1976

Accounting for origination costs and loan fees in the mortgage banking industry; Exposure draft (American Institute of Certified Public Accountants), 1976, Feb. 6

American Institute of Certified Public Accountants. Accounting Standards Task Force on Mortgage Bankers

AICPA

American Institute of Certified Public Accountants
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February 6, 1976

To the Members of the
Accounting Standards
Executive Committee

File 3560 —
Exposure Draft on
Mortgage Bankers

Enclosed for your information is a copy of an exposure draft, Accounting for Origination Costs and Loan Fees in the Mortgage Banking Industry, prepared by the Accounting Standards Task Force on Mortgage Bankers. The draft has been sent to the Mortgage Bankers Association, to the SEC and FASB, and to other Senior Technical Committees of the AICPA for comment.

Sincerely yours,

Tom

THOMAS P. KELLEY
Director
Accounting Standards

TPK:dz

Enclosure(s)

cc: Auditing Standards Executive Committee
Federal Taxation Executive Committee
Vice Presidents, Managing Directors,
Directors, Assistant Directors and
Technical Managers
Committee on Banking
Committee on Savings and Loan Associations

EXPOSURE DRAFT—FEBRUARY 6, 1976

ACCOUNTING FOR ORIGINATION COSTS AND LOAN FEES IN THE MORTGAGE BANKING INDUSTRY

A Proposed Recommendation to the
Financial Accounting Standards Board

EXPOSURE DRAFT

This exposure draft has been prepared by the Accounting Standards Task Force on Mortgage Bankers for public comment. It has not been reviewed or approved by the Accounting Standards Division or any of its other components. It has been distributed to members of the Accounting, Auditing and Federal Taxation Executive Committees of the AICPA, to the AICPA Committees on Banking and Savings and Loan Associations, and to certain organizations outside the accounting profession. Copies are available to interested persons and organizations upon request.

Comments should be sent, in time to arrive not later than March 15, 1976, to—

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INTRODUCTION

1. The Accounting Standards Division of the American Institute of Certified Public Accountants issued a Statement of Position on Accounting Practices in the Mortgage Banking Industry on December 30, 1974 (Statement of Position No. 74-12) outlining the Division's position on mortgage banker accounting for inventory of permanent mortgage loans held for sale and certain other accounting matters. The Division has also noted that mortgage bankers use a variety of practices in accounting for loan origination costs and loan fees and believes that it is desirable to narrow the range of those practices.

2. The Division's recommendations with respect to accounting for origination costs and loan fees, as set forth herein, are applicable to financial statements of mortgage bankers that are intended to present financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles.

THE MORTGAGE BANKING INDUSTRY

3. Mortgage bankers originate, market and service real estate mortgage loans by bringing potential borrowers and investors together. They originate real estate mortgage loans in order to increase their servicing portfolio and the related servicing income. Many mortgage bankers engage in other related operations, including insurance, property management, real estate development

and sales, management of real estate investment trusts, joint venture investments, and construction lending for residential and commercial development. Mortgage bankers acquire mortgage loans 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 and construction financing. The mortgage loans are sold to a variety of permanent investors, including insurance companies, pension funds, savings banks, the Federal National Mortgage Association (FNMA), and since 1970 have been placed in trusts to collateralize Mortgage Backed Securities (MBS) guaranteed by the Government National Mortgage Association (GNMA).

4. Mortgage bankers often originate permanent residential loans without specific commitments from permanent investors to purchase such loans. Since the amount of an individual residential loan is relatively small, mortgage bankers normally obtain block commitments from investors for large dollar amounts of residential loans meeting broad general criteria. However, permanent commercial loans are usually large in amount and require careful underwriting and, normally, mortgage bankers will not issue commitments for commercial loans without first obtaining investors' commitments to purchase the specific loans.

5. Many mortgage bankers solicit construction loans. Mortgage bankers became active in construction lending in order to increase their volume of originations of real estate mortgage loans and many, because of the relatively high interest rates associated with construction loans, found this activity profitable. These loans generally require the borrower to repay the construction loan at or shortly after completion of construction and, consequently, are usually relatively short-term, seldom exceeding three years.

6. Mortgage bankers usually retain the right to service the permanent loans which they originate and sell to investors. The loans being serviced are called a loan servicing portfolio. Loan servicing includes, among other functions, collecting monthly mortgagor payments; forwarding 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. The mortgage banker receives a servicing fee, based on the outstanding principal balance of the loan, for performing these servicing functions. When servicing fees exceed the costs of performing servicing functions the existing contractual rights associated with a servicing portfolio have an economic value, and portions or all of such servicing portfolios have frequently been purchased and sold.

7. Mortgage bankers have traditionally sold their originated loans individually or in relatively small blocks to a variety of different investors. Recently, however, a growing volume of mortgages have been placed in trusts to collateralize mortgage-backed securities guaranteed by GNMA. The securities are created using either the concurrent dates (15 day) method or the internal reserve (45 day) method. When mortgage bankers use the internal reserve (45 day) method, interest is due for a period of thirty days prior to issuance of the security, and the mortgage banker must pay an amount equal to the first month's interest on the supporting mortgage loans to pay the initial interest on the securities. This payment is not recovered by the mortgage banker. Interest on the 15 day security does not commence until issuance and no initial payment is required from the mortgage banker.

ORIGINATION COSTS

Background

8. Costs of originating mortgage loans in-house include (1) direct personnel expenses, (2) other direct costs, and (3) general and administrative expenses such as occupancy, equipment rental, etc. Mortgage bankers may incur expenses at both home office and branch locations for the purpose of originating loans. Certain of these expenses, such as commissions paid to loan originators, may vary

proportionately with origination activity, while other expenses may be more fixed in nature. Some mortgage bankers have indicated that origination fees are adequate to cover direct origination costs; others, particularly those who believe general and administrative and certain other expenses should be allocated to origination activities, disagree. Identification of the costs of originating specific loans is difficult, and many mortgage bankers do not maintain the records necessary to identify such specific loan costs.

9. Many mortgage bankers, however, have incurred in-house origination costs in excess of the revenue derived from their origination operations. They originate such loans in order to obtain the increase in servicing revenue resulting from selling the loans to inestors while retaining the loans in their servicing portfolio.

10. Mortgage bankers, in addition to originating mortgage loans in-house, use other methods to increase their servicing portfolios. One method is to acquire, from other companies, existing contractual rights to service specific mortgage loans for investors. This has been accomplished both by acquiring selected servicing contracts and by acquiring other mortgage banking companies. The purchase price has been allocated to both the value of the future servicing revenue and the value of the contractual relationship with new investors, to whom the mortgage banker may more readily sell future mortgage

loans because of the servicing relationship. The amortization of the amount allocated to the future servicing revenue is tax deductible while the amount allocated to servicing contracts is not.

11. Another method to increase servicing portfolios is to make bulk purchases of mortgage loans from governmental agencies, particularly GNMA, and from FNMA and other mortgage companies. Some of these bulk purchases are made only after contracts for sale of the related mortgage-backed security or the mortgage loans themselves have been negotiated by the mortgage banker with permanent investors; others are made on a "market risk" basis; that is, the loans are marketed on the same basis as loans originated in-house. Mortgage bankers may enter into these transactions even when they estimate that the costs of the mortgage loans will exceed the subsequent selling prices in order to obtain the future servicing revenue. Such bulk purchases have been fairly rare. However, many mortgage bankers expect GNMA and FNMA to continue to conduct auctions of their mortgages and, therefore, mortgage bankers may make more purchases from FNMA and government agencies in the future.

Costs of Originating Mortgage Loans In-House

Current Industry Practice

12. Under present practices followed by most mortgage bankers for both financial reporting and income tax purposes, all income and costs associated with the origination of mortgage loans in-house

are reflected in current operations ; however, a few companies have begun to defer some of these costs on the basis that such costs were incurred to obtain the related future servicing revenue. The components of origination costs deferred varies from company to company. Some companies consider the origination function completed once a loan is funded by the mortgage banker, while others also include the income and costs associated with the warehousing and/or marketing functions in deferred origination costs.

The Division's Position

13. In view of (1) the long-standing practice followed by mortgage bankers of expensing costs of originating mortgage loans in-house as incurred, (2) the fact that mortgage bankers receive origination fees as partial reimbursement of in-house origination costs, (3) the difficulty in identifying the costs of originating specific loans, and (4) the practice followed by other industries with similar activities (costs are reflected in current operations), the Division believes that the deferral of any costs of originating mortgage loans in-house (including warehousing and/or marketing costs) should no longer be considered acceptable.

Bulk Purchases and Sales of Mortgage Loans

Current Industry Practice

14. Generally, the revenues and costs associated with the purchase

and sale of mortgage loans have been recorded in current operations by mortgage bankers. However, because of the large dollar amounts and because of the similarities to the purchase of servicing contracts (see paragraph 16), many mortgage bankers have treated a portion of the purchase price of bulk purchases of mortgage loans from governmental agencies, particularly GNMA, and from FNMA and other mortgage companies (see paragraph 11) as the cost of acquiring future servicing income and have deferred such amounts. The portion of the purchase price allocated to these rights has usually been the difference between the total purchase price, including any transfer fees, and either the eventual sales price of the loans or the market value of the loans at the date of purchase. Some mortgage bankers have also deferred processing costs associated with purchasing and selling the loans and any interest spread between the loan rate and their borrowing rate for warehousing the loans during their holding period. All amounts deferred have been amortized to future operations.

The Division's Position

15. The Division believes 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 the future servicing income associated with the purchased loans when the mortgage banker retains the right to service such loans. The amount deferred should be equal to 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 should not be deemed to exist unless 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 contract 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.

(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 <u>not</u> be deferred.

(d) The amount deferred should not exceed the present value of the amount of future servicing revenue reduced by expected servicing costs determined in accordance with the recommendations in paragraph 18.

(e) Purchases and sales from or to other mortgage bankers should be rare and unusual and in the ordinary course of business if any amounts related thereto are identified as costs of acquiring future servicing income and deferred. The purpose of this requirement is to preclude the capitalization, through such transactions, of in-house origination costs which should be charged to current operations.

1/ See the Division's Statement of Position No. 74-12 for guidelines as to the computation of market value.

Costs of Purchasing Existing Contractual Rights to Service Mortgage Loans

Current Industry Practice

16. The costs associated with the purchase of contractual rights to service mortgage loans have usually been allocated to the current value of the future income from servicing the loans and to the contractual relationship with investors; such costs have been deferred and amortized to operations over future periods. However, costs have usually been allocated to the contractual relationship with investors on a fairly arbitrary basis. While the relationship may make future loan sales to the new investor easier because of the servicing relationship, generally no specific commitment exists on the part of the investor to purchase future loans from the mortgage banker. Absent such future sales, the value of the contractual relationship is limited to the current value of the future servicing income on the serviced loans acquired. Even when the investor agrees to an exclusive territorial relationship, it is usually not possible to estimate the volume or price of future originations and the amount of the related future servicing revenue. However, allocations have often been made to comply with income tax regulations, and the same allocations have often been used for financial accounting purposes.

The Division's Position

17. The Division believes that the purchase price and related fees associated with the purchase of existing contractual rights to service mortgage loans should be deferred and amortized to operations over future periods. The amounts deferred should not exceed the current value of future servicing income, as discussed below. Because it is not possible to make a reasonable estimate of the value of a contractual relationship with investors, the Division has concluded that no portion of the purchase price of purchased servicing should now be allocated to such contractual relationships.

18. The amount deferred as applicable to the current value of future servicing income should not exceed the present value of the amount of future servicing revenues reduced by expected servicing costs. The estimates of future servicing revenues should include probable late charges and other ancillary income. Servicing costs should include direct costs associated with performing the servicing functions associated with the acquired contractual rights and approriate allocations of other costs. The rate used to calculate the present value should be the company's average cost of all capital (debt and equity). The latter rate should be calculated by dividing debt interest costs by the aggregate of equity capital and debt. Debt interest costs should normally be based on the interest rate used for accruing interest expense at the date of acquisition.

19. Any excess of the total purchase price and related fees over the amount deferred as applicable to the current value of future servicing income should be charged to current operations.

Interest Payment on Formation of GNMA Mortgage-Backed Securities (MBS)

Current Industry Practice

20. The initial payment of one month's interest upon issuance of GNMA securities (MBS) using the internal reserve method has been deferred and amortized by some companies, on the basis that this payment was made to secure future mortgage servicing revenue.

The Division's Position

21. The Division believes that the initial interest payment upon issuance of GNMA securities using the internal reserve method should be deferred and amortized.

Amortization of Deferred Costs

Current Industry Practice

22. The two methods currently used for amortizing deferred origination costs are the straight-line and the accelerated methods. Although servicing revenue is generally reflected in operations based on a fixed percentage of the unpaid principal balances of the mortgages, a substantial number of mortgage bankers amortize deferred origination costs on the straight-line method. Most mortgage

bankers using an accelerated amortization method have chosen the sum-of-the-years' digits method. Deferred origination costs are usually amortized over the estimated average remaining lives of the related mortgage loans.

<u>The Division's Position</u>

23. The Division believes that deferred costs applicable to the current value of future servicing income, including amounts initially paid in to the custodial accounts required for certain GNMA mortgage-backed securities, should be amortized in proportion to the estimated net servicing income from the related mortgage loans. This conclusion will usually require the use of an accelerated method of amortization.

LOAN FEES

<u>Background</u>

24. Mortgage bankers frequently charge borrowers fees in addition to the interest charged on the funds advanced. While the types of fees charged may vary and are limited only by the imagination of borrowers and lenders, loan fees can be identified as one or more of the following:

(a) A fee which in reality is an adjustment of the interest rate.

(b) A fee received in compensation to the lender for earmarking funds so that they will be available to the borrower when required. Maintaining such funds in a liquid position may result in a lower yield than could be realized absent the need for liquidity. Also, the lender may need available lines of credit to call upon to honor his commitments, and various costs are normally incurred to maintain such available credit.

(c) A fee received to guarantee the borrower an interest rate at or near the market rate at the time the commitment is issued. The fee is charged to compensate the lender for taking the risk that the market rate of interest for the individual borrower when the loan is funded will be higher than the commitment rate.

(d) A fee to compensate the lender for underwriting and processing the loan.

(e) A fee received to provide a construction lender with assurance that he will be repaid. Such fees are frequently called "standby" or "gap" commitment fees and are not expected to be funded. "Standby" commitments are normally issued to enable the borrower to obtain construction loans from a lender who is unwilling to provide such financing without the protection of a commitment for permanent financing which will repay the construction loan. Such commitments normally provide for an interest rate substantially above the market rate in effect at the time of issuance of the commitment. Commitment fees may also relate to the issuance of a commitment to loan funds to cover possible cost overruns or to provide intermediate term "gap" financing while the borrower is in the process of satisfying provisions of the permanent financing agreement, such as obtaining designated occupancy levels on an apartment project.

(f) A fee received for performing other services.

25. In addition to collecting fees, mortgage bankers often pay fees to obtain commitments from permanent investors to purchase mortgage loans from the mortgage banker.

26. The possible alternatives for the recognition of income from fees are listed below.

(a) Immediate recognition upon receipt

(b) Deferral with amortization--
   (1) over the commitment period
   (2) over the combined commitment and loan period
   (3) over the loan period

(c) Deferral without amortization with recognition in operations when it is clear the commitment will not be funded

(d) Deferral until loan is repaid or sold

Current Industry Practice

27. Mortgage bankers have followed a number of methods for recognition of income from loan fees. Many fees have been recognized as income when received. Other fees have been deferred and recognized as income ratably over the commitment and/or loan period. Some mortgage bankers have deferred such fees and recognized them as income when the loan is repaid or sold.

The Division's Position

28. The terminology applied by mortgage bankers to the fees which they receive varies widely. The selection of the most appropriate treatment for a loan fee should be based not on its descriptive

title but on an analysis of the nature and substance of the related transaction. The Division believes that all fees received by mortgage bankers as a result of their loan origination activities should be accounted for in accordance with the recommendations in the following paragraphs.

29. The Division believes that loan fees collected by mortgage bankers generally represent compensation for a combination of services and may include, for example, an adjustment of the interest rate on the loan, a fee for earmarking funds, and/or an offset of underwriting costs. The Division also believes it is not practicable to separate a loan fee into its components and, therefore, recommends that such fees be accounted for in accordance with their primary purpose as outlined below.

(a) Construction Loan Fees— The Division believes that construction loan fees should be deferred and recognized as income over the combined commitment and construction loan period. The straight-line method of amortization should be used until funding begins; the interest method should be used for the remaining unamortized balance during the loan period. The commitment and loan period of a construction loan is directly related to the length of the construction period, which is affected by many variable factors. The best estimate of the anticipated construction period should be utilized. In the event of a significant revision to the original estimate of the construction period, the unamortized portion of the commitment fee at the time of revising the estimate should be amortized ratably over the revised period. Any subsequent fees collected as a result of changes in the construction period should likewise be amortized over the revised period.

(b) Standby and Gap Financing Fees—
The Division believes that because the volatile nature of the market for real estate loans may require the funding of standby and gap commitments, fees for such commitments should be recognized as income over the combination of the commitment and standby or gap loan period. The straight-line method of amortization should be used during the commitment period and the interest method should be used for the remaining unamortized balance during the loan period if the loan is funded. Any additional fees collected at the time of funding the loan should be amortized over the loan period. If the mortgage banker purchases a standby or gap commitment from another lender, the cost of this commitment should also be deferred and amortized on a basis consistent with that used for the related commitment fee received.

(c) Residential Loan Origination Fees—
Mortgage bankers usually collect origination fees (such as the one percent FHA and VA origination fee) for residential loan originations. The Division believes that the typical residential origination fee clearly relates to the underwriting process of obtaining appraisals, processing the loan application, reviewing legal title to the real estate, and other procedures. Since the costs of these services are charged to expense as incurred, the Division believes that the related fees should be recognized in income as they are collected.

(d) Residential Loan Commitment Fees—
In addition to the origination fee, mortgage bankers often charge a commitment fee to the borrower or to a builder/developer to guarantee the funding of loans. In addition, the mortgage banker often pays commitment fees to permanent investors to ensure the ultimate sale of the funded loans. Normally these commitment fees (both received and paid) relate to blocks of loans for a specified total dollar amount. The Division believes these activities are analogous to the buying and selling of merchandise and, therefore, both the commitment fees paid and those received should be deferred. They should be recognized in operations upon completion of the sale of the loans to the permanent investor. If the commitment fees paid or received relate to a commitment amount for a block of loans, the portion of the fees recognized in operations as the result of an individual loan transaction should be based on the ratio of the individual loan amount to the total commitment amount.

(e) Commercial Loan Commitment Fees— Commitments to fund a loan on an income producing or commercial property frequently have longer terms than those associated with residential loans. The fees from such commitments generally involve larger dollar amounts and they vary more widely as a percentage of the loan amount than residential loan fees. These characteristics warrant a modification to the general position on commitment fees discussed in the preceding paragraph. The Division believes that commitment fees received and paid in connection with a commercial permanent loan should be deferred and recognized in income upon completion of the sale of the loan to the permanent investor unless a commitment in substantially the same form is obtained from a permanent investor. If a mortgage banker purchases a commitment from a permanent investor in substantially the same form as his commitment to fund a loan, the fees received and paid should be recognized in operations at that date.

(f) Commercial Loan Placement Fees—

Mortgage bankers may receive fees for arranging a commitment directly between a lender and a borrower. In transactions of this type, the Division believes that the mortgage banker is serving only as a conduit between lender and borrower and the fees received should be recognized in operations when the mortgage banker has no remaining significant obligations for performance in connection with the transaction.

(g) Fees for Services Rendered— In some cases mortgage bankers will collect fees solely for providing services with respect to the origination of a loan, such as appraisals, etc. The Division believes that such fees should be recognized in operations when the services have been performed.

30. In recognizing loan fees as income, consideration must be given to the collectibility of the fee. If the fee has not been received in cash, there must be evidence that its collectibility is reasonably assured. In cases where a note from the borrower has been accepted for the fee, a strong presumption exists that the collectibility of the fee is contingent upon the funding of the loan.

In such cases, the Division believes that no income should be recognized until the note has been collected.

31. When commitments expire without being funded or loans are repaid prior to the estimated repayment date, the Division believes any unamortized loan fees should be recognized in operations at that time.

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