Statement of Financial Accounting Standards No. 65

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FAS65 Summary

Accounting for Certain Mortgage Banking Activities

September 1982

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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FAS 65: Accounting for Certain Mortgage Banking Activities

FAS 65 Summary

This Statement extracts the specialized accounting and reporting principles and practices from AICPA Statements of Position 74-12, *Accounting Practices in the Mortgage Banking Industry,* and 76-2, *Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry,* and establishes accounting and reporting standards for certain mortgage banking activities.

Mortgage loans and mortgage-backed securities held for sale are reported at the lower of cost or market value. Origination costs associated with loan applications received directly from borrowers are expensed as period costs. The premium paid for the right to service loans in a purchase of mortgage loans ordinarily is capitalized as the cost of acquiring that right.

This Statement also establishes accounting and reporting standards for several different types of loan and commitment fees. Loan origination fees, to the extent they represent reimbursement of loan origination costs, are recognized as revenue when the loan is made. Loan commitment fees ordinarily are recognized as revenue or expense when the loans are sold to permanent investors. Fees for services performed by third parties and loan placement fees are recognized as revenue when all significant services have been performed. Land acquisition, development, and construction loan fees and standby and gap commitment fees are recognized as revenue over the combined commitment and loan periods.

INTRODUCTION

1. Mortgage banking activities primarily consist of two separate but interrelated activities: (a) the origination or acquisition of mortgage loans and the sale of the loans to **permanent investors** [1] 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.

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2. 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.

APPLICABILITY AND SCOPE

3. This Statement establishes 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 Statement also applies to those operations. This Statement does not apply, however, to the normal lending activities of those other enterprises.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Mortgage Loans and Mortgage-Backed Securities

4. Mortgage loans and **mortgage-backed securities** 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.

5. Purchase discounts on mortgage loans and mortgage-backed securities shall not be amortized as interest revenue during the period the loans or securities are held for sale.

6. A mortgage loan or mortgage-backed security transferred to a long-term-investment classification shall be transferred at the lower of cost or market value on the transfer date. Any difference between the carrying amount of the loan or security and its outstanding principal balance shall be amortized to income over the estimated life of the loan or security using the interest method.[2] A mortgage loan or mortgage-backed security 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 or security for the foreseeable future or until maturity.

7. If ultimate recovery of the carrying amount of a mortgage loan or mortgage-backed security held as a long-term investment is doubtful and the impairment is considered to be other

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than temporary, the carrying amount of the loan or security 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 or security.

8. 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 as being held for sale.

9. 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) [3] shall be determined separately as follows:

a. *Committed Loans and Mortgage-Backed Securities.* Market value for mortgage loans and mortgage-backed securities 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 11.
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

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(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.* Market value 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, market value 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. Market value for other uncommitted mortgage-backed securities shall be based on published mortgage-backed securities yields.

10. Capitalized costs of acquiring rights to service mortgage loans, associated with the purchase of existing mortgage loans (paragraphs 16 through 19), shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or market value.

Servicing Fees

11. 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. 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.[4] 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.

Transactions with an Affiliated Enterprise [5]

12. The carrying amount of mortgage loans or mortgage-backed securities to be sold to an **affiliated enterprise** shall be adjusted to the lower of cost or market value of the loans or securities 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 or securities, and acceptance of the commitment by the selling enterprise. The amount of any adjustment shall be charged to income.

13. 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

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agreements or commitments if the originator retains all the risks associated with ownership of the loans.

In-House Origination Costs

14. Costs associated with loan applications received directly from borrowers (in-house originations) shall be expensed as period costs. Those costs include (a) direct costs, such as personnel, financing, and marketing costs, and (b) general and administrative costs, such as occupancy and equipment rental costs.

Costs of Issuing Certain GNMA Securities

15. 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 Statement, shall not exceed the present value of net future servicing income (paragraph 18).

Servicing Rights

16. The right to service mortgage loans for other than an enterprise's own account is an intangible asset that may be acquired separately, in a purchase of mortgage loans, or in a business combination. Subject to the limitations specified in paragraphs 17 and 18, the cost of acquiring that right from others shall be capitalized and amortized in accordance with the requirements of paragraph 19.

17. A mortgage banking enterprise acquiring the right to service loans in a purchase of mortgage loans shall capitalize the portion of the purchase price representing the cost of acquiring that right if a definitive plan for the sale of the mortgage loans exists when the transaction is initiated.[6] A definitive plan exists if (a) the mortgage banking enterprise has obtained, before the purchase date, commitments from permanent investors to purchase the mortgage loans or related mortgage-backed securities, or makes a commitment within a reasonable period (usually not more than 30 days after the purchase date) to sell the mortgage loans or related mortgage-backed securities to a permanent investor or underwriter, and (b) the plan includes estimates of the purchase price and selling price. The amount capitalized shall not exceed (1) the purchase price of the loans, including any transfer fees paid, in excess of the market value of the loans without servicing rights at the purchase date or (2) the present value of net future servicing income, determined in accordance with paragraph 18. The amount capitalized shall be reduced by any amount that the final sales price to the permanent investor exceeds the market value of the loans at the purchase date. All other costs, such as salaries and general and administrative expenses, shall be expensed as period costs.

18. The amount capitalized as the right to service mortgage loans shall not exceed the amount by which the present value of estimated future servicing revenue exceeds the present value of

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expected future servicing costs. 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. The rate used to determine the present value shall be an appropriate long-term interest rate.

19. The amount capitalized as the right to service mortgage loans and the amount capitalized by certain issuers of GNMA securities (paragraph 15) shall be amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing costs).

Loan and Commitment Fees

20. 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 21 through 27.

Loan Origination Fees

21. Fees representing reimbursement of the mortgage banking enterprise's costs of processing mortgage loan applications, reviewing legal title to real estate, and performing other loan origination procedures (loan origination fees) shall be recognized as revenue when the loan is made. If origination costs are not reasonably estimable, a portion of the fees, not to exceed the amount allowable by the Department of Housing and Urban Development and the Veterans Administration, may be recognized as revenue when the loan is made because fees based on those rates generally do not exceed loan origination costs. Any fees in excess of the amount considered to be a reimbursement of loan origination costs shall be recognized as revenue in accordance with paragraphs 23 through 26.

Fees for Services Rendered

22. 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.

Fees Relating to Loans Held for Sale

23. Fees received for guaranteeing the funding of mortgage loans to borrowers, builders, or developers and fees paid to permanent investors to ensure the ultimate sale of the loans (residential or commercial loan commitment fees) shall be recognized as revenue or expense when the loans are sold to permanent investors or when it becomes evident the commitment will not be used. 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.

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24. 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.

Fees Relating to Loans Not Held for Sale

25. Fees for guaranteeing the funding of a mortgage loan to acquire or develop land or to construct residential or income-producing properties shall be recognized as revenue over the combined commitment and loan periods using the best estimate of that period. The straight-line method shall be used during the commitment period to recognize the fee revenue, and the interest method shall be used during the loan period to recognize the remaining fee revenue. If it is not practicable to apply the interest method during the loan period,[7] the straight-line method shall be used. If the original estimate of the combined commitment and loan periods is revised significantly, the remaining commitment fee shall be recognized as revenue over the revised period. Additional fees received as a result of changes in the period shall be recognized as revenue over the revised period.

26. **Standby commitment** and **gap commitment** fees for issuing a commitment to fund a standby or gap loan for purposes such as interim or construction financing shall be recognized as revenue over the combined commitment and loan periods. The straight-line method shall be used during the commitment period to recognize the fee revenue, and the interest method shall be used during the loan period to recognize the remaining fee revenue. If it is not practicable to apply the interest method during the loan period, the straight-line method shall be used. Any additional fees received when the loan is made shall be recognized as revenue over the loan period.

Expired Commitments and Prepayments of Loans

27. 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.

Balance Sheet Classification

28. Mortgage banking enterprises using either a classified or unclassified balance sheet shall distinguish between (a) mortgage loans and mortgage-backed securities held for sale and (b) mortgage loans and mortgage-backed securities held for long-term investment.

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Disclosures

29. The method used in determining the lower of cost or market value of mortgage loans and mortgage-backed securities (that is, aggregate or individual loan basis) shall be disclosed.

30. The amount capitalized during the period in connection with acquiring the right to service mortgage loans (paragraph 16), the method of amortizing the capitalized amount, and the amount of amortization for the period shall be disclosed.

Amendments to Statement 32

31. The references to AICPA Statements of Position (SOPs) 74-12, *Accounting Practices in the Mortgage Banking Industry,* and 76-2, *Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry,* are deleted from Appendix A of FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters.*

Effective Date and Transition

32. The provisions of this Statement, other than those of paragraphs 4 and 28 through 30, shall be applied prospectively to transactions entered into after December 31, 1982, with earlier application encouraged. The provisions of paragraphs 4 and 28 through 30 shall be effective for financial statements for fiscal years beginning after December 15, 1982, with earlier application encouraged. If application of paragraph 4 of this Statement results in a change in accounting, restatement of previously issued annual financial statements to conform to the provisions of that paragraph is encouraged but not required. If it is not practicable or if the issuer of financial statements elects not to restate any prior year, the cumulative effect shall be included in net income in the year in which this Statement is first applied. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes.*) The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a year in which the cumulative effect is included in determining that year's net income shall be disclosed for that year.

33. If previously issued financial statements are restated, the financial statements shall be restated for as many consecutive years as practicable. In the year that this Statement is first applied, the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each restated year presented shall be disclosed. The cumulative effect of applying this Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented).

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

This Statement was approved by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: GLOSSARY

34. This appendix defines certain terms that are used in this Statement.

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 paragraph 17 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.*

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.

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.

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

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loans when other investor funds are limited and selling mortgage loans when other investor funds are available.

Gap commitment

A commitment to provide interim financing while the borrower is in the process of satisfying provisions of a permanent loan agreement, such as obtaining a designated occupancy level on an apartment project. The interim loan ordinarily finances the difference between the floor loan (the portion of a mortgage loan commitment that is less than the full amount of the commitment) and the maximum permanent loan.

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.

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.

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.

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.

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.

Servicing

Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding

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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.

Standby commitment

A commitment to lend money with the understanding that the loan probably will not be made unless permanent financing cannot be obtained from another source. Standby commitments ordinarily are used to enable the borrower to obtain construction financing on the assumption that permanent financing will be available on more favorable terms when construction is completed. Standby commitments normally provide for an interest rate substantially above the market rate in effect when the commitment is issued.

Appendix B: BACKGROUND INFORMATION AND SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

35. As discussed in Statement 32, the FASB is extracting the specialized [8] accounting and reporting principles and practices (specialized principles) from AICPA SOPs and Guides on accounting and auditing matters and issuing them as FASB Statements after appropriate due process. This Statement extracts the specialized principles from SOPs 74-12 and 76-2. Accounting and reporting standards that apply to enterprises in general also apply to mortgage banking enterprises, and the standards in this Statement are in addition to those standards.

36. The Board has not undertaken a comprehensive reconsideration of the specialized principles in SOPs 74-12 and 76-2. Also, most of the background material and discussion of accounting alternatives have not been carried forward from the SOPs. The Board's conceptual framework project on accounting recognition criteria will address recognition issues relating to elements of financial statements. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

37. An Exposure Draft of a proposed FASB Statement, *Accounting for Certain Mortgage Banking Activities,* was issued on February 3, 1982. The Board received 42 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in this appendix.

Applicability and Scope

38. Respondents commented on the appropriateness of this Statement's applying to the mortgage banking operations of other enterprises, such as commercial banks and thrift institutions, when those enterprises conduct operations that are substantially similar to the

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operations of a mortgage banking enterprise. Some respondents said that it would be difficult to define "substantially similar" operations and that the scope of the Statement could result in unintended changes in current accounting principles or practices followed by other enterprises, such as commercial banks and thrift institutions. Those enterprises may engage in some, but generally not all, of the activities of a mortgage banking enterprise. A mortgage banker primarily is engaged in originating, selling, and servicing mortgage loans for other than its own account. However, it also may originate loans for investment purposes and collect related loan fees. Commercial banks and thrift institutions may primarily be engaged in those latter activities and occasionally may sell mortgage loans to others for liquidity or other reasons. Those respondents questioned whether this Statement was intended to apply broadly to all activities discussed in the Statement regardless of the basic nature of the enterprise involved. Other respondents pointed out that commercial banks and thrift institutions originate many types of loans other than mortgage loans and questioned whether the Statement also would apply to activities relating to those loans. Still other respondents said that the scope of the Statement could be viewed as establishing broadly applicable standards with respect to the basis of carrying mortgage loans and to the accounting for servicing rights and loan and commitment fees. They suggested that the scope of the Statement be limited solely to mortgage banking enterprises.

39. In extracting the specialized principles from SOPs 74-12 and 76-2, the Board decided that those principles should apply to mortgage banking operations whether those operations are conducted by a mortgage banking enterprise or by another enterprise. That notion is consistent with the recommendations in SOP 76-2. However, the Board decided not to establish in this project broadly applicable standards for each type of activity in which a mortgage banking enterprise generally is engaged because this project did not include a comprehensive consideration of whether the circumstances in other industries do or do not justify different reporting for those activities. Accordingly, the Board has clarified the scope to indicate that the Statement does not apply to the normal lending activities of those other enterprises.

Sales of Mortgage Loans to an Affiliated Enterprise

40. The "Notice for Recipients" of the Exposure Draft requested respondents to comment on whether the Statement should specify the amount at which sales of loans to an affiliated enterprise are to be reported in the separate financial statements of a mortgage banking enterprise. Of those respondents who commented, a majority recommended that the Statement specify how those sales should be reported. Some respondents noted that separate financial statements of mortgage banking enterprises are common in the mortgage banking industry and that guidance is necessary to ensure continued consistency of reporting among those enterprises. Those respondents pointed out that mortgage banking enterprises generally are required, by terms of their various selling and servicing contracts, to issue separate financial statements. Those financial statements are used for regulatory, credit, and other purposes and may be used by potential purchasers of loans to evaluate the mortgage banking enterprise's ability to perform required services under the servicing agreements.

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41. Other respondents said that transactions with affiliated enterprises are not unique to mortgage banking enterprises and that issues relating to the accounting for transactions with an affiliated enterprise should be addressed in a separate Board project covering all enterprises. They also argued that transactions with an affiliated enterprise should not be addressed in this Statement because they believe that disclosures required by FASB Statement No. 57, *Related Party Disclosures,* provide financial statement users with sufficient information to understand and evaluate the significance of sales of mortgage loans to affiliated enterprises. They suggested that the section on transactions with an affiliated enterprise be deleted.

42. Primarily for the reasons given in paragraph 41, the Board has decided not to specify for mortgage banking enterprises a common basis of measuring transactions with affiliates, except as provided in paragraph 13. However, the Board decided to clarify in paragraph 12 that the carrying amount of mortgage loans or mortgage-backed securities to be sold to an affiliated enterprise must be adjusted to the lower of cost or market value. The Board believes the clarification is consistent with the intent of SOP 74-12. The Board also indicated in a footnote to paragraph 12 that the provisions of Statement 57 apply to the separate financial statements of a mortgage banking enterprise.

Transition

43. The Exposure Draft proposed that accounting changes adopted to conform to the provisions of this Statement be applied retroactively by restating financial statements for as many years as practicable, with the cumulative effect included in income of the earliest year restated. That method of transition was proposed on the premise that it would afford maximum comparability among financial statements. Some respondents disagreed with the proposed transition provisions because they believe the application of certain provisions of the Exposure Draft would be difficult to implement retroactively. In particular, they noted that the Statement specifies different methods of reporting loans and certain fees based on whether an enterprise intends to sell the applicable loans or hold them as investments. Those respondents noted that retroactive restatement may require an enterprise that was not following the provisions of SOPs 74-12 and 76-2 to reconstruct its intent as of the end of several prior reporting periods, a process that would be difficult and time-consuming. They also noted that the provisions of the Statement relating to the acquisition of servicing rights may be difficult to implement retroactively for enterprises that were following the SOPs because, as noted in the "Notice for Recipients" of the Exposure Draft, this Statement changes the reporting of certain acquisitions of servicing rights. They recommended that prospective application be required.

44. The Board considered those views and concluded that prospective application of the transaction-related provisions of this Statement is appropriate. Because the provisions of paragraph 4 relate to the measurement and reporting of mortgage loan and mortgage-backed security portfolios, the Board concluded that those portfolios should be reported by a single method, that is, the lower of cost or market value. The Board also concluded that comparability would be enhanced if enterprises apply the provisions of that paragraph retroactively by restating

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the financial statements of previous periods. Because the benefits of restatement may not justify the cost of restating in some cases, however, the Board decided to permit rather than require retroactive restatement in applying the provisions of paragraph 4.

Other Comments

45. Some respondents noted that the provisions of the Exposure Draft relating to sales of mortgage loans with servicing retained are not followed universally by enterprises in other industries, although those provisions currently are being followed by most mortgage banking enterprises. Paragraph 11 requires that, when mortgage loans are sold with servicing retained, the sales price should be adjusted, for purposes of determining gain or loss on the sale, if the stated servicing fee rate differs materially from normal servicing fee rates. The adjustment is determined by 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. Those respondents said that some financial institutions are recognizing in income the present value of all future servicing income (stated servicing fees in excess of estimated servicing costs) when mortgage loans are sold rather than over the period servicing is performed. The Board believes that the present value of excess servicing fees (the portion that exceeds normal servicing fees) should be recognized as an additional element of the sales price. However, the Board believes that it is inappropriate to recognize, in effect, the present value of all future servicing income as an element of the sales price when loan servicing is a primary revenue-producing activity of an enterprise. Accordingly, this Statement requires that a normal servicing fee be recognized as revenue when the servicing is performed.

46. The Exposure Draft proposed that commitment fees received for issuing floating-rate commitments for certain loans, such as land development and construction loans, should be recognized in income over the commitment period rather than over the combined commitment and loan periods as recommended in SOP 76-2. The provision was included so that the accounting for those fees would more closely parallel the accounting by other financial institutions for similar fees. Some respondents expressed concern about the proposed provision because it was not identical to existing practices of either banks or thrift institutions. Other respondents pointed out that a task force of the AICPA currently is studying issues relating to the accounting for loan origination and commitment fees by all enterprises. They recommended that the current accounting for those fees not be changed until that task force completes its study and the resulting recommendations are sent to the FASB for consideration. Based on those respondents' comments, the Board concluded that the provisions of this Statement relating to fees on loans not held for sale (paragraphs 25 and 26) should be revised to conform more closely to the existing recommendations in SOP 76-2 (that is, commitment fees should be recognized as revenue over the combined commitment and loan periods regardless of whether the commitment is fixed or floating rate).

47. Several respondents suggested that this Statement address the accounting and reporting of certain transactions that are not covered by SOPs 74-12 and 76-2. Those respondents

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recommended that the Board (a) specify the accounting for interest rate futures contracts and forward commitments to purchase or sell mortgage loans and (b) address the issue of whether the issuance of a mortgage-backed security collateralized by the issuer's own loans should be reported as a sale of the mortgage loans or as a borrowing. The Board notes that it currently has other projects in which those and related issues are being considered. For that reason and because the issues are not unique to mortgage banking enterprises, the Board decided not to adopt the suggestions.

48. Several respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required reconsideration of some of the provisions of SOPs 74-12 and 76-2. Those suggestions were not adopted because such a reconsideration is beyond the scope of extracting the specialized principles from the SOPs and because none of the changes was broadly supported. However, based on suggestions from respondents to the Exposure Draft, the Board has made several other changes that it believes clarify the Statement.

49. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraphs 32 and 33 are advisable in the circumstances.

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Footnotes

FAS65, Footnote 1--Terms defined in the glossary (Appendix A) are in **boldface type** the first time they appear in this Statement.

FAS65, Footnote 2--The interest method is discussed in paragraph 15 of APB Opinion No. 21, *Interest on Receivables and Payables,* and paragraphs 16 and 17 of APB Opinion No. 12, *Omnibus Opinion--1967.*

FAS65, Footnote 3--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, Footnote 4--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, Footnote 5--This section on "Transactions with an Affiliated Enterprise" applies to only the separate financial statements of a mortgage banking enterprise. The provisions of FASB Statement No. 57, *Related Party Disclosures,* also apply to the separate financial statements of a mortgage banking enterprise. The provisions of ARB No. 51, *Consolidated Financial Statements,* and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* apply when a mortgage banking enterprise is either consolidated or accounted for by the equity method.

FAS65, Footnote 6— In the absence of a definitive plan for the sale of the related mortgage loans, the cost of acquiring the right to service mortgage loans generally is included as part of the cost of the loans for purposes of determining the lower of cost or market value.

FAS65, Footnote 7--For example, if a construction loan is to be funded over time in proportion to the progress of the construction, the interest method may not be practicable to apply.

FAS65, Appendix B, Footnote 8--The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

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