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August 3, 1981

ISSUES PAPER

Accounting for Bulk Purchases of Mortgages Between Mortgage Bankers

Prepared by
Task Force on Mortgage Banking
Accounting Standards Division
American Institute of Certified Public Accountants

830323

Introduction and Definitions

1. Mortgage bankers are specialized companies that sell mortgages to investing institutions, such as savings and loan associations, life insurance companies, pension funds, the Federal National Mortgage Association (FNMA), and various government agencies. Those institutions are often remotely located from the mortgage properties. The mortgage loans are often insured or guaranteed by various government agencies or mortgage guaranty corporations.

2. Typical mortgage bankers perform two principal functions: (1) the origination or purchase and subsequent sale of residential and commercial mortgages and (2) the servicing of mortgages. The origination of a mortgage involves locating a borrower, completing the mortgage documents, and disbursing funds to close the loan. Mortgage bankers incur significant costs in originating loans, including branch office expenses, salaries, commissions, and other associated costs. Mortgage bankers also acquire mortgage loans for sale to permanent investors from other sources. Among these other sources are purchases from realtors and brokers, purchases from investors, and conversions of various forms of interim financing, such as construction loans, to permanent financing.

3. To protect against price fluctuations on mortgages being accumulated and packaged for sale, a mortgage banker seeks advance commitments from investors to purchase a given volume of loans at a set price or yield. In turn, mortgage bankers make commitments to their customers (builders and borrowers) to finance their loans at a fixed price or yield. Mortgage bankers may assume a significant risk by originating or purchasing loans that are not covered by commitments, thereby exposing themselves to fluctuations in the market value of the loans based on changing interest rates. Purchasing loans with pre-existing sales commitments may minimize or eliminate that risk.

4. Funded mortgages are sold to a variety of permanent investors including insurance companies, pension funds, savings banks, the Federal National Mortgage Association (FNMA), and since 1970 they have been placed in trusts to collateralize Mortgage Backed Securities (MBS) guaranteed by the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Mortgages are packaged in large blocks, typically of $1,000,000 or more. Mortgage bankers sell the mortgages to investors on a "servicing released" or a "servicing retained" basis. If loans are sold "servicing released," the mortgage banker generally has no further responsibilities or income from fees for the loan.

If loans are sold "servicing retained," the mortgage banker becomes responsible for "servicing" the loan. Such servicing consists of collecting and accounting for the monthly payments, maintaining escrow accounts for payment of property taxes, checking insurance coverage, handling foreclosures when necessary, and, if necessary, periodically examining the property. The fee for servicing a loan is a share of the investor's interest income, stated in terms of a fixed percentage of the outstanding principal balance of the mortgage. Since the monthly fees are a fixed percentage of a declining principal balance, the servicing fee received on each mortgage decreases over the life of the mortgage.

5. The total of servicing contracts held by a mortgage banker is its "servicing portfolio." Since servicing fees represent an important source of income to mortgage bankers, they attempt to build their servicing portfolio and thus increase their servicing fees. Mortgage bankers may use four techniques to increase their servicing portfolios. One technique is the "in-house" origination of loans using the mortgage banker's own personnel. The second technique is for mortgage bankers to purchase loans from mortgage brokers (originators who sell all mortgage loans originated without retaining servicing). The third technique is to purchase loans from other

mortgage bankers or from government agencies. The fourth technique is to purchase servicing contracts from other mortgage bankers, thus transferring the loan servicing responsibility and its related revenue from one mortgage banker to another.

Scope

6. This issues paper addresses accounting for bulk purchases of mortgages between mortgage bankers (including brokers) and is applicable to financial statements of mortgage bankers that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. In addition, certain commercial banks and other financial institutions have divisions whose operations are similar to those of mortgage bankers. When such divisions obtain and service loans, the discussion in this issues paper applies.

Authoritative and Other Literature

7. The AICPA's accounting standards division has issued two statements of position on accounting practices in the mortgage banking industry. SOP 74-12, "Accounting Practices in the Mortgage Banking Industry," issued December 30, 1974, discusses valuation of loan inventories, accounting for transactions with affiliates, and classification of balance sheets. SOP 76-2, "Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry," issued August 25, 1976, discusses the accounting treatment of those costs and fees.

8. Paragraph 15 of SOP 76-2 discusses bulk purchases of mortgages from governmental agencies, savings and loan associations, banks, and other mortgage bankers. When issued, it did not represent a change in industry practice. That paragraph states

> The division believes that a portion of the purchase price of certain bulk purchases (usually only purchases from FNMA and GNMA and other governmental agencies) should be deferred as the cost of acquiring rights to receive future servicing revenue associated with the purchased loans when the mortgage banker retains the right to service such loans. The amount deferred should not exceed the

excess of the purchase price of the loans, including any transfer fees paid, over the market value of the loans at the date of purchase,[1] subject to the following limitations and conditions:

(a) At the time the transaction is initiated, there should exist a definitive plan for the sale of the mortgage-backed securities. This plan should include estimates of purchase price and selling price with reasonable support for such estimates. A definitive plan is deemed to exist when the mortgage banker (1) has, previous to the date of the bulk purchase, obtained commitments from permanent investors to purchase the mortgage loans or mortgage-backed securities or (2) enters into a commitment within a reasonable period of time (usually not more than thirty days after the date of the bulk purchase) to sell the mortgage loans or mortgage-backed securities to an investor or underwriter.

(b) The amount deferred should be reduced by any excess of the final sales price to the permanent investor over the market value of the loans at the date of the bulk purchase. The purpose of this requirement is to preclude the deferral of any amount recovered at the date of sale through the sales price.

(c) No costs associated with the transactions other than those identified above (excess of purchase price, including transfer fees, over market value as defined) should be deferred. Therefore, interest, salary, and general and administrative expenses, for example, should specifically not be deferred.

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[1] See the Division's Statement of Position No. 74-12 (section 10.040) for guidelines as to the computation of market value.

(d) The amount deferred should not exceed the present value of the amount of net future servicing income, determined in accordance with the provisions of paragraph 25.

(e) No amounts arising from transactions with other mortgage bankers should be deferred unless such purchases from other mortgage bankers are rare and unusual and not in the ordinary course of business. The purpose of this requirement is to preclude the capitalization, through such transactions, of in-house origination costs that should be charged to current operations.

Changing Economic Environment

9. Many believe that the increase in the number of bulk purchases and changes in the nature of those transactions since the issuance of SOP 76-2 are due to changes in the mortgage bankers' economic environment. One major change resulted from new GNMA minimum net worth requirements (effective October 1, 1979) to service mortgages. Depending on the type of securities to be issued by the mortgage bankers, the minimum net worth requirements are:

- for securities based on single family mortgages: $100,000, plus one percent of the amount of securities outstanding* between $5 million and $20 million, plus 0.2 percent of the amount of such securities outstanding over $20 million.

- for securities based on loans on mobile homes: $500,000, plus 0.2 percent of such securities outstanding over $35 million. (Note that all mobile home loan pools are internal reserve type pools, so the amount of securities outstanding is reduced by one half in all such pools.)

- for securities based on construction or long term mortgages on multi-family projects: $500,000, plus 0.2 percent of any securities outstanding over $35 million.

- for issuers of more than one type of security: $500,000, plus 0.2 percent of any securities outstanding over $35 million.

10. Minimum net worth requirements, leveraging test, and liquidity tests must also be maintained by mortgage bankers to be eligible to sell securities to FHLMC. FHLMC requires its sellers to maintain a minimum net worth that is greater than $100,000 or the amount calculated as follows:

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* The term "securities outstanding" means the unpaid principal balance of securities outstanding in the name of the issuer, plus the outstanding amount of any commitments for guarantee issued by GNMA, plus the amount of any commitments to guaranty being requested. Also, in calculating the required minimum net worth, the amount of any "securities outstanding" that are based on internal reserve pools will be reduced by one-half in making such calculations.

- 5 percent of the net value of all permanent first mortgage loans in inventory qualified for delivery to an investor under an outstanding commitment,

- 5 percent of the net value of all permanent FHA insured or VA guaranteed first mortgage loans in inventory not qualified for delivery to an investor under an outstanding commitment,

- 10 percent of the net value of all other permanent loans in inventory,

- 10 percent of the disbursed amount of all construction loans for single family dwellings in inventory,

- 10 percent of the disbursed amount of all FHA insured construction loans in inventory,

- 20 percent of the disbursed amount of all other construction loans in inventory,

- 30 percent of the net value of all land development loans, investments in joint ventures, investments in REITs and investments in land held for development,

- 50 percent of the net value of real estate acquired more than one year previous to the date of the HUD Approved Mortgagee's applicable financial statement through foreclosure or deed in lieu of foreclosure of a permanent single family mortgage loan, and

- 25 percent of the net value of real estate acquired less than two years previous to the date of the HUD Approved Mortgagee's applicable financial statement through foreclosure or deed in lieu of foreclosure of any other type of mortgage loan, and 50 percent of the net value of such property acquired more than two years previous to the date of the applicable financial statement.

The FHLMC leveraging test requires the ratio of total assets to adjusted net worth not to exceed 25 to 1. The seller also must meet certain liquidity tests. Many smaller mortgage bankers are often unable to meet FNMA and FHLMC requirements and, therefore, sell the loans they originate to other mortgage bankers rather than packaging them for sale to FNMA or FHLMC.

11. Other changes in the mortgage bankers' environment include

- increased availability of mortgage loans due to the negative interest rate spread on mortgages held for sale in late 1978 and 1979,

- increase in the number and amount of GNMA pools, and

- desire to rapidly increase servicing portfolios by the larger mortgage bankers due to perceived economies of sale.

Diversity in Practice

12. Since 1978, more mortgage bankers have been purchasing mortgage loans in bulk and servicing rights from mortgage bankers and others, and accounting for such purchases has diverged. In earlier years, purchases were fairly clearly purchases of loans, with marketing risks and carrying costs assumed by the purchaser. In many recent transactions, however, purchases are structured to be almost indistinguishable from the purchase of servicing contracts, with marketing risks (changes in the fair market value of mortgage loans due to the interest rate fluctuations) and carrying costs often retained by the seller. Therefore, many mortgage bankers capitalize a portion of the costs of bulk purchases as the right to receive future servicing income while others charge those costs to operations at the time of the purchase and sale.

Justification for Accounting Used

13. Many mortgage bankers expense the origination cost on recurring bulk purchases because they interpret SOP 76-2 to preclude capitalization of those costs. Others expense such

costs because it is simpler and more conservative to do so. Other mortgage bankers feel they are in substance purchasing existing contractual rights (intangible assets) to service mortgage loans and therefore are deferring a portion of the purchase price and amortizing it to operations in future years. Others who defer a portion of the cost of bulk purchases believe that SOP 76-2 did not contemplate the magnitude of such transactions or the changing economic circumstances.

Economic Substance of Bulk Purchases

14. Some believe that the magnitude and number of bulk purchases since the issuance of SOP 76-2 represent a change in the overall economic environment of the mortgage banking industry. They believe such changes have resulted in a change in the economic substance of the transactions, and, therefore, these transactions should be accounted for differently from the recommendations of paragraph 15 (e) of the SOP. They believe the recent transactions are in substance purchases of existing contractual rights (intangible assets) to service mortgage loans, and, therefore, a portion of the purchase price should be deferred and amortized to operations in future years. They point out that distinguishing

clearly between the purchase and sale of mortgage loans and the purchase and sale of servicing contracts is difficult, since the economic substance of the transactions is to increase serviced loan portfolios. However, others believe that the scope, magnitude, and number of bulk purchases do not affect the economic substance of the transactions and that SOP 76-2 should be strictly followed.

Rare and Unusual Transactions

15. Some mortgage bankers still interpret "rare and unusual and not in the ordinary course of business" to mean that if a company makes one bulk purchase, the second one would no longer be rare and unusual. Others believe that multiple bulk purchases could be considered rare and unusual.

Circumvention of Origination Costs

16. Some mortgage bankers believe that as long as a company does not intend to circumvent the requirement to expense in-house origination costs, it is permissible to defer a portion of the costs associated with purchases as the cost of acquiring rights to receive future servicing revenue associated with the purchase of loans when the company retains the right to service such loans. Others believe that, regardless of intent, such costs should not be deferred unless the purchases are rare and unusual.

Basic Issues

17. Since more liberal interpretations of paragraph 15 (e) of Statement of Position 76-2 have been applied in recent periods, the task force has considered the need for reconsidering the intent and requirements of that paragraph. The following basic issues need to be addressed:

(a) Are recent bulk purchase transactions between mortgage bankers different in economic substance from bulk purchases as contemplated by SOP 76-2 and do they therefore warrant a different accounting treatment?

(b) How should the term, "rare and unusual and not in the ordinary course of business," be defined for use in paragraph 15 (e) of SOP 76-2?

(c) Should it be permissible to defer a portion of the costs associated with bulk purchases if the intention is not to circumvent the requirement to expense in-house origination costs even if such transactions are not rare and unusual?

Other Issues

18. The diversity of practice in accounting for loan purchases arises from disagreement over more fundamental accounting practices in the mortgage banking industry, particularly the recording of servicing revenue based on the mortgage loan principal balance outstanding (accelerated servicing) and the current expensing of in-house origination costs. Those issues are under consideration by the Financial Accounting Standards Board (see FASB Invitation to Comment, "Accounting for Certain Service Transactions"). (Issues in the service transactions paper have been included in the FASB's accounting recognition criteria project and may not be resolved until the FASB's conceptual framework project is completed.) Because of that FASB study, this issues paper addresses only the issues listed in the Basic Issues section of this issues paper.

*   *   *   *   *

Advisory Conclusions

19. The AICPA Task Force on Mortgage Banking has considered the basic issues contained in this paper and has reached the following advisory conclusions.

Economic Substance of Transactions (Paragraph 15a)

The task force believes that changes in the economic activities and complexity of the methods of selling mortgages (see paragraphs 9 through 11) have made distinguishing clearly between the purchase and sale of mortgage loans and the purchase and sale of servicing contracts difficult since the economic substance of both types of transactions is to increase serviced loan portfolios.

Definition of Rare and Unusual (Paragraph 15b)

Although it may be possible to define the term "rare and unusual and not in the ordinary course of business" for purposes of applying Statement of Position 76-2, the task force believes that any such definition would lack theoretical soundness and would create an artificial point around which future transactions

could be structured. The intent of the previous task force in using the term, "rare and unusual and not in the ordinary course of business," was to prevent circumvention of other provisions of the SOP (expensing in-house origination costs). However, previous task force members and others, in practice, were unable to specifically define the term in the application of SOP 76-2, and, therefore, practice became diverse. In addition, it was not the intent of the previous task force to preclude the capitalization of costs of acquiring future servicing rights.

Circumvention of Expensing In-House Origination Costs (Paragraph 15c)

The task force believes that the issue of circumvention of expensing in-house origination costs should be addressed. Paragraph 20 gives its advisory conclusion on the subject.

20. According to its conclusions, the task force proposes that, as an interim measure, paragraph 15 of Statement of Position 76-2 be revised as follows:

> 15. The division believes that a portion of the purchase price of certain purchases that meet the criteria listed in (a) to (d) below should be deferred as the cost of acquiring rights to receive future servicing revenue associated with the purchased loans when the mortgage banker retains the right to service such loans. The amount deferred should not exceed the excess of the purchase price of the loans, including any transfer fees paid, over the market value of the loans at the date of purchase,[1] subject to the following limitations and conditions:
>
> (a) When the transaction is initiated, there should be a definitive plan for the sale of the mortgage loans or related mortgage-backed securities. The plan should include estimates of purchase prices and selling prices with reasonable support for the estimates. A definitive plan is

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1 See the Division's Statement of Position No. 74-12 (section 10,040) for guidelines as to the computation of market value.

deemed to exist when the mortgage banker (1) has, previous to the date of the bulk purchase, obtained commitments from permanent investors to purchase the mortgage loans or mortgage-backed securities or (2) enters into a commitment within a reasonable period of time (usually not more than thirty days after the date of the bulk purchase) to sell the mortgage loans or mortgage-backed securities to an investor or underwriter.

(b) The amount deferred should be reduced by any excess of the final sales price over the market value of the loans at the date of the bulk purchase. The purpose of this requirement is to preclude the deferral of any amount recovered at the date of sale through the sales price.

(c) No costs associated with the transactions other than those identified above (excess of purchase price, including transfer fees, over market value as defined) should be deferred. Therefore, interest, salary, and general and administrative expenses, for example, should not be deferred.

(d) The amount deferred should not exceed the present value of the amount of net future servicing income, determined in accordance with the provisions of paragraph 25.

21. The task force believes that the following subparagraph should be added to provide additional information to the readers of mortgage bankers' financial statements:

(e) The financial statements or notes should disclose

(1) the financial statement effect of amounts deferred during the year and

(2) the method and amount of amortization of those deferrals.

Evidence of Benefits of Change

22. The task force believes these benefits will be derived from its proposed revision of SOP 76-2:

- The proposed revision provides for the recognition of servicing rights as an asset.

- The proposed revision provides comparability by eliminating the current diversity in practice in accounting for bulk purchases between mortgage bankers.

Accounting Standards Executive Committee

23. The AICPA Accounting Standards Executive Committee unanimously approved (15 yes, 0 no) the task force's proposed revisions to paragraph 15 of Statement of Position 76-2.