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Accounting for bulk purchases of mortgages between mortgage bankers; Issues paper (1979 October 15)

American Institute of Certified Public Accountants. Task Force on Mortgage Banking

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ISSUES PAPER

Accounting for Bulk Purchases of Mortgages Between Mortgage Bankers

Prepared by
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Introduction and Definitions

1. Mortgage bankers are local specialized companies that originate mortgages for sale to a diversified body of 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: the origination of mortgages and 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. On residential loans, origination fees are usually less than these costs of origination. Mortgage bankers try to offset a portion of the origination costs by obtaining a small markup on the sale of the loans to the institutional investor.

3. Funded mortgages are packaged and sold to institutional investors 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 for the loan. If loans are sold "servicing retained," the mortgage banker becomes responsible for "servicing" the loan. 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 participation in 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.

4. 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.

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 protfolio 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 to purchase loans from mortgage brokers. 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. Mortgage bankers may assume a significant risk by originating or purchasing loans that are not covered by commitments, therefore 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 this marketing risk.

6. It is difficult to make a sharp distinction between the so-called "in-house" origination of loans, the purchase and sale of mortgage loans, and the purchase and sale of servicing contracts, since the economic substance of the transactions may be the same.

Authoritative and Other Literature

7. The AICPA's accounting standards division has outstanding 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 division's position on the accounting treatment for those costs and fees.

Other Relevant Research

8. In October 1978, the Financial Accounting Standards Board issued its Invitation to Comment, "Accounting for Certain Service Transactions," which contained a draft statement of position prepared by the AICPA accounting standards division's Task Force on Service Transactions. The draft SOP contained the division's conclusions on (1) the guidelines to apply to transactions in which both services and products are provided, (2) the appropriate manner of revenue recognition, (3) the classification of costs as initial direct costs, direct costs, and indirect costs and the accounting for each, and (4) the accounting for installation and initiation fees. Had it been issued, the draft SOP would have provided accounting guidance for a broad range of industries, including mortgage banking.

Diversity in Practice

9. Historically, except in business combinations, there were a limited number of purchases and sales of loans or servicing contracts between mortgage bankers. Paragraph 15 of SOP 76-2

discusses those purchases and sales. 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:
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> (a) At the time the transaction is initiated, there should exist a definitive plan for the sale of the mortgage loans or related 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.

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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.

(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.

(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.

10. Since 1976, more mortgage bankers have been purchasing mortgage loans from other mortgage bankers, and diversity in accounting for such purchases has emerged. These transactions have many of the attributes of both "in-house" originations and direct purchases of mortgage servicing contracts. In earlier years, purchases were fairly clearly loan transactions, with marketing risks and carrying costs assumed by the purchaser. In many recent transactions, however, purchases are almost indistinguishable from the purchase of servicing contracts, with marketing risks and carrying costs often retained by the seller.

11. Many mortgage bankers expense the origination cost on recurring bulk purchases, recognizing that the purchases are similar to "in-house" originations. Other mortgage bankers feel they are in

substance purchasing existing contractual rights to service mortgage loans and therefore are deferring a portion of the purchase price and amortizing it to operations in future years.

Justification for Accounting Used

Economic Substance of Bulk Purchases

12. 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 that the economic substance of such transactions has been altered and therefore these transactions should be accounted for differently from the recommendations of paragraph 15 (e) of the SOP. 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

13. 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

14. 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 the premium on bulk purchases as the cost of acquiring rights to receive future ser-

vicing revenue associated with the purchased 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

15. Since more liberal interpretations of paragraph 15(e) of Statement of Position 76-2 have surfaced in recent periods, the task force has considered the need for an interpretation of the requirements of that paragraph. The following basic issues need to be considered in order to interpret that paragraph:

a. Are the 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, as used in paragraph 15(e) of SOP 76-2?

c. Should it be permissible to defer the premium on 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

16. The diversity of practice in accounting for loan purchases arises from disagreement over more fundamental accounting practice 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. These issues are under consideration by the Financial Accounting Standards Board (see FASB Invitation to Comment, "Accounting for Certain Service Transactions"), although the Board has decided to take no action on the issues at this time. Because of this FASB study, the task force has elected to address only the specific issues outlined in the Basic Issues section of this issues paper.

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ADVISORY CONCLUSIONS

17. 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 mortgage banking industry have made it difficult to draw a sharp distinction between the so-called "in-house" origination of loans, the purchase and sale of mortgage loans, and the purchase and sale of servicing contracts.

Definition of Rare and Unusual (Paragraph 15b)

Although it may be possible to define the term "rare and unusual and not in the ordianary 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.

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

The task force believes that the entire issue of revenue and expense recognition in the mortgage banking industry needs to be reconsidered. Development of a sound theoretical framework for the industry would resolve the issue involved with deferral of any premiums associated with bulk purchases.

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 ~~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 loans or related 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.

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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.

(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.

(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~~ Deferred amounts arising from transactions with ~~other mortgage bankers~~ related parties or from transactions otherwise not at arm's length should ~~be deferred unless such purchases from other mortgages bankers are rare and unusual and not in the ordinary course of business~~ reflect the economic conditions within which the mortgage banker operates. Consequently, purchases and sales of mortgages between affiliates should be recorded at market value. 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.~~ prevent the circumvention of other provisions of this statement of position that would preclude capitalization of in-house origination costs.

new → (f) Gains arising from sales of loans to other mortgage bankers should be used to offset amounts deferred as the cost of acquiring servicing rights on certain purchases of loans from other mortgage bankers.

new → (g) The notes to the financial statements should disclose the following:

(1) the financial statement effect of any amounts deferred, and

(2) the method and effect of amortization of such deferrals.

The task force next proposes that it proceed with a long-term project that would consider the issue of revenue and expense recognition in the mortgage banking industry, and reconsider the issues addressed in Statement of Position 76-2, including the overall question of the creation of a servicing asset by purchase or by in-house origination. The task force would expect to be able to present its initial proposal on the project during 1980.

18. The AICPA Accounting Standards Executive Committee unanimously approved (14 yes, 0 no) the task force's proposed revisions to paragraph 15 of Statement of Position 76-2. The committee also unanimously agreed on the addition of the following paragraph providing a transition method for the application of those proposed revisions.

> Transition
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> XX. The provisions of this _________________________ should be applied in financial statements for fiscal years beginning after December 25, 1978, although earlier application is encouraged.