

Mortgage Loan Commitments

FHLBank Topeka

Accounting and Reporting for Mortgage Loan
Commitments

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Wilary Winn LLC

Mortgage Loan Commitments

Today's Agenda

Interagency Advisory

Commitments to make mortgage loans

Commitments to sell mortgage loans

Examples

Regulatory Reporting

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Wilary Winn LLC

Mortgage Loan Commitments

Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans

- Issued May 3, 2005
- Provides guidance on accounting and reporting for commitments to:
 - Originate mortgage loans that will be held for resale; and
 - Sell mortgage loans under mandatory and best efforts sales contracts

Mortgage Loan Commitments

Noncompliance Issues noted in the Advisory

- Including the value of the servicing right in the value of the commitment
- Reporting the value of derivative loan sales agreements as assets, when in fact they were liabilities, and vice-versa
- Failing to report the derivatives and their changes in fair value on the balance sheet and income statement

Mortgage Loan Commitments

Interest Rate Lock Commitments (IRLCs)

- Interest rate lock in commitments on mortgage loans that will be held for resale are derivatives
- Commitments to originate mortgage loans to be held for investment and other types of loans are generally not derivatives

Mortgage Loan Commitments

Types of Mortgage Loan IRLCs

- Lock ins for fixed rate loans
- Lock ins for adjustable-rate loans
- Commitments with floating rates

Mortgage Loan Commitments

Characteristics of IRLCs

- Note amount
- Interest rate
- Purchase price
- Time period

Mortgage Loan Commitments

Value of IRLCs

- Conceptually related to the loan's value in the secondary market
- Servicing related elements must be excluded from value
- Need to adjust for likelihood of closing or pull-through

Mortgage Loan Commitments

Secondary Market Value Components

- Price
- Value of servicing
- Discount points
- MPF credit enhancement fees and obligations
- Direct origination fees and costs
- Internally developed intangible assets

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IRLC Value

- IRLCs are not actively traded and so the initial value is zero (unless the borrower is charged a fee)
- Subsequent changes in fair value are to be measured and reported on the balance sheet and income statement

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Simplified Example Assumptions

- Loan amount \$100,000
- Price to borrower 100.50
- Interest rate 6.00%
- Sales price including SRP 102.50
- Value of servicing 1.00
- Projected origination costs \$1,000 or 1.00%

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Simplified Calculation of Value

		Inception	Rates Increase 50 bp	Loan Has Been Processed	Rates Drop 100 bp	Loan Has Been Approved	Loan at Close
Loan Amount	(A)	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000
Lock In Interest Rate		6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Market Interest Rate		6.00%	6.50%	6.50%	5.50%	5.50%	5.50%
Market Value including SRP	(B)	102.50%	100.50%	100.50%	104.50%	104.50%	104.50%
Servicing Value	(C)	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%
Origination Costs	(D)	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%
Borrower Price	(E)	100.50%	100.50%	100.50%	100.50%	100.50%	100.50%
Value as a Percent of Loan (B)-(C)-(D)-(E)	(F)	0.00%	-2.00%	-2.00%	2.00%	2.00%	2.00%
Dollar Value (A)*(F)	(G)	\$ -	\$ (2,000)	\$ (2,000)	\$ 2,000	\$ 2,000	\$ 2,000
Pull-through Percentage	(H)	30.00%	30.00%	60.00%	60.00%	80.00%	100.00%
Net Value (G)*(H)	(I)	\$ -	\$ (600)	\$ (1,200)	\$ 1,200	\$ 1,600	\$ 2,000
Value Recorded		\$ -	\$ (600)	\$ (600)	\$ 2,400	\$ 400	\$ 400

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Accounting Entries for IRLCs

- At inception – none required as initial fair value is zero
- While commitment is outstanding – changes in fair value are recorded
- If commitment expires write the fair value down to zero
- Origination costs and fees received are not amortized under FAS 91 - they are included in the determination of fair value
- The carrying value of the IRLC is an adjustment to the basis of the loan at funding
- The servicing value is to be recognized at the sales date of the loan

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Additional Economic Considerations for IRLCs

- Changes in interest rates can also affect the value of the servicing asset
- Pull-through assumptions in the marketplace are more complex than the simplified example

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Factors Affecting Pull-through

- Market interest rates
- Type of origination – retail or wholesale
- Length of lock
- Purpose of loan – purchase or refinance
- Type of loan – fixed or variable
- Processing status of loan

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Types of Sales Commitments

- Mandatory delivery
- Best efforts delivery
- Master agreements

Mortgage Loan Commitments

Mandatory Delivery Commitment

- An institution commits to deliver a certain amount of loans to an investor at a specified price on or before a specified date
- Requires a pair-off fee based on then current market prices to compensate investor for any shortfall

Mortgage Loan Commitments

Mandatory Delivery Commitment

- Has a “specified underlying” - the specified price
- Requires little or no initial net investment
- Has a “notional amount” - the principal amount of the loan
- Requires or permits net settlement by paying a pair-off fee based on then current market prices
- Is a derivative

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Best Efforts Delivery Commitment

- An institution commits to deliver an individual loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes
- Generally not considered a derivative until the loan closes because it does not meet the net settlement criteria
- The result is that the change in the value of best efforts contracts will not offset the change in the value of the IRLCs for accounting purposes

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Best Efforts Delivery Commitment

- Net settlement is most difficult determination because there are many forms of the contract in the marketplace and the term is used loosely in the industry
- To make the determination, one may have to review the overall master agreement

Mortgage Loan Commitments

Is Net Settlement Present?

Yes

Must deliver the loan

Pair-off fee

Variable penalty

No

Fixed penalty only

No penalty for non-delivery



Mortgage Loan Commitments

Master Agreements

- Generally govern the overall relationship between the institution and the investor and set the parameters under which the institution will deliver loans
- Generally specify the amount of loans that can be delivered within a specified time frame but do not specify the price for loan purchases
- Generally does not specify the price for a particular loan and so there is no “specified underlying” and is therefore not a derivative

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Accounting for Sales Commitments

- Derivative loan commitments are to be accounted for at fair value on the balance sheet

Mortgage Loan Commitments

Description	Journal Entries		Income Statement	Balance Sheet				
	Debit	Credit		Prepaid	IRLC	Cash	Warehouse	Derivative
IRLC	-			-				
Origination Income		-	-					
Record initial value								
Prepaid Loan Costs	500			500				
Cash		500			(500)			
Record origination costs								Record processing costs of \$500
IRLC	2,000				2,000			
Gain on IRLC		2,000	(2,000)					
Loss on Forward	2,000		2,000					
Forward Sale Contract		2,000						(2,000)
Record rate changes								
Prepaid Loan Costs	500			500				
Cash		500			(500)			
Record costs								Record processing, underwriting and commissions expense
Warehouse Loan	103,500						103,500	
Prepaid Loan Costs		1,000		(1,000)				
IRLC		2,000			(2,000)			
Cash		100,500			(100,500)			
Record loan closing								Loan closes at 100.50
Cash	104,500				104,500			
Warehouse Loan		103,500				(103,500)		
Forward Sales Contract	2,000							2,000
Pair-off Fee		2,000			(2,000)			
Gain on Sale		1,000	(1,000)					
	215,000	215,000	(1,000)	-	-	1,000	-	-



Mortgage Loan Commitments

Netting of Derivatives for Reporting Purposes

- May net gains and losses of individual derivative commitments only under certain conditions, generally only under the legal right of offset
- The value of sales commitments covering the pipeline may not be netted against the value of the IRLCs, they must be reported separately
- The value of sales commitments covering the warehouse may not be netted against the value of the warehouse loans, they must be reported separately

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Loans Held for Sale

- Reported at lower of cost or market unless “hedge accounting” is used
- To qualify for hedge accounting, the risk management policy must be thoroughly documented

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Types of Hedges

- Fair Value
 - Changes in value run through income statement
- Cash Flow
 - Changes in value run through OCI

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Accounting for Fair Value Hedges

- The designated risk in a fair value hedge can be the risk of change:
 - in the overall value
 - due to changes in interest rates
 - due to the changes in interest rates and borrower creditworthiness

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Fair Value Hedges must be Highly Correlated

- Dollar offset measurement must be within a range of 80% to 125%
- Under a statistical approach the hedged item and the hedging instrument must have a coefficient of determination (i.e. R-squared) equal to .8 or greater
- Can assume correlation if the critical terms of the hedging instrument and the hedged item are the same – “short cut method”

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Income Statement Effect

- Changes in the fair value of the IRLCs, sales commitments and (warehouse loans depending on the circumstances) are reported as “other noninterest income” or “other noninterest expense”

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Regulatory Reporting IRLCs

- Report notional amount of fixed-rate, adjustable rate and floating rate commitments with no adjustment for pull-through
 - Schedule RCL – Item 12.d.(1), Column A or
 - TFR Schedule CC – lines 280-300
- Report derivatives with positive fair value held for purposes other than trading (assets)
 - Schedule RCL – Item 15.b.(1), Column A or
 - TFR Schedule SC – line 689
 - 5300 page 2 – line 28
- Report derivatives with negative fair value held for purposes other than trading (liabilities)
 - Schedule RCL – Item 15.b.(2), Column A or
 - TFR Schedule SC – line 796
 - 5300 page 3 – line 3

Mortgage Loan Commitments

Regulatory Reporting - Sales Commitments

- Report notional amount of sales commitments
 - Schedule RCL – Item 12.b, Column A or
 - TFR Schedule CC – line 330
- Report derivatives with positive fair value held for purposes other than trading (assets)
 - Schedule RCL – Item 15.b.(1), Column A or
 - TFR Schedule SC – line 689
- Report derivatives with negative fair value held for purposes other than trading (liabilities)
 - Schedule RCL – Item 15.b.(2), Column A or
 - TFR Schedule SC – line 796

Mortgage Loan Commitments

Regulatory Reporting IRLCs and Sales Commitments

- Total notional amount of derivative contracts held for purposes other than trading
 - Schedule RCL – Item 14, Column A
 - TFR – NA
 - 5300 – NA

Mortgage Loan Commitments

Background on Wilary Winn LLC

- Wilary Winn provides independent, fee-based advice to financial intermediaries, including banks, credit unions, finance companies, and mortgage bankers.
- Our services include assessments and valuation of complex financial assets, including mortgage servicing rights, and the development and implementation of interest rate risk management programs.

Mortgage Loan Commitments

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Interest Rate Lock In Commitments

Loan Number	Borrower	Loan Amount	Reg. Ref.	Lock in Rate	Lock in Price	Market Rate	Market Price	Market - Lock in Price	Pull Through	Value Percent	Value Dollars	Value for Accounting Purposes
<u>Commitments with Positive Value</u>												
1001	Winn	\$ 200,000		6.00%	101.00%	5.50%	102.00%	1.00%	75.00%	0.75%	\$ 1,500	\$ 1,500
1003	Wilary	\$ 250,000		6.25%	101.50%	5.50%	103.00%	1.50%	80.00%	1.20%	\$ 3,000	\$ 3,000
		\$ 450,000	(1)								\$ 4,500	\$ 4,500(2)
<u>Commitments with Negative Value</u>												
1002	Otting	\$ 250,000		5.25%	100.50%	5.50%	99.00%	-1.50%	85.00%	-1.27%	\$ (3,187)	\$ (3,187)
1004	Hart	\$ 225,000		5.00%	100.00%	5.50%	98.00%	-2.00%	90.00%	-1.80%	\$ (4,050)	\$ (4,050)
		\$ 475,000	(1)								\$ (7,237)	\$ (7,237)(3)

Closed Loan Inventory

Loan Number	Borrower	Loan Amount	Lock in Rate	Lock in Price	Market Rate	Market Price	Market - Lock in Price	Pull Through	Value Percent	Value Dollars	Value for Accounting Purposes	
<u>Loans with Positive Value</u>												
1005	Nokken	\$ 150,000		6.00%	100.50%	5.50%	102.00%	1.50%	100.00%	1.50%	\$ 2,250	-(a)
1007	Lidke	\$ 237,500		6.25%	100.75%	5.50%	103.00%	2.25%	100.00%	2.25%	\$ 5,344	-(a)
		\$ 387,500									\$ 7,594	-
<u>Loans with Negative Value</u>												
1008	Turley	\$ 187,500		5.25%	101.00%	5.50%	99.00%	-2.00%	100.00%	-2.00%	\$ (3,750)	\$ (3,750)
1009	Gatewood	\$ 175,000		5.00%	102.00%	5.50%	98.00%	-4.00%	100.00%	-4.00%	\$ (7,000)	\$ (7,000)
		\$ 362,500									\$ (10,750)	\$ (10,750)

(a) loan cannot be written above cost unless hedge accounting is elected and correlation is proved

Sales Commitments

Comm Number	Investor	Comm Amount	Rate on Comm	Comm Price	Market Rate	Market Price	Comm - Market Price	Pull Through	Value Percent	Value Dollars	Value for Accounting Purposes
<u>Mandatory Sales Commitments</u>											
2001 FHLB		\$ 348,750 (4)	6.13%	101.25%	5.50%	102.50%	-1.25%	n/a	-1.25%	\$ (4,359)	(4,359)(3)
2003 FHLB		\$ 387,500 (4)	6.13%	100.63%	5.50%	102.50%	-1.87%	n/a	-1.87%	\$ (7,266)	(7,266)(3)
		\$ 736,250									
<u>Best Efforts Sales Commitments</u>											
2002 Fannie Mae		\$ 415,625	5.13%	100.25%	5.50%	98.50%	1.75%	n/a	1.75%	\$ 7,273	(b)
2004 Wells Fargo		\$ 362,500 (4)	5.13%	101.50%	5.50%	98.50%	3.00%	n/a	3.00%	\$ 10,875	(c) (2)
		\$ 778,125									
Total derivative contracts 1 + 4		\$ 2,023,750 (5)									

(b) best efforts commitment is not a derivative and value cannot be recognized for accounting purposes

(c) best efforts commitment value can be recognized for accounting purposes because it applies to closed loans and is therefore considered a derivative

Regulatory Reporting

- (1) Over the counter written options
- (2) Derivatives with positive value - asset
- (3) Derivatives with negative value - liability
- (4) Forward contracts
- (5) Derivatives held for purposes other than sale or trading