

# Accounting for Interest Rate Lock Commitments

**Mortgage Bankers Association  
Presentation to  
Bank Regulatory Agency Representatives  
February 20, 2004**



# Agenda

- I. Introduction
  - II. Characteristics of Interest Rate Lock Commitments
  - III. Accounting for Interest Rate Lock Commitments
  - IV. Ramifications and Challenges of Proposed SAB
  - V. MBA Recommendations
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Appendix – IRLC Valuation Example

# I. Introduction

- The MBA would like to work with the SEC to address accounting for interest rate lock commitments (IRLCs) under SFAS 133.
- The January 13, 2004 ABA presentation included a description of the mortgage banking business model specific to IRLCs:
  - IRLC is a forward commitment; the value changes over time due to several factors (rates, proximity to close, economic factors, etc.).
  - Once the borrower locks in the interest rate, the lender is exposed to price risk in the event it intends to sell the loans.
  - The FASB provided special accounting treatment for IRLCs as derivatives because a distinct accounting model exists in SFAS 65, *Accounting for Certain Mortgage Banking Activities*, for mortgage loans originated to be held for resale.
  - SFAS 149, an amendment to SFAS 133, changed DIG Issue C13 to consider only originated IRLCs (i.e., commercial, retail & broker) where the intent was to sell an underlying loan. Purchased IRLCs (i.e., mandatory or best efforts commitments issued through the correspondent channel) must be evaluated under SFAS 149 regardless of the intent to sell or hold the underlying loan for investment.

## I. Introduction, *continued*

- A primary objective of GAAP, pursuant to the Concepts Statements (Statement of Financial Accounting Concepts No. 5: Recognition and Measurement in Financial Statements of Business Enterprises), is to ensure accounting results produce information that is reliable and relevant to users of financial statements.
- To be consistent with Concepts Statement No. 5, it is critical that mortgage bankers' financial reporting reflect the economics of loan production hedging activities by requiring all changes in the value of the IRLC to be recognized in earnings as well as offsetting changes in the value of the hedging instrument.

## II. Characteristics of Interest Rate Lock Commitments

<u>Characteristic</u>	<u>Written Option</u>	<u>Commercial IRLC</u>	<u>Mandatory Residential IRLC</u>	<u>Retail or Best Efforts Residential IRLC</u>
<b>Initial premium</b>	Yes – premium considers intrinsic value of underlying & time to contract expiration	No - borrower pays cash collateral deposit	No	No - Hedge Cost is normally embedded in loan rate
<b>At or out of the money exercise</b>	None	>98% due to bilateral contractual nature – fallout results from material adverse changes post commitment	100% or penalties equating losses are enforced	Highly predictable (up to 90% pull through rate)
<b>Settlement of option or contract</b>	Normally cash settlement	Delivery of cash from lender to borrower in exchange for promissory note.	Delivery of underlying loans for cash or "pair-off" cash settlement applies to make issuer whole	There is a two-sided aspect of settlement. IRLC holder must complete loan qualification hurdles and deliver a promissory note.
<b>Variables driving option exercise or contract settlement</b>	Market price of underlying vs strike	Bilateral contractual nature of commitment requires performance, otherwise damages can be assessed (i.e., lose deposit)	Bilateral contractual nature of commitment requires performance	Several variables are considered: <ul style="list-style-type: none"> <li>• Time to home purchase</li> <li>• Cost of reapplication</li> <li>• Current mkt rates, to the extent visible</li> </ul>
<b>Performance obligations</b>	Mandatory performance by writer	Bilateral, mandatory performance	Bilateral, mandatory performance	Conditional performance by writer
<b>Issuer Return</b>	Capped at premium received	Not capped	Not capped	Not capped

## II. Characteristics of Interest Rate Lock Commitments, *continued*

**Conclusion** – There are many types of IRLCs with differing underlying characteristics:

- Commercial IRLCs are forward contracts due to their bilateral contractual nature.
- Mandatory Residential IRLCs are forward contracts due to their bilateral contractual nature.
- Retail or Best Efforts IRLCs are not traditional written options because:
  - They have complex variables that give the borrower incentive to exercise them when they are “at” or “out of the money;” and
  - They have conditional performance obligations.

### III. Accounting for Interest Rate Lock Commitments

- Historical accounting for IRLCs has consistently provided a two-sided, matching approach:
  - Under SFAS 80, matching was achieved through deferral of hedge results until loan sale.
  - Under SFAS 133, as amended by SFAS 149, matching continued as both the derivative hedging the IRLC and the IRLC itself were marked to market through earnings.
  - Under SFAS 80 and SFAS 133, there has not been diversity in practice in measuring the **change** in value of IRLCs with respect to interest rates and the passage of time.
  
- Currently, pursuant to SFAS 133, as amended by SFAS 149:
  - Loan commitments (IRLCs) that are derivatives must be recognized at fair value;
  - Fair value guidance in SFAS 133 states that if quoted market prices are unavailable, management's best estimate of fair value may be based on valuation techniques, including cash flow valuation techniques; and
  - In arriving at a best estimate of fair value using cash flow techniques, management should consider the cash flows that a third party would include in bidding on a loan commitment or commitments, discounted as appropriate.

### III. Accounting for Interest Rate Lock Commitments, *continued*

The FASB addressed the valuation of financial instruments similar to IRLCs and concluded that they can, in fact, possess positive fair values:

- Paragraph 14(d) of the FASB *Preliminary Views: Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* describes a loan commitment (IRLC) as one of several items defined as “contractual obligations to exchange financial instruments and corresponding rights to require exchange of financial instruments.”
- Included in the Board’s discussion of the valuation of a cardholder’s option to borrow under a revolving credit card agreement (another similar type of IRLC), the Board concluded in paragraph 107 that:
  - “The cardholder’s option to borrow is different from many other options because it can be either an asset or a liability to the card issuer, which is the writer of the option. Many, more traditional written options are always liabilities to the writer because the holders are expected to exercise the options only when the exercise price is detrimental to the writers. However, a cardholder often is motivated to exercise (to borrow) by factors other than the exercise price (that is, the interest rate on the card).”

### III. Accounting for Interest Rate Lock Commitments, *continued*

<u>Characteristic</u>	<u>Written Option</u>	<u>Cardholder's Option (Revolving Credit Card Agreement)</u>	<u>Retail or Best Efforts Residential IRLC</u>
<b>Initial premium</b>	Yes	Yes – Annual Fee	No - Hedge Cost is normally embedded in loan rate
<b>At or out of the money exercise</b>	Only when option is in the money	Yes – not predictable	Highly predictable (up to 90% pull through rate)
<b>Settlement of option or contract</b>	Normally cash settlement	Cash settlement	There is a two-sided aspect of settlement. IRLC holder must complete loan qualification hurdles and deliver a promissory note.
<b>Variables driving option exercise or contract settlement</b>	Market Price Of Underlying vs strike	Contractual nature of commitment requires performance by lender; borrower influenced by other variables (i.e., exercise prices, interest rate, card affiliations, etc.)	Several variables are considered: <ul style="list-style-type: none"> <li>• Time to home purchase</li> <li>• Cost of reapplication</li> <li>• Current mkt rates, to the extent visible</li> </ul>
<b>Performance obligations</b>	Mandatory performance by writer	Mandatory performance by writer	Conditional performance by writer
<b>Fair Value</b>	Liability	Asset or Liability	Asset or Liability

*Unlike traditional written options, IRLCs and cardholder options can have a positive fair value because underlying consumers are often compelled to exercise (or borrow) by factors other than the exercise price.*

## IV. Ramifications and Challenges of Proposed SAB

The proposed SAB would:

- Treat all IRLCs the same when there are many types of IRLCs with differing underlying characteristics.
- Create an accounting model mismatch for IRLCs and their related hedges.
- Not address diversity in practice:
  - How would the value of the liability be measured?
  - At what level would the liabilities be measured?
  - Given no observable market values for the SEC's proposed valuation model, what technique(s) should companies rely on?
- Create operational challenges because mortgage companies would have to account for their IRLCs differently, depending upon whether they are mandatory or best effort contracts (see table on page 4). Currently companies do not have the systems capability to distinguish between contracts that are mandatory or best effort for hedging and accounting purposes. Instead, systems capabilities and risk metrics focus on form of delivery, not source channel for product.

## IV. Ramifications and Challenges of Proposed SAB, *continued*

The proposed SAB would also:

- Require enormous time, resources and costs to implement systems and reporting changes with little or no benefit to readers of the financial statements. Essentially, the proposed SAB would misrepresent the economic substance of mortgage banking companies' loan production and hedging activities.
- Raise significant public policy concerns through the following chain of events:
  - New guidance would cause a significant increase in accounting income volatility;
  - Accounting volatility in turn would result in mortgage banking companies' decline in debt rating;
  - Which would lead to an increased cost of capital;
  - To avoid a decline in their debt rating, companies would purchase options to reduce accounting income volatility;
  - Either of these approaches would result in added expense to the consumer as companies would pass on the costs.

## V. MBA Recommendations

The MBA recommends, in order of preference:

1) The SEC defer to the FASB to address proper accounting for IRLCs, given:

- That all IRLCs are not the same; the creation/finalization of appropriate valuation and accounting guidance needs to be sensitive to this fact.
- The challenges associated with measuring and reporting the fair values of IRLCs are similar to the challenges being addressed by other current FASB projects.
- The outcome of this issue has implications for the treatment of other instruments which is a matter that deserves further FASB scrutiny and consideration.
- The FASB's deliberative due process ensures that the final outcome will weigh industry considerations with overriding GAAP considerations.

2) The SEC reconsider its position that IRLCs can only be liabilities. At a minimum:

- The SEC acknowledge in the scope that Commercial and Mandatory Residential IRLCs are excluded from the proposed SAB, as they are not written options.
- Additionally, the focus may be best served if it were to narrow the scope to address diversity in practice in accounting for and the valuation of Retail or Best Efforts commitments (should focus on accounting at the inception of the contracts, "day 1" accounting).

## Appendix – IRLC Valuation Example

## Appendix – IRLC Valuation Example

- A. Definition of an Interest Rate Lock Commitment (IRLC)**
- B. IRLC – Rate Break Down**
- C. IRLC - Valuation Example**

*Note: Due to the bilateral contractual nature of mandatory and commercial commitments, we excluded those IRLCs for the purposes of this valuation example.*

## A. Definition of an Interest Rate Lock Commitment (IRLC)

- An interest rate lock commitment represents a lender's agreement to make money available to a borrower within a specified time period at a specified rate for a specified tenor.
- An interest rate lock commitment is a financial instrument, as it is “a contract that both imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity and conveys to that second entity a contractual right to receive cash or another financial instrument from the first entity.”
- In arriving at fair value of financial instruments under SFAS 107, management would first look at quoted market prices, if available, as the best evidence of fair value. If quoted market prices are not available, management's best estimate of fair value might be based on the quoted market price of a financial instrument with similar characteristics, adjusted as appropriate for the effects of tailoring or other differences.

## B. IRLC - Rate Break Down

### **Primary Mortgage Rate (or Note Rate):**

- The interest rate a borrower pays expressed as a percent of the outstanding principal balance.
- This rate is explicitly stated on the borrower's mortgage instrument. For comparative purposes, to adjust for points, fees or discounts, this rate is expressed in terms of annual percentage yield.
- Essentially represents interest rate of the loan underlying the IRLC.

The value of an IRLC is realized in different ways based on different business strategies. Each mortgage banking institution focuses on the best execution strategy for their particular circumstances.

The next slide illustrates a couple of scenarios originators can select, across a few of the broad market choices.

## C. IRLC – Valuation Example

IRLC Valuation: Intangible Discussion						
			Whole Loan Market			
			<u>Servicing Retained</u>	<u>Price</u>	<u>Servicing Released</u>	<u>Price</u>
<b>IRLC Rate (Note Rate)</b>			5.75		5.75	
<b>Note Rate Sold</b>			5.50	99.50%	5.75	100.75%
<b>Valued Retained Interest (IO)</b>			0.25	1.25%	0.00	0.00%
<b>Total IRLC Value</b>				<u>100.75%</u>		<u>100.75%</u>

**IRLCs have the same value regardless of sales strategy.**

# C. IRLC – Valuation Example, *continued*

<b>IRLC Day One 3 Step Valuation Process</b>			
	<u>Customer Pays 2 Pts</u>	<u>Customer Pays 1 Pt</u>	<u>Customer Pays 0 Pts</u>
IRLC Rate	5.50%	5.75%	6.00%
<b>Typical Sales Strategy</b>			
Agency G-Fee	-0.25%	-0.25%	-0.25% Default/Capital Cost
Buy-Down G-Fee		0.25%	Sell into liquid coupon
Retained Interest	<u>-0.25%</u>	<u>-0.25%</u>	<u>-0.25%</u> Required by Agencies
Net Security Rate Sold	<u>5.00%</u>	<u>5.50%</u>	<u>5.50%</u>
<b>Valuation of IRLCs</b>			
<b>Step 1: Value IRLC Rate</b>			
Net Security Price	98.50%	100.50%	100.50% Forward Price/Less Hedge Cost
Buy-Down Paid	0.00%	-1.00%	0.00%
Retained Interest	<u>1.25%</u>	<u>1.25%</u>	<u>1.25%</u>
Value of IRLC Rate	<u>99.75%</u>	<u>100.75%</u>	<u>101.75%</u>
<b>Step 2: Value Other Contractual Cash Flows</b>			
Orig Fees/Points	2.00%	1.00%	0.00% IRLC contractual term
Orig Costs	<u>-1.00%</u>	<u>-1.00%</u>	<u>-1.00%</u> Cost of realizing fees
Net Value	<u>100.75%</u>	<u>100.75%</u>	<u>100.75%</u>
<b>Step 3: Determine Day 1 Value</b>			
Net Value From Step 2	100.75%	100.75%	100.75%
Par	<u>100.00%</u>	<u>100.00%</u>	<u>100.00%</u>
Embedded Margin	<u>0.75%</u>	<u>0.75%</u>	<u>0.75%</u>

Whether and/or how to record the embedded margin on day 1 is the source of diversity in practice.