definitive plan at the purchase or origination date and later sells or securitizes the mortgage loans should allocate the cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on the relative fair values at the date of sale or securitization. In those situations, the Board concluded that the costs of allocating the cost of the mortgage loans based on the relative fair values at the date of purchase or origination would outweigh the benefits. The Board decided not to require or (in order to maintain consistency among mortgage banking enterprises) permit a mortgage banking enterprise to allocate costs before the sale or securitization date if it does not have a definitive plan for sale or securitization of mortgage loans at the purchase or origination date of those loans.

Recognition of Gains on the Sale of Mortgage Loans

30. Paragraph 17 of Statement 65 extracted the requirement from AICPA Statement of Position 76-2, *Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry*, that the amount of any gain on sale of mortgage loans with servicing rights retained be applied to reduce the amount of capitalized mortgage servicing rights. The Board decided to eliminate that requirement because it believes that the market for

mortgage servicing rights will provide sufficient information to develop reasonable estimates of the fair values of mortgage servicing rights and that those fair values will prevent disproportionate cost allocations. Further, the addition of the requirement to assess capitalized mortgage servicing rights for possible impairment based on their fair values should address many of the concerns that capitalized mortgage servicing rights could be overstated as a result of allocating too much cost to those rights. Consistent with that decision, this Statement nullifies the consensus in EITF Issue No. 86-39, "Gains from the Sale of Mortgage Loans with Servicing Rights Retained."

31. Gains that result from the sale of mortgage loans can be attributed to various factors. A mortgage banking enterprise can create additional value by purchasing or originating mortgage loans in one market and packaging them for sale in another market, comparable to buying at wholesale and selling at retail. For example, a mortgage banking enterprise may originate mortgage loans with contractual interest rates of 10 percent, pool those mortgage loans, and sell the pool at par to yield 9 percent. An investor would be willing to receive 9 percent on its investment because, rather than purchasing or originating individual mortgage loans, it has acquired a passive investment in a pool of mortgage loans. That investment is serviced by another entity, often is guaranteed by another third party, and usually is marketable. The cost (receiving a lower yield on the investment than the contractual rate on the underlying mortgage loans) of those benefits may be more than offset by the cost that would have been incurred if the investor had originated and serviced the individual mortgage loans within the package. In addition, changes in market conditions after the purchase or origination of the mortgage loans can result in a gain or loss on the sale of those loans.

32. The gain or loss recognized on the sale of an originated loan may be different from what would have been recognized had the loan been acquired in a purchase transaction. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, applies to entities that originate and purchase mortgage loans and requires that those entities defer all loan origination fees and direct loan origination costs. Costs other than direct loan origination costs are required to be charged to expense when incurred. As a result, when a mortgage banking enterprise originates loans, only direct loan origination costs are deferred as part of the cost of the loans. However, when a mortgage banking enterprise purchases loans, the cost of the loans may include the seller's indirect costs of origination as well as direct costs because the seller generally wants to pass all costs to the purchaser. Thus, all other things being the same, the costs capitalized for originated loans generally will be less than the costs capitalized for purchased loans. As a result, the gain on the sale of originated mortgage loans generally will be greater than the gain that would have been recognized if the loans had been purchased.

Securitization of Mortgage Loans

33. The Exposure Draft proposed that an enterprise account for the securitization of mortgage loans as a sale of mortgage loans with servicing rights retained and an acquisition of

mortgage-backed securities. The fair value of the resulting mortgage-backed securities would have been considered the sales price of the mortgage loans and the cost of the mortgage-backed securities. Some respondents said that issues about securitization of mortgage loans should be addressed in the Boards agenda project on financial instruments. Some said that a securitization of mortgage loans should be accounted for as a transfer from the loan portfolio to the mortgage-backed securities portfolio at the amortized cost of the mortgage loans with no gain or loss recognition.

34. The purpose of this Statement is to provide for the capitalization of mortgage servicing rights associated with originated loans and for measuring impairment of mortgage servicing rights. The Board decided not to address accounting for securitization of mortgage loans in this Statement. Issues about securitization of mortgage loans will be addressed in the Boards broader agenda project on accounting for transfers of financial assets and extinguishments of liabilities. However, if it is practicable to estimate the fair values of mortgage servicing rights and mortgage loans (without the mortgage servicing rights), this Statement requires that an enterprise allocate the cost of purchasing or originating the mortgage loans between the mortgage servicing rights and the loans when mortgage loans are securitized.

Impairment

35. Because mortgage servicing rights are sensitive to prepayments, their values diminish when prepayments of the underlying mortgage loans occur. If mortgage refinancing activity increases dramatically as borrowers respond to substantial declines in mortgage interest rates, mortgage servicing rights will decrease in value due to the accelerated payments on the underlying loan portfolio.

36. This Statement requires that a mortgage banking enterprise measure impairment of all capitalized mortgage servicing rights based on their fair values and nullifies Section A of Issue 86-38. Prior to the effective date of this Statement, the consensus reached on Issue 86-38 required that a mortgage banking enterprise adjust the amortization of the mortgage servicing rights when unexpected prepayments occurred. It did not require recognition of impairment if the estimated future net servicing income exceeded the net carrying amount of the mortgage servicing rights. The estimate of future net servicing income could be based on either discounted or undiscounted amounts.

37. The Board considered an approach that would have required that a mortgage banking enterprise measure impairment of capitalized mortgage servicing rights based on the present value of expected future net servicing income discounted at the interest rate inherent in the original amount recognized or, as a practical expedient, on the fair value of the mortgage servicing rights. That approach would have been similar to the approach in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, that requires a creditor to measure impairment of a loan based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, on the observable market price of the

loan or the fair value of the collateral if the loan is collateral dependent. The inherent rate would equate the present value of the original estimated future net servicing income with the original amounts recognized as mortgage servicing rights.

38. The Board observed that loans are financial instruments and that mortgage servicing rights are not because the mortgage banking enterprise must provide services to receive the servicing fee. Therefore, the Board decided that there was no compelling reason for measuring impairment of mortgage servicing rights and impairment of a loan on the same basis. The Board also noted that a measurement based on an inherent rate would generally result in a larger measure of impairment than a measurement based on fair value. While not directly tied to interest rate movements, the rate of prepayment historically has been highly correlated to those rate changes. Therefore, when prepayments increase following a decline in interest rates, a measure of impairment based on fair value would produce a higher value (and a lower measure of impairment) than a measure based on the reduced estimate of future cash flows discounted at the interest rate inherent in the original amounts recognized as mortgage servicing rights. That higher value would result because the current discount rate inherent in a fair value measure would be less than the discount rate inherent in the original amounts recognized as mortgage servicing rights. In contrast, when interest rates rise, a fair value measure would produce a lower value, from a higher interest rate than the inherent rate. However, in an increasing interest rate environment, estimates of cash flows generally would increase because expected prepayments would decrease, so the mortgage servicing rights would not likely be impaired under either measurement method.

39. The Board noted that, given a choice of methods, mortgage banking enterprises generally would elect to use the fair value of the mortgage servicing rights over the inherent rate approach because the fair value approach would result in a smaller measure of impairment. Based partly on that observation, the Board concluded that two measurement methods would be unnecessary. For reasons of consistency, comparability, and practicality, the Board concluded that impairment of capitalized mortgage servicing rights should be measured based on fair value.

40. The Exposure Draft proposed for purposes of evaluating and measuring impairment that a mortgage banking enterprise stratify the amortized cost of its capitalized mortgage servicing rights based on the risk characteristics of the underlying mortgage loans. Impairment would have been measured as the excess of the capitalized amount in each stratum over the fair value of that stratum.

41. Respondents said that a mortgage banking enterprise uses a portfolio approach for managing its mortgage servicing rights and that the stratified method proposed in the Exposure Draft for measuring impairment would be inconsistent with that management approach. Respondents suggested that impairment should be measured as the amount by which the carrying amount of the portfolio exceeds the fair value of the portfolio (a "portfolio method"). The Board observed that while many types of assets are managed as a portfolio, impairment often is measured on a more disaggregated basis. For example, investments in loans generally are managed as a

portfolio; however, Statement 114 requires that an entity measure impairment of certain loans at the individual loan level (but allows aggregation if loans have risk characteristics in common). The unrealized gains on one loan are not used to offset unrealized losses on another loan.

42. Respondents generally agreed that cash flow projections used to determine the fair value of the servicing rights portfolio should be made on a stratified basis. However, many said that their current accounting systems do not have the capability of stratifying the cost of those mortgage servicing rights in the detail that would have been required by the Exposure Draft. The Board decided to simplify the stratification approach proposed in the Exposure Draft. In contrast to the stratified approach proposed in the Exposure Draft, this Statement provides a mortgage banking enterprise with flexibility to assess the risk characteristics of the underlying loans and choose the predominant characteristics to stratify the cost of the mortgage servicing rights. The Board believes that that flexibility will reduce the cost of implementing the Statement. To further reduce the cost of implementation, the Board decided that a mortgage banking enterprise should be permitted to apply its previous accounting policies for stratifying mortgage servicing rights to those mortgage servicing rights that were capitalized prior to the adoption of this Statement.

43. The transition provisions of this Statement preclude a mortgage banking enterprise from capitalizing mortgage servicing rights retained in transactions in which it originated mortgage loans and sold or securitized those loans before the adoption of this Statement. Likewise, a mortgage banking enterprise is not required to capitalize those mortgage servicing rights for which it is not practicable to estimate the fair values of those rights and the related mortgage loans. The fair value of those mortgage servicing rights that have not been recognized should not be used in the impairment evaluations and measurements of capitalized mortgage servicing rights. If a mortgage banking enterprise were to offset the measurement of impairment of capitalized mortgage servicing rights with the fair value of mortgage servicing rights that have not been recognized, a financial statement user might conclude that the capitalized mortgage servicing rights were not impaired.

Disclosures

44. This Statement extends the disclosures required by Statement 65 for purchased mortgage servicing rights to originated mortgage servicing rights.

45. The Exposure Draft would have required that a mortgage banking enterprise provide enough information to allow financial statement users to make independent judgments about the value of its mortgage servicing rights. That information about the mortgage loans serviced for others would have included by type of loan serviced the fair value of mortgage servicing rights, the principal balance of loans outstanding, the average loan balance, the weighted-average contractual maturities (the weighted-average number of months until the final principal payment) of the loans, the projected weighted-average life of the loans, the weighted-average note rates of the loans, and the weighted-average servicing fee rate. Some respondents said that those disclosures would be excessive and that a mortgage banking enterprise should not be required to

disclose the fair value of the mortgage servicing rights as well as the information needed to recalculate that fair value. The Board decided to limit the disclosures to the fair value of capitalized mortgage servicing rights and the methods and significant assumptions used to estimate that fair value. This Statement does not preclude a mortgage banking enterprise from also disclosing the fair value of mortgage servicing rights that are not capitalized.

Transition

46. The Board concluded that this Statement should be applied prospectively to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans and to impairment evaluations of all capitalized mortgage servicing rights. The Board further concluded that retroactive capitalization of originated mortgage servicing rights should be prohibited. The Board recognizes the benefits of comparative financial statements but questions the ability of entities to recreate historical estimates of net servicing income that would be necessary for restatement, particularly in light of changes in prepayment estimates that may have occurred since the origination of the mortgage loans. Similarly, because this Statement eliminates the requirement to reduce the amount of capitalized mortgage servicing rights by the amount of any gain on the sale of mortgage loans and requires periodic impairment assessments, the Board questions whether necessary data would be available at a reasonable cost to restate previously issued financial statements.

47. The Board observed that although a mortgage banking enterprise may not be able to recreate historical estimates of the servicing revenue and cost streams necessary for restatement, it should be able to estimate the fair value of all remaining mortgage servicing rights and recognize them as a "fresh start." However, the Board noted that such a transition approach would be inconsistent with the requirement in this Statement to measure mortgage servicing rights at amortized cost. The Board also considered whether the requirement to base the measurement of impairment on fair value should be applicable only to mortgage servicing rights acquired after the effective date of the Statement and rejected that approach because the Board decided that all mortgage servicing rights should be measured for impairment on a discounted basis. For practical reasons, the Board decided that a mortgage banking enterprise should be permitted to apply its previous accounting policies for stratifying mortgage servicing rights to mortgage servicing rights that were capitalized prior to the adoption of this Statement.

48. This Statement does not allow a mortgage banking enterprise to report the effect of initially applying this Statement as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. The Board decided that the cost of isolating a "cumulative effect" would exceed the related benefit of that information. This Statement does not preclude a mortgage banking enterprise from disclosing in the notes to the financial statements the effect of initially applying this Statement if a mortgage banking enterprise believes it is practicable to do so.

Appendix B: FASB *CURRENT TEXT*, MORTGAGE BANKING ACTIVITIES

49. Statement 65 has been amended by Statements 91, 115, and 122. This appendix contains the FASB *Current Text*, Section Mo4, "Mortgage Banking Activities," which integrates Statement 65 and those amendments. The integrated text was edited by the FASB staff but has not been subjected to the FASB's due process procedures used for issuing FASB pronouncements. The authority of the integrated text is derived from the underlying FASB pronouncements, which remain in force, and does not in any way supersede, change, or otherwise affect the original pronouncements from which the integrated text was drawn.

MORTGAGE BANKING ACTIVITIES SECTION Mo4

Sources: FASB Statement 65; FASB Statement 91; FASB Statement 115; FASB Statement 122; FASB Technical Bulletin 87-3

Summary

This section applies to certain activities of a mortgage banking enterprise and to the mortgage banking operations of other enterprises, such as commercial banks and thrift institutions.

Mortgage loans held for sale are reported at the lower of cost or market value. Mortgage-backed securities are reported in accordance with the provisions of Section I80, "Investments: Debt and Equity Securities." Loan origination fees and related direct loan origination costs for loans held for sale shall be capitalized as part of the carrying amount of the related loan and shall not be amortized.

A mortgage banking enterprise that acquires mortgage servicing rights through either the purchase or origination of mortgage loans and sells or securitizes those loans with servicing retained shall allocate the cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the entire cost of acquiring the loans shall be allocated to the mortgage loans (without the mortgage servicing rights) and no cost shall be allocated to the mortgage servicing rights.

Loan origination fees and related direct loan origination costs for loans held for investment shall be deferred and recognized as an adjustment to yield. Loan commitment fees shall be deferred and recognized over the

life of the loan or until the loan is sold, while fees paid to permanent investors shall be recognized as expense when loans are sold. Fees for services performed by third parties and loan placement fees are recognized as revenue when all significant services have been performed.

Introduction

.101 [Deleted 10/82 because of FASB Statement 65, *Accounting for Certain Mortgage Banking Activities*.]

.102 Mortgage banking activities primarily consist of two separate but interrelated activities: (a) the [FAS65, ¶1] purchase or origination [FAS122, ¶3(a)] of mortgage loans and the sale of the loans to **permanent investors** and (b) the subsequent long-term **servicing** of the loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from realtors and brokers, purchases from investors, and conversions of various forms of interim financing to permanent financing. [FAS65, ¶1]

.103 A **mortgage banking enterprise** usually retains the right to service mortgage loans it sells to permanent investors. A servicing fee, usually based on a percentage of the outstanding principal balance of the mortgage loan, is received for performing loan administration functions. When servicing fees exceed the cost of performing servicing functions, the existing contractual right to service mortgage loans has economic value. Because of their value, rights to service mortgage loans frequently have been purchased and sold. [FAS65, ¶2]

Scope

.104 This section [presents] accounting and reporting standards for certain activities of a mortgage banking enterprise. Other enterprises, such as commercial banks and thrift institutions, may conduct operations that are substantially similar to the primary operations of a mortgage banking enterprise (for example, through subsidiaries or divisions). In those circumstances, this section also applies to those operations. This section does not apply, however, to the normal lending activities of those other enterprises; [such activities are addressed in Section L20, "Lending Activities."] [FAS65, ¶3]. With respect to mortgage servicing rights, this section does not apply to the right to service loans other than mortgage loans. It does not apply to a mortgage banking enterprise that retains mortgage loans and sells the right to service those loans. It does not apply to transactions in which a mortgage banking enterprise sells partial interests in mortgage loans with servicing rights retained other than those in which the interests retained by the mortgage banking enterprise represent excess servicing receivables (paragraph .112 of this section). [FAS122, ¶13]

Mortgage Loans and Mortgage-Backed Securities

.105 Mortgage loans held for sale shall be reported at the lower of cost or market value, determined as of the balance sheet date. The amount by which cost exceeds market value shall be accounted for as a valuation allowance. Changes in the valuation allowances shall be included in the determination of net income of the period in which the change occurs. [FAS65, ¶4] **Mortgage-backed securities** held for sale in conjunction with mortgage banking activities shall be classified as trading securities and reported at fair value in accordance with provisions of Section I80, "Investments: Debt and Equity Securities." [FAS115, ¶128(a)]

.106 Purchase discounts on mortgage loans shall not be amortized as interest revenue during the period the loans or securities are held for sale. [FAS65, ¶5]

.107 A mortgage loan transferred to a long-term-investment classification shall be transferred at the lower of cost or market value on the transfer date. [FAS65, ¶6] The securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan and the purchase of a mortgage-backed security classified as a trading security at fair value. [FAS115, ¶128(c)] Any difference between the carrying amount of the loan and its outstanding principal balance shall be recognized as an adjustment to yield by the interest method. [1] [FAS91, ¶27(a)] A mortgage loan shall not be classified as a long-term investment unless the mortgage banking enterprise has both the ability and the intent to hold the loan for the foreseeable future or until maturity. [FAS65, ¶6]

.108 If ultimate recovery of the carrying amount of a mortgage loan held as a long-term investment is doubtful and the impairment is considered to be other than temporary, the carrying amount of the loan shall be reduced to its expected collectible amount, which becomes the new cost basis. The amount of the reduction shall be reported as a loss. A recovery from the new cost basis shall be reported as a gain only at the sale, maturity, or other disposition of the loan. [FAS65, ¶7]

.109 As a means of financing its mortgage loans or mortgage-backed securities held for sale, a mortgage banking enterprise may transfer mortgage loans or mortgage-backed securities temporarily to banks or other financial institutions under formal repurchase agreements that indicate that control over the future economic benefits relating to those assets and risk of market loss are retained by the mortgage banking enterprise. Under those agreements, those same mortgage loans or mortgage-backed securities generally are reacquired from the banks or other financial institutions when the mortgage banking enterprise sells the loans or securities to permanent investors. Mortgage loans or mortgage-backed securities also may be transferred temporarily without a repurchase agreement but under circumstances that indicate a repurchase agreement exists on an informal basis, for example, when the mortgage banking enterprise (a) makes all of the necessary marketing efforts, (b) retains any positive or negative interest spread on the loans or securities, (c) retains the risk of fluctuations in loan or security market values, (d) reacquires any uncollectible loans, or (e) routinely reacquires all or almost all of the loans or securities from the bank or other financial institution and sells them to permanent investors. Mortgage loans and mortgage-backed securities held for sale that are transferred under formal or informal repurchase agreements of the nature described in this paragraph shall (1) be accounted for as collateralized financing arrangements and (2) continue to be reported by the transferor [FAS65, ¶8] as being either mortgage loans held for sale or mortgage-backed securities classified as trading securities under Section I80. [FAS115, ¶128(e)]

.110 The market value of mortgage loans and mortgage-backed securities held for sale shall be determined by type of loan. At a minimum, separate determinations of market value for residential (one- to four-family dwellings) and commercial mortgage loans shall be made. Either the aggregate or individual loan basis may be used in determining the lower of cost or market value for each type of loan. Market value for loans subject to investor purchase commitments (committed loans) and loans held on a speculative basis (uncommitted loans) [2] shall be determined separately as follows:

a. *Committed Loans and Mortgage-Backed Securities*. Market value for mortgage loans covered by investor commitments shall be based on commitment prices. Any commitment price that provides for servicing fee rates materially different from current servicing fee rates shall be adjusted in accordance with paragraph .112. [FAS65, ¶9] If the fair value of a mortgage-backed security subject to an investor purchase commitment exceeds the commitment price, the implicit loss on the commitment shall be recognized. [FAS115, ¶128(f)]
b. *Uncommitted Loans*. Market value for uncommitted loans shall be based on the market in which the mortgage banking enterprise normally operates. That determination would include consideration of the following:
   (1) Commitment prices, to the extent the commitments clearly represent market conditions at the balance sheet date
   (2) Market prices and yields sought by the mortgage banking enterprise's normal market outlets
   (3) Quoted **Government National Mortgage Association (GNMA)** security prices or other public market quotations for long-term mortgage loan rates
   (4) **Federal Home Loan Mortgage Corporation (FHLMC)** and **Federal National Mortgage Association (FNMA)** current delivery prices.
c. *Uncommitted Mortgage-Backed Securities*. [FAS65, ¶9] Fair value [FAS115, ¶128(g)] for uncommitted mortgage-backed securities that are collateralized by a mortgage banking enterprise's own loans ordinarily shall be based on the market value of the securities. If the trust holding the loans may be readily terminated and the loans sold directly, [FAS65, ¶9] fair value [FAS115, ¶128(g)] for the securities shall be based on the market value of the loans or the securities, depending on the mortgage banking enterprise's sales intent. [FAS65, ¶9] Fair value [FAS115, ¶128(g)] for other uncommitted mortgage-backed securities shall be based on published mortgage-backed securities yields. [FAS65, ¶9]

.111 Capitalized costs of acquiring rights to service mortgage loans, associated with the purchase [FAS65, ¶10] or origination of [FAS122, ¶3(b)] mortgage loans (refer to paragraphs .117 through .120), shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or market value. [FAS65, ¶10]

Servicing Fees

.112 If mortgage loans are sold with servicing retained and the stated servicing fee rate differs materially from a **current (normal) servicing fee rate**, the sales price shall be adjusted, for purposes of determining gain or loss on the sale, to provide for the recognition of a normal servicing fee in each subsequent year. [(Refer to paragraphs .501 through .507 for further guidance on determining a normal servicing fee rate.)] The amount of the adjustment shall be the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been specified. [3] The adjustment and any gain or loss to be recognized shall be determined as of the date the mortgage loans are sold. In addition, if normal servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans shall be accrued at that date. [FAS65, ¶11]

Transactions with an Affiliated Enterprise [4]

.113 The carrying amount of mortgage loans to be sold to an **affiliated enterprise** shall be adjusted to the lower of cost or market value of the loans as of the date management decides that a sale to an affiliated enterprise will occur. The date shall be determined based on, at a minimum, formal approval by an authorized representative of the purchaser, issuance of a commitment to purchase the loans, and acceptance of the commitment by the selling enterprise. The amount of any adjustment shall be charged to income. [FAS65, ¶12]

.114 If a particular class of mortgage loans or all loans are originated exclusively for an affiliated enterprise, the originator is acting as an agent of the affiliated enterprise, and the loan transfers shall be accounted for at the originator's acquisition cost. Such an agency relationship, however, would not exist in the case of "right of first refusal" contracts or similar types of agreements or commitments if the originator retains all the risks associated with ownership of the loans. [FAS65, ¶13]

.115 [Deleted 12/86 because of the issuance of FASB Statement 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.]

Costs of Issuing Certain GNMA Securities

.116 One month's interest cost, which is required to be paid to a trustee by issuers of GNMA securities electing the **internal reserve method**, shall be capitalized and amortized. The aggregate amount capitalized, including amounts capitalized under other provisions of this section, shall not exceed the present value of net future servicing income [FAS65, ¶15] (refer to paragraph .120). The rate used to determine the present value shall be an appropriate long-term interest rate. [FAS122, ¶3(c)]

Mortgage Servicing Rights

.117 A mortgage banking enterprise may purchase mortgage servicing rights separately or it may acquire mortgage servicing rights by purchasing or originating mortgage loans and selling or securitizing those loans with servicing rights retained. When a mortgage banking enterprise purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related mortgage servicing rights. If the mortgage banking enterprise sells or securitizes the loans and retains the mortgage servicing rights, the enterprise shall allocate the total cost of the mortgage loans (the recorded investment in the mortgage loans including net deferred loan fees or costs and any purchase premium or discount) to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values (refer to paragraph .119) as follows:

a. A mortgage banking enterprise that purchases or originates mortgage loans with a definitive plan to sell or securitize those loans and retain the mortgage servicing rights shall allocate the cost of the mortgage loans based on the relative fair values at the date of purchase or origination. [4a] The allocation shall be based on the assumption that a normal servicing fee will be received and that the rights to the remaining cash flows from the underlying mortgage loans will be sold or securitized. A definitive plan exists if (1) the mortgage banking enterprise has obtained, before the purchase or origination date, commitments from permanent investors to purchase the mortgage loans or related mortgage-backed securities, makes a commitment within a reasonable period (usually not more than 30 days after the purchase or origination date) to sell the mortgage loans or related mortgage-backed securities to a permanent investor or underwriter, or has made, before the purchase or origination date, commitments to deliver the mortgage loans for securitization and (2) estimates of the selling price have been made.
b. A mortgage banking enterprise that does not have a definitive plan at the purchase or origination date and later sells or securitizes the mortgage loans and retains the mortgage servicing rights shall allocate the amortized cost of the mortgage loans as described in paragraph .117(a) based on the relative fair values at the date of sale or securitization.

If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the entire cost of purchasing or originating the mortgage loans shall be allocated to the mortgage loans (without the mortgage servicing rights) and no cost shall be allocated to the mortgage servicing rights. [FAS122, ¶3(d)]

Impairment of Mortgage Servicing Rights

.118 For the purpose of evaluating and measuring impairment of capitalized mortgage servicing rights, a mortgage banking enterprise shall stratify those rights based on one or more of the predominant risk characteristics of the underlying loans. Those characteristics may include loan type, [5] size, note rate, date of origination, term, and geographic location. [FAS122, ¶3(e)] However, a mortgage banking enterprise may continue to apply its previous accounting policies for stratifying mortgage servicing rights to those mortgage servicing rights that were capitalized prior to fiscal years beginning after December 15, 1995. [5a] [FAS122, ¶6]

.118A Impairment shall be recognized through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the capitalized mortgage servicing rights for a stratum exceed their fair value (refer to paragraph 119). The fair value of mortgage servicing rights that have not been capitalized shall not be used in the evaluation of impairment. [FAS122, ¶3(e)]

.118B Subsequent to the initial measurement of impairment, the mortgage banking enterprise shall adjust the valuation allowance to reflect changes in the measurement of impairment. Fair value in excess of the amount capitalized as mortgage servicing rights (net of amortization), however, shall not be recognized. This section does not address when a mortgage banking enterprise should record a direct write-down of capitalized mortgage servicing rights. [FAS122, ¶3(e)]

.119 The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring mortgage servicing rights should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates. [FAS122, ¶3(f)]

Amortization of Capitalized Mortgage Servicing Rights

.120 The amount capitalized as the right to service mortgage loans [FAS65, ¶19] (net of any valuation allowances) [FAS122, ¶3(g)] and the amount capitalized by certain issuers of GNMA securities (refer to paragraph .116) shall be amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing costs). [FAS65, ¶19] For this purpose, estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental cost basis. [FAS122,

¶3(g)] [(Refer to paragraphs .508 and .509 for guidance on accounting for the capitalized cost of a purchased servicing right when mortgage loans are refinanced.)]

Loan and Commitment Fees

.121 Mortgage banking enterprises may receive or pay nonrefundable loan and commitment fees representing compensation for a variety of services. Those fees may include components representing, for example, an adjustment of the interest yield on the loan, a fee for designating funds for the borrower, or an offset of loan origination costs. Loan and commitment fees shall be accounted for as set forth in paragraphs .122 through .128. [FAS65, ¶20]

Loan Origination Fees and Costs

.122 If the loan is held for resale, loan origination fees and the direct loan origination costs as specified in Section L20 shall be deferred until the related loan is sold. If the loan is held for investment, such fees and costs shall be deferred and recognized as an adjustment of yield as specified in paragraphs .117 through .119 of Section L20. [FAS91, ¶27(c)]

Fees for Services Rendered

.123 Fees representing reimbursement for the costs of specific services performed by third parties with respect to originating a loan, such as appraisal fees, shall be recognized as revenue when the services have been performed. [FAS65, ¶22]

Fees Relating to Loans Held for Sale

.124 Fees received for guaranteeing the funding of mortgage loans to borrowers, builders, or developers shall be accounted for as prescribed in paragraph .107 of Section L20. Fees paid to permanent investors to ensure the ultimate sale of the loans (residential or commercial loan commitment fees) shall be recognized as expense when the loans are sold to permanent investors or when it becomes evident the commitment will not be used. [FAS91, ¶27(d)] Because residential loan commitment fees ordinarily relate to blocks of loans, fees recognized as revenue or expense as the result of individual loan transactions shall be based on the ratio of the individual loan amount to the total commitment amount. [FAS65, ¶23]

.125 Fees for arranging a commitment directly between a permanent investor and a borrower (loan placement fees) shall be recognized as revenue when all significant services have been performed. In addition, if a mortgage banking enterprise obtains a commitment from a permanent investor before or at the time a related commitment is made to a borrower and if the commitment to the borrower will require (a) simultaneous assignment of the commitment to the investor and (b) simultaneous transfer to the borrower of the amount received from the investor, the related fees also shall be accounted for as loan placement fees. [FAS65, ¶24]

Fees and Costs Relating to Loans Not Held for Sale

.126 Fees and costs associated with originating or acquiring or committing to originate or acquire loans for investment shall be accounted for as prescribed in Section L20. [FAS91, ¶27(e)]

.127 [Deleted 12/86 because of the issuance of Statement 91.]

Expired Commitments and Prepayments of Loans

.128 If a loan commitment expires without the loan being made or if a loan is repaid before the estimated repayment date, any related unrecognized fees shall be recognized as revenue or expense at that time. [FAS65, ¶27]

Balance Sheet Classification

.129 Mortgage banking enterprises using either a classified or unclassified balance sheet shall distinguish between (a) mortgage loans held for sale and (b) mortgage loans held for long-term investment. [FAS65, ¶28]

Disclosures

.130 The method used in determining the lower of cost or market value of mortgage loans (that is, aggregate or individual loan basis) shall be disclosed. [FAS65, ¶29]

.131 The amount capitalized during the period in connection with [FAS65, ¶30] purchasing or originating [FAS122, ¶3(h)] the right to service mortgage loans (refer to paragraph .117), the method of amortizing the capitalized amount, and the amount of amortization for the period shall be disclosed. [FAS65, ¶30]

.132 The fair value of capitalized mortgage servicing rights and the methods and significant assumptions used to estimate that fair value shall be disclosed. If no cost is allocated to certain mortgage servicing rights in accordance with the last sentence of paragraph .117 of this section, the mortgage banking enterprise shall describe those mortgage servicing rights and shall disclose the reasons why it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights). [FAS122, ¶3(i)]

.133 The risk characteristics of the underlying loans used to stratify capitalized mortgage servicing rights for purposes of measuring impairment shall be disclosed. [FAS122, ¶3(i)]

.134 For each period for which results of operations are presented, the activity in the valuation allowances for capitalized mortgage servicing rights, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances shall be disclosed. [FAS122, ¶3(i)]

Glossary

.401 **Affiliated enterprise.** An enterprise that directly or indirectly controls, is controlled by, or is under common control with another enterprise; also, a party with which the enterprise may deal if one party has the ability to exercise significant influence over the other's operating and financial policies as discussed in Section I82, paragraph .104. [FAS65, ¶34]

.402 **Current (normal) servicing fee rate.** A servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans. [FAS65, ¶34]

.403 **Federal Home Loan Mortgage Corporation (FHLMC).** Often referred to as "Freddie Mac," FHLMC is a private corporation authorized by Congress to assist in the development and maintenance of a secondary market in conventional residential mortgages. FHLMC purchases mortgage loans and sells mortgages principally through mortgage participation certificates (PCs) representing an undivided interest in a group of conventional mortgages. FHLMC guarantees the timely payment of interest and the collection of principal on the PCs. [FAS65, ¶34]

.404 **Federal National Mortgage Association (FNMA).** Often referred to as "Fannie Mae," FNMA is an investor-owned corporation established by Congress to support the secondary mortgage loan market by purchasing mortgage loans when other investor funds are limited and selling mortgage loans when other investor funds are available. [FAS65, ¶34]

.405 [Editorial deletion, 12/86.]

.406 **Government National Mortgage Association (GNMA).** Often referred to as "Ginnie Mae," GNMA is a U.S. governmental agency that guarantees certain types of securities (mortgage-backed securities) and provides funds for and administers certain types of low-income housing assistance programs. [FAS65, ¶34]

.407 **Internal reserve method.** A method for making payments to investors for collections of principal and interest on mortgage loans by issuers of GNMA securities. An issuer electing the internal reserve method is required to deposit in a custodial account an amount equal to one month's interest on the mortgage loans that collateralize the GNMA security issued. [FAS65, ¶34]

.408 **Mortgage-backed securities.** Securities issued by a governmental agency or corporation (for example, GNMA or FHLMC) or by private issuers (for example, FNMA, banks, and mortgage banking enterprises). Mortgage-backed securities generally are referred to as *mortgage participation certificates* or *pass-through certificates* (PCs). A PC represents an undivided interest in a pool of specific mortgage loans. Periodic payments on GNMA PCs are backed by the U.S. government. Periodic payments on FHLMC and FNMA PCs are guaranteed by those corporations, but are not backed by the U.S. government. [FAS65, ¶34]

.409 **Mortgage banking enterprise.** An enterprise that is engaged primarily in originating, marketing, and servicing real estate mortgage loans for other than its own account. Mortgage banking enterprises, as local representatives of institutional lenders, act as correspondents between lenders and borrowers. [FAS65, ¶34]

.410 **Permanent investor.** An enterprise that invests in mortgage loans for its own account, for example, an insurance enterprise, commercial or mutual savings bank, savings and loan association, pension plan, real estate investment trust, or FNMA. [FAS65, ¶34]

.411 **Servicing.** Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, and paying taxes and insurance from escrow funds when due. [FAS65, ¶34]

.412 [Editorial deletion, 12/86.]

Supplemental Guidance

Application of the Definition of a Normal Servicing Fee Rate

.501 *Question*—Federally sponsored secondary market makers for mortgage loans, such as the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA), set minimum servicing fee rates for transactions with them. For purposes of determining gain or loss on mortgage loans sold to those agencies with servicing retained, should mortgage servicers consider the servicing fee rates set by such agencies for transactions with them to be a *normal servicing fee rate* as that term is used in this section? [FTB87-3, ¶1]

.502 *Background*—Enterprises that conduct mortgage banking activities buy or originate mortgage loans and may sell the loans but retain the right to service them (collect mortgage and escrow payments, maintain loan payment records, and so forth) in return for a fee. Those who make a market for loans establish minimum servicing fee rates that will be paid to the servicer from the underlying loans' cash flows. The fee is generally expressed as a percentage of the outstanding loan balance. Several alternatives are available to the seller-servicer on how the loans are packaged and to whom they are sold. The seller-servicer may (a) sell the whole loans to the federally sponsored secondary market makers or exchange the loans for pass-through certificates collateralized by such loans or (b) sell the whole loans to private-sector investors, including private secondary market makers, thrifts, pension funds, and insurance companies. Alternatively, the seller-servicer may sell participations in pools of loans either through brokers or directly to investors. [FTB87-3, ¶2]

.503 *Response*—Yes. The servicing fee rates set by GNMA, FHLMC, and FNMA in servicing agreements should be considered a normal servicing fee rate for a transaction with those agencies. This section defines a *normal servicing fee rate* as a servicing fee rate that is representative of servicing fee rates *most* commonly used in comparable servicing agreements covering similar types of mortgage loans. The fact that federally sponsored secondary market makers specify minimum servicing fee rates for transactions with them indicates that the normal servicing fee rate for those transactions should be no less than those agencies' minimum servicing fee rates. In addition, if normal servicing fees are expected to be less than the estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans should be accrued as of the date the mortgage loans are sold. [FTB87-3, ¶3]

.504 *Question*—If a seller-servicer sells mortgage loans directly to private-sector investors and retains the servicing of those loans, what rate should the seller-servicer use as the servicing fee rate? [FTB87-3, ¶4]

.505 *Response*—As stated in paragraph .503, this section defines a normal servicing fee rate as a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans. Implicit in the phrase *most commonly used in comparable servicing agreements* is the requirement to consider servicing fee rates that are customary in the secondary market. Consequently, the seller-servicer should consider the normal servicing fee rate that would have been specified in comparable servicing agreements if the loans had been sold to or securitized by one of the federally sponsored secondary market makers. [FTB87-3, ¶5]

.506 The seller-servicer should first select the federally sponsored secondary market maker whose servicing terms are most comparable to those specified in the servicing agreement. The seller-servicer should then select the rate used by that federally sponsored agency for loans similar to those sold under the servicing agreement. If the seller-servicer determines that the selected federally sponsored agency does not make a secondary market for the type of loans sold, the seller-servicer should use a similar process to select the predominant rate used by major private-sector secondary market makers as the normal servicing fee rate for similar loans. [FTB87-3, ¶6]

.507 If the stated servicing fee rate is not considered a normal servicing fee rate, the seller-servicer should adjust the sales price of the loans for purposes of determining gain or loss on the sale, to provide for the recognition of a normal servicing fee in each subsequent year. The amount of the adjustment should be the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been specified. The adjustment and any gain or loss to be recognized should be determined as of the date the mortgage loans are sold. In addition, if normal servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans should be accrued at that date. [FTB87-3, ¶7]

Accounting for the Capitalized Cost of a Purchased Servicing Right When Mortgage Loans Are Refinanced

.508 *Question*—When an enterprise that is servicing mortgage loans refinances a loan that is being serviced (resulting in prepayment of the old loan and origination of a new loan), should the enterprise consider the estimated future net servicing income (that is, servicing revenue in excess of servicing costs) from the new loan in determining how to amortize any capitalized cost related to acquiring the mortgage servicing right for the old loan? [FTB87-3, ¶8]

.509 *Response*—No. The mortgage servicing right represents a contractual relationship between the servicer and the investor in the loan, not between the servicer and the borrower. The cost of the mortgage servicing right may require adjustment as a result of the refinancing transaction depending on the servicer's assumptions in recording the servicing asset. If the refinancing transaction represents prepayment activity anticipated by the servicer when the servicing asset was recorded, an adjustment would not be necessary. However, if actual prepayments differ from anticipated prepayments, an adjustment to the servicing asset would be required. [FTB87-3, ¶10]

Footnotes

FAS122, Appendix B, Footnote 1--The interest method shall be applied as set forth in paragraphs .117 and .118 of Section L20. [FAS91, ¶27(b)]

FAS122, Appendix B, Footnote 2--A mortgage loan shall be considered uncommitted for purposes of determining market value if the loan does not meet the specific terms of a commitment or if a reasonable doubt exists about the acceptance of the loan under a commitment. [FAS65, ¶9, fn3]

FAS122, Appendix B, Footnote 3--The adjustment ordinarily will approximate the present value, based on an appropriate interest rate, of the difference between normal and stated servicing fees over the estimated life of the mortgage loans. [FAS65, ¶11, fn4]

FAS122, Appendix B, Footnote 4--Paragraphs .113 and .114 apply to only the separate financial statements of a mortgage banking enterprise. The provisions of Section R36, "Related Parties," paragraphs .101 through .104, also apply to the separate financial statements of a mortgage banking enterprise. The provisions of Section C51, "Consolidations," paragraphs .101 through .103, .107 through .117, and .119 through .123, and Section I82, "Investments: Equity Method," apply when a mortgage banking enterprise is either consolidated or accounted for by the equity method. [FAS65, ¶12, fn5]

FAS122, Appendix B, Footnote 4a--In the absence of a definitive plan for the sale or securitization of the related mortgage loans, the cost of purchasing or originating the right to service mortgage loans is included as part of the cost of the loans for purposes of determining the lower of cost or market value. [FAS122, ¶3(d)]

FAS122, Appendix B, Footnote 5--Loan type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans. [FAS122, ¶3(e)]

FAS122, Appendix B, Footnote 5a--[Those fiscal years are before the required effective date of paragraphs .117 through .119. If a mortgage banking enterprise adopts the provisions in those paragraphs earlier than the required effective date (the fiscal year beginning after December 15, 1995), that enterprise may continue to apply its previous accounting policies for stratifying mortgage servicing rights only to those mortgage servicing rights capitalized prior to adoption of the provisions in those paragraphs.]