Statement of Financial Accounting Standards No. 134

FAS134 Status Page

Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise

October 1998

Financial Accounting Standards Board
of the Financial Accounting Foundation
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an amendment of FASB Statement No. 65

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INTRODUCTION

1. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* establishes accounting and reporting standards for certain activities of mortgage banking enterprises and other enterprises that conduct operations that are substantially similar to the primary operations of a mortgage banking enterprise.

2. Statement 65, as amended by FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* requires that after the securitization of a mortgage loan held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed security as a trading security. This Statement further amends Statement 65 to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. This Statement conforms the subsequent accounting for securities retained after the securitization of mortgage loans by a mortgage banking enterprise with the subsequent accounting for securities retained after the securitization of other types of assets by a nonmortgage banking enterprise.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to Statement 65

3. The second sentence of paragraph 6 of Statement 65, which was added by Statement 115 and amended by Statement 125, is deleted. The following is added to the end of paragraph 6:

> After the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of Statement 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process.

4. The fifth sentence of paragraph 4 of Statement 65, as amended by Statement 115, FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations,* and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* is deleted.

Amendment to Statement 115

5. The third and fourth sentences of paragraph 12(a) of Statement 115 are deleted.

Effective Date and Transition

6. This Statement shall be effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged and is permitted as of the issuance of this Statement. On the date this Statement is initially applied, an enterprise may reclassify mortgage-backed securities and other beneficial interests retained after the securitization of mortgage loans held for sale from the trading category, except for those with sales commitments in place. [1] Those securities and other interests shall be classified based on the entity's ability and intent, on the date this Statement is initially applied, to hold those investments. Transfers from the trading category that result from implementing this Statement shall be accounted for in accordance with paragraph 15(a) of Statement 115.

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:

Edmund L. Jenkins, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
Gaylen N. Larson
James J. Leisenring
Gerhard G. Mueller

Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Background Information

7. Prior to its amendment by Statements 115 and 125, Statement 65 required that mortgage loans and mortgage-backed securities be classified as either held for sale or long-term investments. Mortgage loans and mortgage-backed securities held for sale were reported at the lower of cost or market value. Statement 65 permitted an enterprise to transfer loans or mortgage-backed securities from a held-for-sale to a long-term investment category if the enterprise had both the ability and the intent to hold those loans or securities for the foreseeable future or until maturity.

8. Statement 115 did not allow for debt or marketable equity securities to be measured at the lower of cost or market and amended Statement 65 to require that "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" (paragraph 128(c)). Statement 125 amended Statement 115 and required that "after the securitization of a mortgage loan held for sale, the mortgage-backed security shall be classified as a trading security" (paragraph 237(a)). As a result, Statement 65, as amended, required that an enterprise engaged in mortgage banking activities classify all mortgage-backed securities retained after the securitization of mortgage loans held for sale as trading under Statement 115, regardless of whether the enterprise intended to sell those securities or hold them as long-term investments. Therefore, all unrealized gains or losses on those securities were recognized currently in earnings.

Decision to Amend Statement 65

9. In March 1997, the Mortgage Bankers Association of America (MBAA) asked the Board to reconsider the accounting for securities retained after the securitization of mortgage loans held for sale. The MBAA explained that an enterprise engaged in mortgage banking activities was required to classify those securities exclusively as trading. The MBAA observed that a nonmortgage banking enterprise engaged in the securitization of other types of assets was able to classify the retained securities as trading, available-for-sale, or held-to-maturity under Statement 115.

10. The Board believes that the fair value of financial assets and liabilities provides more relevant and understandable information than cost or cost-based measures and has a project on its agenda to consider measuring all financial instruments at fair value. The Board, therefore,

considered rejecting the MBAA's request to amend Statement 65 and, instead, addressing the issues as part of its fair value project. However, because the requirements for entities engaged in mortgage banking activities were more stringent than for other entities and it is expected to be several years before a standard addressing the fair value of all financial instruments is effective, the Board decided to address the concerns of the MBAA through an amendment of Statement 65. The Board decided that Statement 65 should be amended to require that an enterprise engaged in mortgage banking activities classify mortgage-backed securities retained after the securitization of mortgage loans held for sale based on its ability and intent to sell or hold those investments. The Board based its decision on several factors, including the concerns of the MBAA.

11. First, an enterprise engaged in mortgage banking activities frequently does not plan to sell all securities or other retained interests resulting from the securitization of mortgage loans held for sale. The enterprise may retain some of those beneficial interests as long-term investments because they are illiquid and difficult to sell. Those beneficial interests also may be retained because the enterprise decides, for a variety of reasons, to maintain a financial interest in the mortgage loans that it originates.

12. Second, some enterprises do not engage in mortgage banking but their activities are similar to those of a mortgage banking enterprise. Because the receivables they originate, transfer, and service are not *mortgages,* their activities are not within the scope of Statement 65. Those enterprises, unlike mortgage banking enterprises, are not required to classify securities retained after the securitization of their receivables as trading. They may, instead, choose to classify their retained securities as available-for-sale and, in some cases, held-to-maturity under Statement 115. The Board considered requiring that those enterprises classify securities retained after securitizing nonmortgage receivables as trading. While that approach would result in greater consistency among enterprises engaged in similar activities, it would require that the scope of this project be expanded significantly. The Board decided against that approach and chose, instead, to amend Statement 65. This approach provides a "level playing field" among enterprises engaged in similar activities while addressing only mortgage banking activities at this time.

13. Third, allowing an enterprise to classify retained securities based on its ability and intent to sell or hold those investments is consistent with the approach in Statement 115. While Statement 115 restricts the ability to classify debt securities as held-to-maturity, it permits an enterprise to choose the appropriate classification based on the enterprise's ability and intent to sell or hold the securities. This Statement allows an enterprise engaged in mortgage banking activities an opportunity to choose the appropriate classification for its retained securities, rather than requiring a trading classification in all cases.

14. In April 1998, the Board issued an Exposure Draft, *Accounting for Mortgage-Backed Securities and Certain Other Interests Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise,* for a 45-day comment period. Twenty-five organizations and individuals responded to the Exposure Draft. In August 1998, the Board

discussed the issues raised in the comment letters in a public Board meeting. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

The Approach in This Statement

15. The Exposure Draft proposed that an enterprise decide whether securities and other beneficial interests that are retained after the securitization of mortgage loans held for sale would, themselves, be held for sale to determine their proper classification. Retained securities that the enterprise holds for sale would have been classified in the trading category, with changes in their fair value recognized currently in earnings. Other retained nonsecurity beneficial interests that the enterprise holds for sale would have been accounted for like securities and also classified as trading. The Board reasoned that a mortgage banking enterprise should use the same criteria to identify retained securities intended to be sold as it uses to identify loans intended to be sold. That approach would primarily ensure that losses on retained securities and other beneficial interests intended to be sold would be recognized currently in earnings.

Accounting for Retained Securities

16. Many respondents commented that the approach in the Exposure Draft was complex and did not completely level the playing field between a mortgage banking enterprise and a nonmortgage banking enterprise engaged in securitization activities. Those respondents indicated that the accounting for securities retained after the securitization of mortgage loans should be the same as the accounting for securities retained after the securitization of other types of assets. The Board agreed with those respondents and decided to require that retained securities be accounted for in accordance with Statement 115.

17. The Board was concerned that because the term *trading* is not defined precisely in Statement 115, a mortgage banking enterprise could avoid a trading classification for retained securities it had committed to sell. That might occur because the settlement periods for the retained securities of a mortgage banking enterprise may be longer than the typical settlement periods for other types of securities classified as trading in paragraph 12(a) of Statement 115. The Board decided to require a trading classification for any retained securities that a mortgage banking enterprise commits to sell before or during the securitization process.

Accounting for Other Beneficial Interests

18. Statement 115's amendment of Statement 65 addressed only the accounting for *securities* that are retained as beneficial interests. The Exposure Draft proposed that retained nonsecurity interests that are held for sale also be classified as trading. Several respondents to the Exposure Draft observed that paragraph 4 of Statement 65 provides applicable guidance for those other beneficial interests and that other enterprises that securitize loans are not required to classify nonsecurity interests as trading. Because the objective of this project was to conform, as nearly as possible, the accounting for all securitizations of loans, the Board agreed and deleted that

requirement. This Statement also does not address the accounting for other beneficial interests that are not held for sale. The Board observes that paragraph 6 of Statement 65 provides applicable guidance. Some of those other retained beneficial interests, however, are subject to the provisions of paragraph 14 of Statement 125 and, therefore, must be measured like investments in debt securities classified as available-for-sale or trading under Statement 115.

Classifying Retained Securities as Held-to-Maturity

19. The Board considered restricting the potential categories to trading or available-for-sale for retained securities but decided that that restriction was unjustified. Some observed that permitting an enterprise engaged in mortgage banking activities to classify retained securities as held-to-maturity was undesirable and incompatible with the Board's project to consider measuring all financial instruments at fair value. However, others observed that nonmortgage banking enterprises may choose to classify debt securities as held-to-maturity if all of the necessary provisions of Statement 115 are met. The Board decided that it is beyond the scope of this Statement to reconsider whether Statement 115 should continue to permit historical cost accounting for some securities. Therefore, the Board decided to permit an enterprise engaged in mortgage banking activities to apply the same intent-based accounting that is applied by other enterprises. Therefore, any sales or transfers of retained securities that are classified as held-to-maturity for reasons other than those in paragraphs 8 and 11 of Statement 115 would call into question an enterprise’s ability and intent to hold other debt securities to maturity in the future.

20. The Board expects that many mortgage-backed securities retained after the securitization of mortgage loans held for sale would not be classified as held-to-maturity under Statement 115, as amended by Statement 125. Specifically, the Board notes that paragraph 7 of Statement 115 was amended by Statement 125 to require that "a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment." Likewise, paragraph 14 of Statement 125 requires that "interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement” (references omitted). However, retained beneficial interests that meet the definition of a derivative or that contain embedded derivative instruments must be accounted for in accordance with Statement 133 upon its adoption. Paragraph 14 of Statement 133 provides an exception for certain interest-only and principal-only strips.

Transition

21. The Board decided to permit an enterprise a one-time opportunity to reclassify mortgage-backed securities and other beneficial interests from the trading category, without

regard to the restriction in paragraph 15 of Statement 115. That opportunity is available only on the date that this Statement is initially applied. Transfers from the trading category that result from implementing this Statement should be accounted for in accordance with paragraph 15(a) of Statement 115, that is, the unrealized gain or loss at the date of transfer will have already been recognized in earnings and should not be reversed. While this Statement does not address the accounting for other retained beneficial interests, some mortgage banking enterprises may have classified all of the interests that were measured like securities in accordance with paragraph 14 of Statement 125 as trading. Accordingly, some of those other retained beneficial interests may be eligible for transfer into the available-for-sale category when implementing this Statement. An enterprise engaged in mortgage banking activities often holds other securities unrelated to those retained after the securitization of mortgage loans previously held for sale by that enterprise. Statement 65 did *not* require that those securities be classified as trading, and they should already be classified in one of the three categories required by Statement 115. Therefore, the transition provisions of this Statement do *not* apply to those investments.

Footnotes

FAS134, Footnote 1–Mortgage-backed securities and other beneficial interests may be reclassified from the trading category when initially applying this Statement without regard for the provisions in paragraph 15 of Statement 115, which states that "given the nature of a trading security, transfers into or from the trading category . . . should be rare."