

*Capital Markets  
Accounting Developments  
Advisory 2005-03*

*February 4, 2005*

**SEC Staff Accounting Bulletin 105, “Application of Accounting Principles To Loan Commitments”**

**Overview**

On March 9, 2004, the Staff of the Securities and Exchange Commission (the “SEC Staff”) issued Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments* (“SAB 105”). SAB 105 provides guidance on the initial recognition and measurement of loan commitments that meet the definition of a derivative, and summarizes the related disclosure requirements.

***SFG Observation:*** *Historically, loan-commitment derivatives were valued and recorded in a variety of ways. SAB 105 requires a single approach for loan commitments that meet the definition of a derivative and thus will impact most mortgage-banking enterprises.*

**Effective Date**

SAB 105 applies to all loan commitments accounted for as derivatives as of April 1, 2004. The SEC Staff will not object if registrants continue to use an accounting treatment that differs from the treatment prescribed by SAB 105 for outstanding commitments outstanding as of March 31, 2004.

***SFG Observation:*** *Due to the short tenor of loan commitments, the new guidance now applies to most loan commitments.*

**Scope**

SAB 105 addresses loan commitments that the Financial Accounting Standards Board (FASB) defines as derivatives in paragraph 6 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“FAS 133”), as amended by FAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*.

Loan commitments that relate to the origination of mortgage loans that will be held for sale, are discussed in paragraph 21 of FAS 65, *Accounting for Mortgage Banking Activities*.

Paragraph 6(c) of FAS 133, as amended by FAS 149, reads (in part):

Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender).

Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

Paragraph 10(i) of FAS 133, as added by FAS 149 reads:

*Loan commitments.* The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement.

Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of Statement 65, are not subject to this Statement.

In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement.

**SFG Observation:** *As a result of these amendments, the issuer of mortgage loan commitments that are held for sale must account for the commitments as derivative contracts. Similarly SAB 105 does not apply to*

*(1) commitments to purchase mortgage loans that do not meet the definition of a derivative under paragraph 6 of FAS 133, or*

*(2) commitments that are explicitly excluded from the scope of FAS 133, as discussed in paragraph 10(i) (i.e., commitments to originate mortgage loans that will be held for investment purposes and loan commitments to originate other types of loans).*

*Loan commitments for mortgage loans that will be held for sale as discussed in FAS 65 relate to both residential and commercial mortgage loans. The scope of SAB 105 is limited to the retail channel or the origination of mortgage loans. Many mortgage bankers enter into commitments to purchase mortgage loans that will be held for sale through a wholesale channel.*

*A wholesale channel typically encompasses one or more of the following elements:*

- *a broker network,*
- *correspondent table-funding arrangements, and*
- *correspondent purchases of closed loans.*

*The broker networks and table-funding arrangements typically result in the mortgage-banking enterprise entering into the commitment directly with the borrower.*

*SAB 105 applies to commitments relating to mortgage loans that will be classified as held for sale and are purchased through broker arrangements and table-funding arrangements. These commitments are within the scope of SAB 105, since the loan commitments are entered into directly with the borrower.*

*A commitment to purchase closed loans from a correspondent does not result in a commitment with a borrower, but rather a commitment to purchase the loan from another lender. These commitments need to be assessed to determine whether they meet the definition of a derivative under paragraph 6 of FAS 133.*

*Most commitments to purchase residential mortgage loans will meet the definition of a derivative. Whether a commitment to purchase a commercial mortgage loan meets that definition is less clear, and will depend on the specific facts and circumstances.*

*The guidance in SAB 105 should be applied, by analogy, to commitments to purchase from a correspondent a closed loan that meets the definition of a derivative.*

### **Key Provisions**

The key provisions of SAB 105 for recognizing and measuring loan-commitment derivatives indicate that the measurement of a loan-commitment derivative's fair value **should exclude** the expected future cash flows related to the associated servicing of the loan. Inclusion of any cash flows related to servicing would result in recognition of a servicing right before it has been contractually separated from the underlying loan.

The guidance states that any internally-developed intangible assets, such as customer relationship intangible assets, **should not be** included in the measurement of the estimated fair value of the loan-commitment derivative.

**SFG Observation:** *SAB 105 applies only to the initial recognition and measurement of loan-commitment derivatives. The SAB does not provide guidance on accounting for changes in a derivative's fair value after initial recognition.*

The fair value of loan-commitment derivatives is typically determined, in part, by considering the value that can be generated when the underlying loan is sold in the secondary mortgage market, such as a securitization or a whole-loan sale.

### **What attributes affect the FV of a loan commitment?**

Typically, the fair value of a loan commitment reflects the following elements:

- The price that the underlying loan can be sold for in the secondary mortgage market -- the securitization security price or the price from a whole-loan sale
- Costs associated with guaranteeing the loan -- guarantee fees relative to agency mortgage-backed securities, such as Fannie Mae mortgage-backed securities or Freddie Mac participation certificates
- Points expected to be collected from the borrower
- The value of the normal servicing fee
- The value of servicing in excess of the normal servicing fee
- Direct fees and costs associated with the origination of the underlying loan
- Costs associated with the acquisition of the right to service the underlying loan -- a servicing release premium, for example

- Internally-developed intangible assets

**SFG Observation:** *The SEC Staff believes that the fair value of a loan-commitment derivative should take into account all of the components noted above except:*

- *the value of the normal servicing fee,*
- *any costs associated with acquiring the right to service the underlying loan, and*
- *any internally-developed intangible assets.*

The value of a hypothetical loan-commitment derivative and the estimated fair values for each of its components is presented in the table below.

Loan amount	\$100,000
Loan interest rate	6.00%
Projected interest rate upon securitization	5.50%
Normal servicing fee	.25%
Guarantee fee	.20%
Excess servicing	.05%
Projected security price	99.0%
Projected price loss on loan/security	(\$1,000)
Projected cost of guarantee fee	- 1
Points collected from borrower	\$1,500
Projected value of normal servicing fee	\$2,000
Projected value of excess servicing	\$300
Projected net cost to originate	(\$1,800)
Projected internally-developed intangible assets	Nil
Projected fallout rate	25%

<sup>1</sup>The projected cost of the guarantee fee is implicit in the projected security price, as the security price pertains to a guaranteed mortgage-backed security.

The price of the underlying loan in the secondary mortgage market can be determined by:

- (1) estimating the gross gain or loss expected to be realized from the sale of the MBS, or

(2) determining the price for the loan in a whole-loan sale exclusive of any servicing release premiums.

### GSE Fees

The fee paid to a GSE or GNMA is included in the price of the underlying MBS as the secondary market is purchasing a guaranteed MBS. The cost of the guarantee is implicit in the price of the projected security.

In the above example, the projected loss on the sale of the underlying loan is \$1,000. This is determined by taking the \$100,000 loan amount and multiplying it by the projected security price of 99% to arrive at the expected price of \$99,000.

### Points

Points collected from the borrower represent the income that is expected to be received from the borrower when the loan is funded. Borrowers pay points to obtain a lower interest rate on their loans. If a borrower pays no points, the interest rate on their loan will be higher, which will result in a greater gain or lower loss when the underlying loan is sold.

The points represent a fundamental component in the overall value of the loan, and are included in the estimate of a loan-commitment derivative's fair value. In our example, the value ascribed to points is the \$1,500 that will be collected from the borrower.

### Normal Servicing

The projected value of the normal servicing fee is the value that the mortgage-banking enterprise expects to realize when the underlying loan is sold and the servicing is contractually separated from the underlying loan.

In the example, the projected value of the normal servicing fee is \$2,000, which was determined using a discounted cash flow analysis based on cash flow assumptions and projections used by market participants. The entity should not consider the value of the normal servicing fee when recognizing loan-commitment derivatives at fair value.

**SFG Observation:** *The SEC Staff believes the value of the normal servicing fee should be excluded from the estimated fair value of loan-commitment derivatives. The value associated with other related servicing cash flows -- such as ancillary fee income, float income, late charges, costs to service, interest costs on escrows and servicing advances, and default costs -- also should be excluded.*

*If a mortgage-banking enterprise anticipates selling whole loans and receiving a servicing release premium for the sale of the right to service the loans, the estimated value of the premium should be excluded from the estimate of the loan-commitment derivative's fair value.*

*Similarly, if a mortgage-banking enterprise has a commitment to purchase a loan and anticipates paying the correspondent a service release premium as part of the acquisition price, that premium should be excluded from the estimated fair value of the loan-commitment derivative, since the premium relates to the acquisition of the right to service the underlying loan.*

The projected value of excess servicing is the value of the remaining strip of cash flows from the underlying loan after an entity has considered the interest rate that the MBS will bear, the normal servicing fee, and the guarantee fee. For example:

Loan interest rate	6.00%
Interest rate on MBS	(5.50%)
Normal servicing fee	(0.25%)
Guarantee fee	(0.20%)
Excess servicing	0.05%

In our example, the projected value of the excess servicing is \$300, stemming from the net spread of 10 bps.

**SFG Observation:** *Excess servicing is not part of the contractually specified normal servicing fee. Excess servicing is the net result of a number of factors that affect the sales-execution decision.*

*The SEC Staff believes that the value of the excess servicing should be incorporated in the estimate of a loan-commitment derivative's fair value. Excess servicing is not part of the contractually specified normal servicing fee. The value of excess servicing is typically included in the MSR when the servicing is contractually separated from the loan. The value of the excess servicing embedded in a MSR would be relinquished if the servicing right were sold or if the agency were to revoke the servicing contract.*

*Despite these factors, the excess servicing value should be included in the value of the loan-commitment derivative primarily because the excess servicing results from an execution decision by the mortgage-banking enterprise.*

*When evaluating the fair value of non-agency loan commitments, any cash flows in excess of the normal servicing fee should be included in the retained interest after the underlying loan is securitized. The value of these excess cash flows or retained interests is included in the value of the loan-commitment derivative.*

#### Origination Costs

The origination of a mortgage loan involves the costs to originate the loan and the collection of related fees from the borrower. These costs and fees usually result in a net cost to originate that must be recorded when the loan is funded, in accordance with FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

The net origination costs associated with a loan-commitment derivative must be considered when estimating the derivative's fair value. (In the example, the net cost is \$1,800.)

#### Internally-Developed Intangible Assets

Internally-developed intangible assets, such as customer relationships, must be excluded from the estimate of the fair value of loan-commitment derivatives. These intangibles are recognized only when loan commitments and loan-commitment derivatives are acquired in connection with a business combination.

**SFG Observation:** Historically, most mortgage-banking enterprises have not ascribed any value to internally-developed intangible assets when determining the fair value of loan-commitment derivatives. As a result, SAB 105's requirement to exclude the value of these assets from the estimated fair value of a loan commitment has not had a significant impact on mortgage-banking enterprises.

### Fall Out

Mortgage-banking enterprises expect that some of the counterparties to their outstanding loan commitments will not execute a loan. The loan commitments that do not result in a loan are referred to as fallout. The FV of loan-commitment derivatives should be adjusted to reflect the estimated percentage of fallout.

Based on the previous example, the following table summarizes the various components used to estimate the fair value of loan-commitment derivatives, and illustrates whether a particular component's value should be included in the fair value determination in accordance with SAB 105:

	<b>Include in Fair Value</b>	<b>Exclude from Fair Value</b>	<b>Total Fair Value</b>
Loss on projected security price	\$ (1,000)	\$ -	\$ (1,000)
Projected cost of guarantee fee	-	-	-
Points collected from borrower	1,500	-	1,500
Projected value of normal servicing fee	-	2,000	2,000
Projected value of excess servicing	300	-	300
Projected net cost to originate	(1,800)	-	(1,800)
Projected internally-developed intangible assets	-	-	-
Estimated fair value of the underlying loan	<b>(1,000)</b>	<b>2,000</b>	<b>1,000</b>
Adjustment for fallout (Note 2)	<u>250</u>	<u>(500)</u>	<u>(250)</u>
Estimated fair value of loan commitment	\$ (750)	\$ 1,500	\$ 750

Note <sup>2</sup> -- The adjustment for fallout is calculated by taking the estimated fair value of the underlying loan times the fallout factor -- 25 percent in the example x (\$1,000) and \$2,000.

The FV of the loan commitment within the scope of SAB 105 has an initial fair value of (\$750), based on the mortgage-banking enterprise's pricing model.

**SFG Observation:** *The change in fair value will be estimated using the initial fair value determined by the lender's pricing model.*

*As noted above, the SEC Staff believes that the change in a loan-commitment derivative's fair value should consider all components except:*

- *the value of the normal servicing fee,*
- *any costs associated with acquiring the right to service the underlying loan, and*
- *any internally-developed intangible assets.*

*The SEC Staff's guidance does not prohibit the recording of an asset for a loan-commitment derivative resulting from positive changes in fair value that occur after the initial recognition of the derivative.*

*The fair values that are measured after the inception of a loan-commitment derivative must be supported with reasonable, objective and verifiable assumptions. Entities should thoroughly document all assumptions and models at the time of measurement.*

### EITF Issue 02-3

Loan-commitment derivatives are not, as a rule, actively traded. Consequently, there is no active market to observe the fair value of these derivatives.

Entities that are recognizing loan-commitment derivatives must consider the guidance in EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* ("EITF 02-3"). EITF 02-3 states that an entity should not recognize an unrealized gain or loss at the inception of a derivative contract, unless the derivative's fair value is:

- (1) represented by a quoted market price in an active market,
- (2) evidenced by a comparison with other observable, current market transactions, or
- (3) determined through valuation techniques that incorporate observable market data.

The transaction price at inception represents the best information available for purposes of estimating the derivative's fair value.

**SFG Observation:** *In accordance with EITF 02-3, the amount exchanged (or transaction price) at the time that an entity enters into a loan-commitment derivative is the best evidence of fair value when there is no active market for, nor any observable market data on, the derivative.*

*In most cases the initial fair value that an entity records for accounting purposes will be zero due to the absence of market data. This result occurs even if, under the lender's pricing model, there is an expectation on the commitment date that there will be a gain on the sale of the loan.*

*If an entity pays a transaction price, such as a lock fee, upon entering into a commitment, the entity should record the commitment at that price. After initial recognition, the entity must measure and report in the financial statements subsequent changes in the derivative's fair value, in accordance with the provisions of FAS 133.*

*The difference between the fair value estimated using the lender's pricing model and the amount recognized in accordance with EITF 02-3 should be treated as an adjustment to the model price. The initial difference should not be recorded until the loan is funded.*

## Disclosures

SAB 105 states that mortgage-banking enterprises should disclose the following information about loan-commitment derivatives:

1. The accounting policy pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*
2. The methods and assumptions used to estimate fair value, and any associated hedging strategies for loan commitments accounted for as derivatives, as required by FAS 107, *Disclosures about Fair Value of Financial Instruments*, FAS 133, and Item 305 of Regulation S-K
3. Disclosures required by Item 303 of Regulation S-K and any related interpretive guidance

**SFG Observation:** SAB 105 does not add new or additional disclosure requirements; however, mortgage-banking enterprises should consider disclosing the changes in a loan-commitment derivative's fair value for each period presented.

Any disclosures related to FV should include all information necessary to understand how that fair value is computed.

Enterprises also should consider disclosing the asset or liability related to the subsequent changes in interest rates. The enterprise's disclosures should be as transparent as possible to facilitate analysis by analysts and investors.

## **Other Considerations**

When a loan that is subject to a loan commitment is ultimately funded, the carrying value of the loan-commitment derivative should be recorded as part of the basis of the loan. The commitment ceases to exist as a separate asset or liability and is exchanged in consideration for the loan.

The basis adjustment to the loan should not be amortized; rather, when the loan is sold, the basis adjustment should be recognized as part of the gain or loss on the sale that is recorded in the income statement.

When a loan is transferred to a held-for-investment portfolio, the basis adjustment associated with the loan should be amortized as an adjustment to the yield, in accordance with FAS 91.

**SFG Observation:** The unrealized gain and loss at inception of the loan-commitment derivative estimated using the lender's pricing model will not be recognized in most cases due to the requirements of EITF 02-3.

EITF 02-3 does not provide guidance on how an entity should subsequently recognize unrealized gains and losses that were estimated using the lender's model at inception of a derivative contract. As a result, most mortgage bankers should not account for unrealized gains or losses estimated at the derivative contract's inception.

## FAS 91 Considerations

When a loan that is subject to a loan commitment is funded, an entity must record:

- (1) direct costs related to the loan's origination, and
- (2) fees collected from the borrower, in accordance with FAS 91.

**SFG Observation:** *The net costs of origination are part of the loan-commitment derivative's initial fair value estimated under the lender's pricing model. In accordance with EITF 02-3, however, the fair value to be initially recorded generally will be zero.*

*The net costs usually do not change during the life of the loan-commitment derivative. The fair value of the net cost to originate the loan is not recorded until the loan is funded. When the loan is funded, the net fees and costs must be recorded and accounted for in accordance with FAS 91.*

*Prior to the issuance of SAB 105, many mortgage-banking enterprises recorded the estimated value of the net costs to originate as part of the value of the loan commitment-derivative at its inception.*

*The approach used to value loan commitment derivatives does not extend to the fair value measurement of mortgage loans held for sale when determining the loan's*

- (1) estimated market value for the lower of cost or market analysis, in accordance with FAS 65, and*
- (2) change in fair value, in accordance with FAS 133 (i.e., if the loan is subject to a fair-value hedge).*

*The FV measurement under FAS 65 and FAS 133 for a mortgage loan held for sale is the value of the entire loan, which incorporates the value of the right to service the loan.*

## **Questions**

Questions regarding this advisory may be directed to:

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**SEC Staff Accounting Bulletin: No. 105 – Application of Accounting Principles to Loan Commitments**

**SECURITIES AND EXCHANGE COMMISSION -- 17 CFR Part 211 -- [Release No. SAB 105]**

**Staff Accounting Bulletin No. 105**

**AGENCY:** Securities and Exchange Commission

**ACTION:** Publication of Staff Accounting Bulletin

**SUMMARY:** This staff accounting bulletin summarizes the views of the staff regarding the application of generally accepted accounting principles to loan commitments accounted for as derivative instruments.

**DATE:** March 9, 2004

**FOR FURTHER INFORMATION CONTACT:** John James, Greg Cross or Eric Schuppenhauer, Office of the Chief Accountant (202) 942-4400, or Louise Dorsey, Division of Corporation Finance (202) 942-2960, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jill M. Peterson

Assistant Secretary

**Date:** March 9, 2004

Part 211 - (AMEND)

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 105 to the table found in Subpart B.

**STAFF ACCOUNTING BULLETIN NO. 105**

The staff hereby adds Section DD to Topic 5 of the Staff Accounting Bulletin Series. Topic 5:DD provides guidance regarding loan commitments accounted for as derivative instruments.

**TOPIC 5: MISCELLANEOUS ACCOUNTING**

\* \* \* \* \*

**DD. Loan Commitments Accounted for as Derivative Instruments**

**Facts:**

- Bank A enters into a loan commitment with a customer to extend a mortgage loan at a specified rate.
- Bank A intends to sell the mortgage loan after it is funded.

- Under Statement No. 133, such a loan commitment should be accounted for as a derivative instrument and measured at fair value. (Note 1)
- Bank A expects to receive future cash flows related to servicing rights from servicing fees (included in the loan's interest rate or otherwise), late charges, and other ancillary sources, or from selling the servicing rights into the market.

**Question 1:** In recognizing the loan commitment, may Bank A consider the expected future cash flows related to the associated servicing of the loan?

**Interpretive Response:** No.

The staff believes that incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. However, servicing assets are to be recognized **only** once the servicing asset has been **contractually separated** from the underlying loan by sale or securitization of the loan with servicing retained. (Note 2)

Further, no other internally-developed intangible assets (such as customer relationship intangible assets) should be recorded as part of the loan commitment derivative.

Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a loan commitment either individually, in a portfolio, or in a business combination).

**Question 2:** What disclosures should Bank A provide with respect to loan commitments accounted for as derivative instruments?

**Interpretive Response:** Bank A should disclose its accounting policy for loan commitments pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*.

Bank A should provide disclosures related to loan commitments accounted for as derivatives, including methods and assumptions used to estimate fair value and any associated hedging strategies, as required by:

- Statement No. 107(Note 3),
- Statement No. 133, and
- Item 305 of Regulation S-K.

Additionally, Bank A should provide disclosures required by Item 303 of Regulation S-K and any related interpretive guidance.

**Question 3:** Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

**Interpretive Response:** The staff will not object if registrants that have not been applying the accounting described in this bulletin continue to use their existing accounting policies for loan commitments accounted for as derivatives **entered into on or before** March 31, 2004.

For loan commitments accounted for as derivatives and entered into subsequent to that date, the staff expects all registrants to apply the accounting described in this bulletin.

Financial statements filed with the Commission before applying the guidance in this bulletin should include disclosures similar to those described in SAB Topic 11:M.

### **Endnotes**

Note 1 -- Paragraph 3 of FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amended paragraph 6(c) of Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to add: "...loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender)." Similar guidance is provided in Statement 133 Implementation Issue No. C13, *Scope Exceptions: When a Loan Commitment Is Included in the Scope of Statement 133*.

Note 2 -- See paragraph 61 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Note 3 -- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.