



## FEDERAL RESERVE BANK OF DALLAS

2200 N. PEARL ST.  
DALLAS, TX 75201-2272

June 9, 2005

**Notice 05-29**

**TO:** The Chief Executive Officer of each  
financial institution and others concerned  
in the Eleventh Federal Reserve District

### **SUBJECT**

**Accounting and Reporting for Commitments  
to Originate and Sell Mortgage Loans**

### **DETAILS**

The Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration have issued an *Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans*. The advisory provides guidance on the appropriate accounting and reporting for both derivative loan commitments and forward loan sales commitments.

### **ATTACHMENTS**

A copy of the Board's SR letter 05-10 and the interagency advisory are attached.

### **MORE INFORMATION**

For more information, please contact Arthur Lindo, Manager, Accounting Disclosure and Policy Section, (202) 452-2695. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at [www.dallasfed.org/banking/notices/index.html](http://www.dallasfed.org/banking/notices/index.html).



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

DIVISION OF BANKING  
SUPERVISION AND  
REGULATION

**SR 05-10**  
**May 3, 2005**

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH  
FEDERAL RESERVE BANK AND TO DOMESTIC AND  
FOREIGN BANKING ORGANIZATIONS SUPERVISED BY  
THE FEDERAL RESERVE

SUBJECT: Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans

The Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration have issued the attached Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans. The advisory provides guidance on the appropriate accounting and reporting for both derivative loan commitments (that is, commitments to originate mortgage loans that will be held for resale) and forward loan sales commitments (that is, commitments to sell mortgage loans). Many institutions have experienced difficulty in reporting derivative loan commitments and forward loan sales commitments, and the Federal Reserve reminds institutions that they are expected to apply Generally Accepted Accounting Principles when accounting for these transactions.

As specified in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, institutions must account for both derivative loan commitments and forward loan sales commitments as derivatives. In addition, the Federal Reserve expects all supervised institutions to follow the related guidance in the SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*.

Reserve Banks are asked to distribute this SR letter and the attached interagency advisory to state member banks, bank holding companies, and foreign banking organizations supervised by the Federal Reserve as well as to supervisory and examination staff. Questions pertaining to this letter should be directed to Arthur Lindo, Manager Accounting Policy & Disclosure Section, (202) 452-2695 or Greg Sierra, Financial Analyst, (202) 872-4972.

Richard Spillenkothen  
Director

**INTERAGENCY ADVISORY ON ACCOUNTING AND REPORTING FOR  
COMMITMENTS TO ORIGINATE AND SELL MORTGAGE LOANS**

**Executive Summary**

This advisory provides supplemental guidance on the appropriate accounting and reporting for commitments to:

- Originate mortgage loans that will be *held for resale*, and
- Sell mortgage loans under mandatory delivery and best efforts contracts.

Commitments to originate mortgage loans that will be held for resale are derivatives and must be accounted for at fair value on the balance sheet by the issuer. All loan sales agreements, including both mandatory delivery and best efforts contracts, must be evaluated to determine whether the agreements meet the definition of a derivative under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (collectively, FAS 133). Institutions should also account for loan sales agreements that meet the definition of a derivative at fair value on the balance sheet.

The advisory discusses the characteristics that should be considered in determining whether mandatory delivery and best efforts contracts are derivatives and the accounting and regulatory reporting treatment for both commitments to originate mortgage loans that will be held for resale and those loan sales agreements that meet the definition of a derivative. The advisory also addresses the guidance that should be considered in determining the fair value of derivatives. A simplified example is included to provide general guidance on one approach that may be used to value commitments to originate mortgage loans that will be held for resale.

The Agencies<sup>1</sup> believe the accounting guidance in this advisory is consistent with generally accepted accounting principles (GAAP). Institutions are expected to apply the guidance in this advisory when preparing their regulatory reports.

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<sup>1</sup> The Agencies are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of Thrift Supervision (OTS).

## Background

The Agencies previously issued instructional clarifications that summarized the reporting requirements for derivatives, including mortgage loan commitments, to assist institutions in properly applying the requirements of FAS 133 when preparing their regulatory reports. Based on the Agencies' review of regulatory reports, it is evident that some institutions are not following the appropriate accounting and reporting for commitments to originate mortgage loans that will be held for resale and agreements to sell mortgage loans. Some commonly noted issues are:

- Including the value of mortgage servicing rights in the value of loan commitments that meet the definition of a derivative;
- Reporting the value of loan sales agreements that meet the definition of a derivative as assets when in fact they were liabilities and vice versa; and
- Failing to report these derivatives and changes in the fair values of the derivatives within their balance sheets and income statements.

Accordingly, this advisory provides additional guidance on the application of FAS 133. In addition, the Agencies expect all institutions, including those that are not required to file reports with the Securities and Exchange Commission (SEC), to follow the guidance in SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments* (SAB 105).

## Definitions

### *Derivative loan commitment*

For the purpose of this advisory, the term "derivative loan commitment" refers to a lender's commitment to originate a mortgage loan that will be held for resale. Notwithstanding the characteristics of a derivative set forth in FAS 133, these commitments to originate mortgage loans *must* be accounted for as derivatives by the issuer under FAS 133 and include, but are not limited to, those commonly referred to as "interest rate lock commitments."

In a derivative loan commitment, the lender agrees to extend credit to a borrower under certain specified terms and conditions in which the interest rate and the maximum amount of the loan<sup>2</sup> are set prior to or at funding. Under the agreement, the lender commits to lend funds to a potential borrower (subject to the lender's approval of the loan) on a fixed or adjustable rate basis, regardless of whether interest rates change in the market, or on a floating rate basis. In a typical derivative loan commitment, the borrower can choose to:

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<sup>2</sup> In accordance with the Background Information and Basis for Conclusions in Statement of Financial Accounting Standards No. 149 (FAS 149), the notional amount of a derivative loan commitment is the maximum amount of the borrowing. See FAS 149, paragraph A27.

- “Lock-in” the current market rate for a fixed-rate loan (i.e., a fixed derivative loan commitment);
- “Lock-in” the current market rate for an adjustable-rate loan that has a specified formula for determining when and how the interest rate will adjust (i.e., an adjustable derivative loan commitment); or
- Wait until a future date to set the interest rate and allow the interest rate to “float” with market interest rates until the rate is set (i.e., a floating derivative loan commitment).

Derivative loan commitments vary in term and expire after a specified time period (e.g., 60 days after the commitment date). Additionally, derivative loan commitments generally do not bind the potential borrower to obtain the loan, nor do they guarantee that the lender will approve the loan once the creditworthiness of the potential borrower has been determined.

#### *Forward loan sales commitment*

For the purpose of this advisory, the term “forward loan sales commitment” refers to either (1) a mandatory delivery contract; or (2) a best efforts contract that, upon evaluation under FAS 133, meets the definition of a derivative.

#### *Mandatory delivery contract*

A mandatory delivery contract is a loan sales agreement in which an institution commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the institution fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor for the shortfall. Variance from the originally committed principal amount is usually permitted, but typically may not exceed 10 percent of the committed amount.

All loan sales agreements must be evaluated to determine whether they meet the definition of a derivative under FAS 133.<sup>3</sup> A mandatory delivery contract has a specified underlying (the contractually specified price for the loans) and notional amount (the committed loan principal amount), and requires little or no initial net investment. Additionally, a mandatory delivery contract requires or permits net settlement or the equivalent thereof as the institution is obligated under the contract to either deliver mortgage loans or pay a pair-off fee (based on the then-current market prices) on any shortfall on the delivery of the committed loan principal amount. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the mortgage loans to be delivered are considered readily convertible to cash.<sup>4</sup> Based on these

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<sup>3</sup> See FAS 133, paragraph 6, for the characteristics of a financial instrument or other contract that meets the definition of a derivative.

<sup>4</sup> See FAS 133, paragraph 57(c)(1), for a description of contracts that have terms that implicitly or explicitly require or permit net settlement.

characteristics, a mandatory delivery contract meets the definition of a derivative at the time an institution enters into the commitment.

### *Best efforts contract*

For the purpose of this advisory, the term “best efforts contract” refers to a loan sales agreement in which an institution commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. Generally, the price the investor will pay the seller for an individual loan is specified prior to the loan being funded (e.g., on the same day the lender commits to lend funds to a potential borrower). A best efforts contract that has *all* of the following characteristics would meet the definition of a derivative:

- An underlying (e.g., the price the investor will pay the seller for an individual loan is specified in the contract);
- A notional amount (e.g., the contract specifies the principal amount of the loan as an exact dollar amount or as a principal range with a determinable maximum amount<sup>5</sup>);
- Requires little or no initial net investment (e.g., no fees are exchanged between the seller and investor upon entering into the agreement or a fee that is similar to a premium on other option-type contracts is exchanged); *and*
- Requires or permits net settlement or the equivalent thereof (For example: the seller is contractually obligated to either deliver the loan to the investor if the loan closes or pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor if the loan closes and is not delivered. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the loan to be delivered is considered readily convertible to cash.).

### *Master agreement*

An institution may enter into one of several types of arrangements with an investor to govern the relationship between the institution and the investor and set the parameters under which the institution will deliver individual mortgage loans through separate best efforts contracts. Such an arrangement might include, for example, a “master agreement” or an “umbrella contract.” These arrangements may specify an overall maximum principal amount of mortgage loans that the institution may deliver to the investor during a specified time period, but generally they do not specify the price the investor will pay for individual loans. Further, while these arrangements may include “pair-off” fee provisions for loans to be sold under individual best efforts contracts covered by the arrangements, the seller is neither contractually obligated to deliver the amount of mortgages necessary to fulfill the maximum principal amount specified in the arrangement nor required to pay a “pair-off” fee on any shortfall. Because these arrangements generally either do

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<sup>5</sup> The use of a maximum amount as the notional amount of a best efforts contract is consistent with the loan commitment discussion in the Background Information and Basis for Conclusions in FAS 149. See FAS 149, paragraph A27.

not have a specified underlying or determinable notional amount or do not require or permit net settlement or the equivalent thereof, the arrangements typically do not meet the definition of a derivative. As discussed above, an individual best efforts contract governed by one of these arrangements may, however, meet the definition of a derivative.

As the terms of individual best efforts contracts and “master agreements” or “umbrella contracts” vary, institutions must carefully evaluate such contracts to determine whether the contracts meet the definition of a derivative in FAS 133.

## **Accounting and Reporting**

### *Accounting policies*

Well-managed institutions have written and consistently applied accounting policies for commitments to originate mortgage loans that will be held for resale and to sell mortgage loans under mandatory delivery and best efforts contracts, including approved valuation methodologies and procedures to formally approve changes to those methodologies. The methodologies should be reasonable, objectively supported, and fully documented. Procedural discipline and consistency are key concepts in any valuation measurement technique. Institutions should ensure that internal controls, including effective independent review or audit, are in place to provide integrity to the valuation process. Therefore, institutions’ practices should reflect these concepts to ensure the reliability of their valuations of derivative loan commitments and forward loan sales commitments.

### *Derivative loan commitments*

Institutions should account for derivative loan commitments at fair value on the balance sheet, regardless of the manner in which the intended sale of the mortgage loans will be executed (e.g., under a best efforts contract, a mandatory delivery contract, or the institution’s own securitization). Institutions should report each fixed, adjustable, and floating derivative loan commitment as an “other asset” or an “other liability” in their regulatory reports based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.<sup>6</sup>

With respect to floating derivative loan commitments, because the interest rate on such a commitment “floats” on a daily basis with market interest rates, the fair value of a floating

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<sup>6</sup> In preparing Reports of Condition and Income (Call Reports), fixed, adjustable, and floating derivative loan commitments should not be reported as unused commitments in Schedule RC-L, Derivatives and Off-Balance Sheet Items, because these commitments must be reported as derivatives in this schedule.

In preparing NCUA 5300 Call Reports (5300 Call Reports), fixed, adjustable, and floating derivative loan commitments should not be reported as unused commitments on Schedule G, Off-Balance Sheet Commitments and Contingent Assets and Liabilities (instead, refer to instructions, page 1a, line 13).

For Thrift Financial Report (TFR) purposes, fixed, adjustable, and floating derivative loan commitments should be included when reporting outstanding commitments in Schedule CC, Consolidated Commitments and Contingencies. For Schedule CMR, Consolidated Maturity/Rate, refer to the instructions as various types of derivative loan commitments have differing reporting guidelines.

derivative loan commitment approximates zero as long as the creditworthiness of the borrower has not changed. However, as with other derivative loan commitments, institutions must report the entire gross notional amount of floating derivative loan commitments in their regulatory reports.

Commitments to originate mortgage loans that will be held for investment purposes and commitments to originate other types of loans are not within the scope of FAS 133 and, therefore, are not accounted for as derivatives.<sup>7</sup> Institutions should report the unused portion of these types of commitments, which are *not* considered derivatives, as “unused commitments” in their regulatory reports.

#### *Forward loan sales commitments*

Institutions should account for forward loan sales commitments for mortgage loans as derivatives at fair value on the balance sheet. Each forward loan sales commitment should be reported as an “other asset” or an “other liability” based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.<sup>8</sup>

#### *Netting of contracts*

For balance sheet presentation purposes,<sup>9</sup> institutions may not offset derivatives with negative fair values (liabilities) against those with positive fair values (assets), unless the criteria for “netting” under GAAP have been satisfied.<sup>10</sup> In addition, institutions may not offset the fair value of forward loan sales commitments against the fair value of derivative loan commitments (the pipeline) or mortgage loans held for sale (warehouse loans). Rather, forward loan sales commitments must be accounted for separately at fair value, and warehouse loans must be accounted for at the lower of cost or fair value (commonly referred to as “LOCOM”),<sup>11</sup> with certain adjustments to the cost basis of the loans if hedge accounting is applied.

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<sup>7</sup> See FAS 133, paragraph 10(i).

<sup>8</sup> Regardless of whether the underlying mortgage loans will be held for investment or for resale, commitments to purchase mortgage loans from third parties under either mandatory delivery contracts or best efforts contracts are derivatives if, upon evaluation, the contracts meet the definition of a derivative under FAS 133. Institutions should report loan purchase commitments that meet the definition of a derivative at fair value on the balance sheet.

<sup>9</sup> FAS 133 does not provide specific guidance on financial statement presentation (i.e., where the fair value of derivatives or the changes in the fair value of derivatives should be classified).

<sup>10</sup> When an institution has two (or more) derivatives with the same counterparty, contracts with positive fair values and negative fair values may be netted if the conditions set forth in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39), are met. Those conditions are as follows: 1) each of the parties owes the other determinable amounts; 2) the reporting party has the right to set off the amount owed with the amount owed by the other party; 3) the reporting party intends to set off; and 4) the right of setoff is enforceable at law. In addition, without regard to the third condition, fair value amounts recognized for derivative contracts executed with the same counterparty under a master netting arrangement may be offset.

<sup>11</sup> See Statement of Financial Accounting Standards No. 65, *Accounting for Certain Mortgage Banking Activities* (FAS 65), paragraph 4.



### *Hedge accounting*

Institutions should follow the guidance in FAS 133 when applying hedge accounting to their mortgage banking activities. If the FAS 133 qualifying criteria are met, institutions may apply:

- Fair value hedge accounting in a hedging relationship between forward loan sales commitments (hedging instrument) and fixed-rate warehouse loans (hedged item), or
- Cash flow hedge accounting in a hedging relationship between forward loan sales commitments (hedging instrument) and the forecasted sale of the warehouse loans and/or the loans to be originated under derivative loan commitments (forecasted transaction).<sup>12</sup>

If an institution does not apply hedge accounting, either because the FAS 133 hedge criteria are not met or the institution chooses not to apply hedge accounting, forward loan sales commitments should be treated as nonhedging derivatives. If an institution does not apply hedge accounting, the institution will account for its warehouse loans at the lower of cost or fair value. Because nonhedging forward loan sales commitments are accounted for at fair value through earnings, such an approach causes volatility in reported earnings if the fair value of the warehouse loans increases above their cost basis. In this situation, the volatility is a result of recognizing the full amount of any decline in the fair value of the forward loan sales commitments in earnings while not adjusting the carrying amount of the warehouse loans above their cost basis.

### *Income statement effect*

Unless cash flow hedge accounting is applied, institutions should include the periodic changes in the fair value of derivative loan commitments and forward loan sales commitments in current period earnings. Institutions should report these changes in fair value in either “other noninterest income” or “other noninterest expense,” but not as trading revenue, in their regulatory reports. However, an institution’s decision on whether to report the changes in fair value in its regulatory reports in an income or expense line item should be consistent with its presentation of these changes in its general-purpose external financial statements (including audited financial statements)<sup>13</sup> and should be consistent from period to period.

## **Valuation**

### *Fair value*

FAS 133 indicates that the guidance in Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107), should be followed in

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<sup>12</sup> See FAS 133, paragraphs 20–21, and related FAS 133 guidance for hedging instruments, hedged items, and forecasted transactions that qualify for fair value and cash flow hedge accounting.

<sup>13</sup> See footnote 9 above.

determining the fair value of derivatives.<sup>14</sup> That guidance provides that quoted market prices are the best evidence of the fair value of financial instruments. However, when quoted market prices are not available, which is typically the case for derivative loan commitments and forward loan sales commitments, estimates of fair value should be based on the best information available in the circumstances (e.g., valuation techniques based on estimated expected future cash flows). When expected future cash flows are used, they should be the institution's best estimate based on reasonable and supportable assumptions and projections.

Estimates of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. In the absence of (a) quoted market prices in an active market, (b) observable prices of other current market transactions, or (c) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of an arrangement.

An institution should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data.<sup>15</sup> Based on this guidance, derivative loan commitments generally would have a zero fair value at inception.<sup>16</sup> However, subsequent changes in the fair value of a derivative loan commitment must be recognized in financial statements and regulatory reports (e.g., changes in fair value attributable to changes in market interest rates).

When estimating the fair value of derivative loan commitments and those best efforts contracts that meet the definition of a derivative, institutions should consider predicted "pull-through" (or, conversely, "fallout") rates. A pull-through rate is the probability that a derivative loan commitment will ultimately result in an originated loan. Some factors that may be considered in arriving at appropriate pull-through rates include (but are not limited to) the origination channel [which may be either internal (retail) or external (wholesale or correspondent, to the extent the institution rather than the correspondent closes the loan<sup>17</sup>)], current mortgage interest rates in the market versus the interest rate incorporated in the derivative loan commitment, the purpose of the mortgage (purchase versus refinancing), the stage of completion of the underlying application and underwriting process, and the time remaining until the expiration of the

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<sup>14</sup> See FAS 133, paragraph 17.

<sup>15</sup> See footnote 3 in Emerging Issues Task Force Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (EITF 02-3).

<sup>16</sup> If a potential borrower pays the lender a fee upon entering into a derivative loan commitment (e.g., a rate lock fee), there is a transaction price, and the lender should recognize the derivative loan commitment as a liability at inception at an amount equal to the fee charged to the potential borrower.

<sup>17</sup> If an institution commits to purchase a loan that will be closed by a correspondent in the correspondent's name, the institution would have a loan purchase commitment rather than a derivative loan commitment. Refer to footnote 8.

derivative loan commitment. Estimates of pull-through rates should be based on historical information for each type of loan product adjusted for potential changes in market interest rates that may affect the percentage of loans that will close. Institutions should not consider the pull-through rate when reporting the notional amount of derivative loan commitments in regulatory reports but, rather, must report the entire gross notional amount.

### *SAB 105*

In March 2004, the SEC issued SAB 105 to provide guidance on the proper accounting and disclosures for derivative loan commitments. SAB 105 is effective for derivative loan commitments entered into after March 31, 2004. SAB 105 indicates that the expected future cash flows related to the associated servicing of loans should not be considered in recognizing derivative loan commitments. Incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. Servicing assets should only be recognized when the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.<sup>18</sup> Further, no other internally-developed intangible assets (such as customer relationship intangible assets) should be recognized as part of derivative loan commitments. Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a derivative loan commitment either individually, in a portfolio, or in a business combination).

### **Standard-Setter Activities**

Institutions should be aware that the SEC or the Financial Accounting Standards Board (FASB) may issue additional fair value, measurement, or recognition guidance in the future (e.g., the FASB currently expects to issue a Fair Value Measurement statement in the third quarter of 2005). To the extent additional guidance is issued, institutions must also consider such guidance in developing fair value estimate methodologies for derivative loan commitments and forward loan sales commitments as well as measuring and recognizing such derivatives.

### **Changes in Accounting for Derivative Loan Commitments and Loan Sales Agreements**

Institutions should follow Accounting Principles Board Opinion No. 20, *Accounting Changes* (APB 20), if a change in their accounting for derivative loan commitments, best efforts contracts, or mandatory delivery contracts is necessary. APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states, “[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.”

For regulatory reporting purposes, an institution must determine whether the reason for a change in its accounting meets the APB 20 definition of an accounting error. If the reason for the change meets this definition, the error should be reported as a prior period adjustment if the

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<sup>18</sup> See Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, paragraph 61.

amount is material. Otherwise, the effect of the correction of the error should be reported in current earnings.

If the effect of the correction of the error is material, the institution should also consult with its primary federal regulatory agency to determine whether any of its prior regulatory reports should be amended. If amended regulatory reports are not required, the institution should report the effect of the correction of the error on prior years' earnings, net of applicable taxes, as an adjustment to the previously reported beginning balance of equity capital. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, Item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," with an explanation in Schedule RI-E, Item 4. On the 5300 Call Report, the credit union should report the adjustment directly to undivided earnings in the Statement of Financial Condition. For the TFR, the institution should report the amount in Schedule SI, Line SI668, "Prior period adjustments."

The effect of the correction of the error on income and expenses since the beginning of the year in which the error is corrected should be reflected in each affected income and expense account on a year-to-date basis beginning in the next quarterly Income Statement (Call Report), Income and Expense schedule (5300 Call Report), or Consolidated Statement of Operations (TFR) to be filed and not as a direct adjustment to retained earnings.

### **Summary**

The Agencies expect institutions to account for and report derivative loan commitments and forward loan sales commitments as derivatives in accordance with GAAP, which includes the use of valuation techniques that are reasonable and supportable in the determination of fair value. An institution's failure to account for and report derivative loan commitments and forward loan sales commitments in regulatory reports in accordance with GAAP may be an unsafe and unsound practice.

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**Example<sup>19</sup>**  
**ABC Mortgage Institution**  
**(Best efforts contracts and no application of fair value hedge accounting)**

The Agencies developed this simplified example to provide an institution that has a limited number of derivative loan commitments general guidance on one approach that may be used to value such commitments.<sup>20</sup> This example also illustrates the regulatory reporting requirements for derivative loan commitments and forward loan sales commitments.

The guidance in this example is for illustrative purposes only as there are several ways that an institution might estimate the fair value of its derivative loan commitments. A second approach to valuing derivative loan commitments is described in *Derivative Loan Commitments Task Force Illustrative Disclosures on Derivative Loan Commitments*, a practice aid developed by staff of the American Institute of Certified Public Accountants (AICPA) and a task force comprising representatives from the financial services, mortgage banking, and public accounting communities.<sup>21</sup> As indicated in the body of the interagency advisory, an institution must consider the guidance in FAS 133, FAS 107, EITF 02-3, and SAB 105 in measuring and recognizing derivative loan commitments and forward loan sales commitments. In addition, institutions should be aware that the SEC or the FASB may issue additional guidance in the future that may alter certain aspects of this example.

## **Background**

ABC Mortgage Institution (ABC) enters into fixed, adjustable, and floating derivative loan commitments to originate mortgage loans that it intends to sell. The institution accounts for the commitments as derivative financial instruments as required under FAS 133.

ABC enters into best efforts contracts with a mortgage investor under which it commits to deliver certain loans that it expects to originate under derivative loan commitments (i.e., the pipeline) and loans that it has already originated and currently holds for sale (i.e., warehouse loans). ABC and the mortgage investor agree on the price that the investor will pay ABC for an individual loan with a specified principal amount prior to the loan being funded. Once the price that the mortgage investor will pay ABC for an individual loan and the notional amount of the loan are specified, and ABC is obligated to deliver the loan to the investor if the loan closes, the contract represents a forward loan sales commitment. Under FAS 133, ABC accounts for these forward loan sales commitments as derivative financial instruments.

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<sup>19</sup> This example uses the definitions and concepts presented in the body of the “Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans” (interagency advisory). Reference should be made to the interagency advisory for clarification of the terms and concepts used in this example.

<sup>20</sup> Estimating fair values when quoted market prices are unavailable requires considerable judgment. Valuation techniques using simplified assumptions may sometimes be used (with appropriate disclosure in the financial statements) to provide a reliable estimate of fair value at a reasonable cost. See FAS 107, paragraphs 60–61.

<sup>21</sup> The practice aid is available at [www.aicpa.org/download/members/div/acctstd/Illustrative\\_Disclosure\\_on\\_Derivative\\_Loan\\_Commitments.pdf](http://www.aicpa.org/download/members/div/acctstd/Illustrative_Disclosure_on_Derivative_Loan_Commitments.pdf)

At December 31 of a given year, the notional amounts of ABC's mortgage banking derivative loan commitments and forward loan sales commitments are as follows:

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Table 1. Notional Amounts of Derivative Loan Commitments and Forward Loan Sales Commitments.

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	<u>Notional Amount</u>	
Derivative loan commitments:		
Fixed-rate commitments	\$ 8,500,000	
Adjustable-rate commitments	1,500,000	
Floating-rate commitments	<u>2,000,000</u>	
Total derivative loan commitments	<u>\$12,000,000</u>	[A] <sup>22</sup>
Forward loan sales commitments:		
Pipeline loan commitments	\$12,000,000	
Warehouse loan commitments	<u>8,000,000</u>	
Total forward loan sales commitments	<u>\$20,000,000</u>	[B]

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Market interest rates have changed throughout the time period that ABC's derivative loan commitments and forward loan sales commitments have been outstanding. Some of the fixed-rate commitments are at rates above current market rates while others are at rates at or below current market rates. All of ABC's adjustable-rate commitments are at rates below current market rates.

Based on its past experience, ABC estimates a pull-through rate of 70 percent on its fixed-rate commitments for which the locked-in rate is above current market rates (i.e., 70 percent of the commitments will actually result in loan originations) and a pull-through rate of 85 percent for its fixed-rate commitments for which the locked-in rate is at or below current market rates. ABC also estimates a pull-through rate of 85 percent for all of its adjustable-rate commitments that are below market rates.

The pull-through rate assumptions in this example have been simplified for illustrative purposes. In determining appropriate pull-through rates, institutions must consider all factors that affect the probability that derivative loan commitments will ultimately result in originated loans. Therefore, institutions are expected to have more granularity (i.e., stratification) in their application of pull-through rate assumptions to their derivative loan commitments.

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<sup>22</sup> Alpha references in Table 1 and the text of this example refer to the "Reference" column in Table 3.

## Discussion of ABC's Approach to Valuing Derivative Loan Commitments and Forward Loan Sales Commitments

ABC estimates the fair value of its derivative loan commitments using the best information available in the circumstances because quoted market prices are not available. In this case, ABC uses valuation techniques that take into account current secondary market loan pricing information.<sup>23</sup> ABC had noted the appropriate reference price for the underlying loans on the day that each derivative loan commitment was given to a borrower and assigned an initial fair value of zero to each loan commitment consistent with the guidance in SAB 105 and EITF 02-3. At the end of the month, ABC compares the current reference price of each underlying loan with its initial reference price and calculates the price difference. ABC then calculates the fair value of these derivatives by multiplying the price difference by the estimated pull-through rate. This approach is illustrated in Table 2 below.

Table 2. ABC's Calculation of the Fair Value of Derivative Loan Commitments:  
An Example of a Fixed Derivative Loan Commitment for which the  
Locked-In Rate Is above the Current Market Rate\*

<b>Notional Amount of Loan</b>	<b>Initial Reference Price of Loan To Be Originated Under Commitment — Excluding Servicing Rights</b>	<b>Current Reference Price of Loan To Be Originated Under Commitment — Excluding Servicing Rights</b>	<b>Price Difference</b>	<b>Pull-Through Rate</b>	<b>Fair Value of Derivative Loan Commitment</b>
(1)	(2)	(3)	[(3) - (2)]	(4)	[(3)-(2)] × (4)
\$100,000	\$100,000	\$100,500	\$500	70%	\$350

\* The example in this table presents the fair value calculation for one derivative loan commitment. The fair value of this derivative, which is positive, would be added to all the other derivative loan commitments with positive fair values. Netting derivatives with positive fair values (assets) against derivatives with negative fair values (liabilities) is not permitted unless the conditions stipulated in FIN 39 are met. Refer to footnote 10 of the interagency advisory.

As illustrated in Table 2, ABC excludes time value from its fair value estimate methodology due to the short-term nature of the derivative loan commitments. As the exclusion of time value is not appropriate for all fair value estimates, an institution must consider the terms of its specific agreements in determining an appropriate estimation methodology.

In the example in Table 2, ABC estimated the initial reference price of the underlying loan to be originated under the commitment, excluding the value of the associated servicing rights, to be \$100,000. That is, at the date it entered into the fixed derivative loan commitment with the

<sup>23</sup> In general, source data for secondary market loan pricing information may include, for example, quotations from rate sheets; brokers; or electronic systems such as those provided by third-party vendors, market makers, or mortgage loan investors. When secondary market loan pricing information that includes the value of servicing rights is used, the fair value of the derivative loan commitments ultimately must exclude any value attributable to servicing rights.

borrower, ABC estimated it would receive \$100,000, excluding the value of the associated servicing rights, if the underlying loan was funded and sold in the secondary market on that day. Because this amount is equal to the notional amount of the loan, ABC would not experience a gain or loss on the sale of the underlying loan (before considering the effect of the loan origination fees and costs associated with the loan). As such, the fair value of this derivative loan commitment would be zero, and there would not be any unrealized gain or loss at the inception of the derivative loan commitment. This may not be true for all derivative loan commitments.

ABC defers all unrealized gains and losses at the inception of its derivative loan commitments until the underlying loans are sold. ABC's policy is based on the short-term nature of its derivative loan commitments and was adopted in order to not accelerate the timing of gain recognition. As this practice may not be appropriate for all derivative loan commitments or other derivatives initially accounted for under EITF 02-3 and due to the lack of authoritative guidance in this area, institutions should consult with their accounting advisors concerning the appropriate accounting for their specific agreements.

After applying the methodology described above to individual derivative loan commitments, ABC aggregates the fair values of the derivative loan commitments by type (i.e., fixed, adjustable, and floating) and by whether the commitments have above, at, or below market rates. The fair values of the fixed derivative loan commitments with above market rates, adjusted for the appropriate pull-through rate, total \$21,000 [C], which represents an asset. The aggregate fair value of the fixed derivative loan commitments that have at or below market rates, adjusted for the appropriate pull-through rate, sums to (\$31,000) [D], which represents a liability. For the adjustable derivative loan commitments, the aggregate fair value, adjusted for the pull-through rate, is approximately (\$2,000) [E], which is also a liability. The fair value of the floating derivative loan commitments approximates zero.

ABC also estimates the fair value of its forward loan sales commitments outstanding at the end of the month using a similar methodology as that described above. Based upon this information, ABC determines that the estimated fair value of the forward loan sales commitments related to its derivative loan commitments and warehouse loans with above market rates is approximately (\$45,000) [F], which represents a liability, because current market interest rates for comparable mortgage loans are lower than the rates in effect when the derivative loan commitments were initiated. (Consequently, current offered delivery prices for similar commitments are greater than the delivery prices of ABC's existing forward loan sales commitments. Therefore, the change in the fair value of ABC's forward loan sales commitments since they were entered into represents a loss.) The fair value of ABC's forward loan sales commitments related to its derivative loan commitments and warehouse loans with at or below market rates is estimated to be \$50,000 [G], which is an asset.<sup>24</sup>

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<sup>24</sup> The absolute value of the fair value of the forward loan sales commitments is greater than the absolute value of the fair value of the related derivative loan commitments because the forward loan sales commitments also apply to, and act as an economic hedge of, ABC's warehouse loans. ABC accounts for its warehouse loans at the lower of cost or fair value in accordance with FAS 65. In this example, ABC does not apply hedge accounting to its warehouse loans.



## Regulatory Reporting

The following table illustrates the regulatory reporting requirements for the derivative-related dollar amounts cited in the example.

Table 3. Regulatory Reporting Implications for Derivative Loan Commitments and Forward Loan Sales Commitments.

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### **Regulatory Reporting Implications: Derivative loan commitments**

	<b>Amount</b>	<b>Reference</b>
Notional amount of “Over-the-counter written options” <sup>25</sup>	\$12,000,000	[A]
Derivatives with a <i>positive</i> fair value held for purposes other than trading (asset)	\$21,000	[C]
Derivatives with a <i>negative</i> fair value held for purposes other than trading (liability)	\$33,000	[D+E]

### **Regulatory Reporting Implications: Forward loan sales commitments**

	<b>Amount</b>	<b>Reference</b>
Notional amount of “Forward contracts”	\$20,000,000	[B]
Derivatives with a <i>positive</i> fair value held for purposes other than trading (asset)	\$50,000	[G]
Derivatives with a <i>negative</i> fair value held for purposes other than trading (liability)	\$45,000	[F]

### **Regulatory Reporting Implication: Derivative loan commitments and forward loan sales commitments**

	<b>Amount</b>	<b>Reference</b>
Total notional amount of derivative contracts held for purposes other than trading	\$32,000,000	[A+B]

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As illustrated in Table 3, depending upon particular market circumstances, individual derivative loan commitments and forward loan sales commitments may have either positive or negative fair values, which ABC properly reports gross as assets or liabilities on its balance sheet. In addition, for regulatory reporting purposes, ABC consistently reports the periodic *changes* in the fair value of its derivative contracts in “other noninterest expense” in its income statement. Alternatively, ABC could have chosen to consistently report these fair value changes in “other noninterest income” in its regulatory reports.

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<sup>25</sup> Because derivative loan commitments are in certain respects similar to options, they are reported with “Over-the-counter written options” for regulatory reporting purposes.