# ACCOUNTING FOR UNDERWRITING AND LOAN COMMITMENTS

## Objective

The objective of this paper is to discuss existing generally accepted accounting principles (GAAP) associated with commitments to lend money or underwrite securities in the context of illiquid (or less liquid) market conditions that currently exist in many segments of the credit markets. The paper articulates certain existing accounting practices and requirements of GAAP literature related to the specific issues discussed, with the intention of helping preparers and auditors understand the application of existing GAAP in the context of illiquid market conditions.

## Background

Companies may enter into commitments to lend money or underwrite securities. In the current credit environment, some of these commitments to underwrite securities or make loans may result in the issuance of securities or funding of loans that at the time of purchase or funding are off-market – that is, not at an interest rate that reflects the current market rate at the time of purchase or funding absent the commitment.[1]

## Issues

1. How should companies with commitments (forward contracts) to underwrite securities account for any deterioration in the fair value of the commitments prior to purchase of the underlying securities?

2. How should companies account for any deterioration in the value of the loan commitments (due to both interest-rate risk and credit risk) prior to funding loans that are not debt securities?

## Accounting Literature

EITF Issue 96-11, *Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FAS 115*

FAS 5, *Accounting for Contingencies*

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[1] The scope of this paper is limited to accounting for commitments related to underwriting of the initial issuance of debt securities and the origination of loans. It does not include in its scope a commitment to purchase loans or debt securities. Guidance on the accounting for certain existing loans or debt securities acquired in a transfer that have experienced a decline in credit quality since origination is provided in AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer.*

SOP 01-06, *Accounting by Certain Entities (Including Entities with Trade Receivables) that Lend to or Finance the Activities of Others*

SFAS 65, *Accounting for Certain Mortgage Banking Activities*

SFAS 133, *Accounting for Derivative Instruments and Hedging Activities (as amended)*

SAB 105, *Application of Accounting Principles to Loan Commitments*

FAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

AICPA Audit and Accounting Guide, *Depository and Lending Institutions*

AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*

**Analysis**

Issue 1: Commitments to Underwrite Securities

Forward contracts to underwrite securities that will be accounted for by the entity under FAS 115 are covered by EITF Issue 96-11, Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FAS 115. In EITF Issue 96-11, the Task Force reached a consensus that forward contracts to purchase securities that will be accounted for under FAS 115 should, at inception, be designated as held-to-maturity, available-for-sale, or trading and accounted for in a manner consistent with the accounting prescribed by FAS 115 for that category of securities.

*Held-to-Maturity*

Changes in fair value of the forward contract would not be recognized unless a decline in the fair value of the underlying securities is other than temporary, in which case a loss would be recognized in earnings.

*Available-for-Sale*

Changes in the fair value of the forward contract would be recognized in other comprehensive income. However, if a decline in the fair value is considered other-than-temporary, the decline would be recognized as an impairment charge in earnings. If an entity does not have the intent and ability to hold the securities until recovery, or if the entity intends to sell the securities, declines in value would be considered other-than-temporary.

*Trading*

Changes in the fair value of the forward contract would be recognized in earnings as they occur.

*Derivatives*

Forward contracts that are derivatives subject to FAS 133 should be recognized as assets or liabilities and measured at fair value. Paragraph 18 of FAS 133 addresses the accounting for changes in the fair value of a derivative.

Issue 2: Commitments to Fund Loans that Are Not Debt Securities

Companies must assess their loan commitments to fund loans that are not debt securities based on whether, 1) the commitment would be considered a derivative under FAS 133 and SAB 105, 2) the company has early adopted FAS 159 and elected to account for loan commitments at fair value, 3) the company applies industry-specific accounting guidance that requires financial instruments to be accounted for at fair value, 4) the company intends to sell the loan upon funding the commitment, or 5) the company has the intent and ability to hold the loan, when funded, for investment in its loan portfolio.

*Commitments that are derivatives*

Paragraph 10(i) of FAS 133, as amended, indicates that issuers of commitments to originate (1) mortgage loans that will be held for investment purposes or (2) other types of loans (i.e., other than mortgage loans) are not subject to the requirements of FAS 133. However, as discussed in paragraph A33 of FAS 149, the Board concluded that commitments to originate mortgage loans that will be held for resale should be accounted for by issuers as derivatives under FAS 133. Accordingly, a lender’s intent with respect to mortgage loans and the related commitments is important to the accounting analysis under FAS 133.

Commitments to originate mortgage loans that will be held for resale should be recorded on the balance sheet at fair value with changes in fair value recorded in earnings.[2] Under FAS 133, both interest-rate risk and credit risk would be considered in recording the derivative loan commitment at fair value.

*Commitments accounted for under the fair value option*

Paragraph 7(c) of FAS 159 allows companies to elect the fair value option for written loan commitments. Thus, an entity could elect to account for those loan commitments that are not required to be accounted for as derivatives under FAS 133, at fair value with changes in fair value recorded in earnings. Under FAS 159, both interest-rate risk and credit risk would be considered in recording the commitment at fair value.

*Commitments accounted for under industry-specific accounting guidance*

Companies may have industry-specific accounting guidance that indicates financial instruments, such as loan commitments, should be accounted for at fair value. For example, a broker-dealer must account for all of its lending commitments at fair value based on the guidance in the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*. In applying the guidance in this industry guide, both interest-rate risk and credit risk would be considered in recording all loan commitments at fair value.

[2] Note, however, that pursuant to SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*, future cash flows related to servicing or other internally-generated intangible assets should be excluded from the fair value to arrive at the fair value of the loan commitment.

*Intention to sell the loan upon funding the commitment*

A company's intent becomes important in determining the appropriate accounting for loan commitments not specifically addressed by the preceding discussion because the applicable accounting considerations, whether under broad principles (e.g., FAS 5) or more specific accounting guidance used by analogy (e.g., EITF Issue No. 96-11), would require a company to consider its intent to either sell or hold the loan after origination.

There are two acceptable accounting policy alternatives for how a company should account for loan commitments that (1) are not accounted for at fair value under FAS 133, FAS 159, or industry-specific accounting guidance and ~~(2~~) relate to loans that the company intends to hold for sale.

*Alternative A*

Consistent with the accounting for a funded loan under FAS 65 and SOP 01-06, companies may account for a loan commitment that meets both of the criteria above using a lower of cost or fair value model ("LOCOM") by analogy to EITF Issue No. 96-11 if it intends to hold the loan for sale upon its funding. The LOCOM model can also be supported by analogy to a 1999 speech by Pascal Desroches of the SEC's Office of the Chief Accountant. By analogy to the staff's guidance related to written options, the writer of the loan commitment would record any declines in fair value through earnings.

Under the LOCOM model, the terms of the committed loan should be compared to current market terms and, if those terms are below market, a loss should be recorded to reflect the current fair value of the commitment. Both interest-rate risk and credit risk would be considered in measuring the fair value (i.e., "exit price") of the commitment. The loss would be recorded in the income statement separate from the provision for credit losses, and a liability would be recorded on the balance sheet separate from the allowance for credit losses.

*Alternative B*

Alternatively, companies may account for contingent losses on loan commitments under FAS 5 if the loss is probable and reasonably estimable. Under the FAS 5 approach, if a company intends to hold the funded loan for sale, it should consider its intent to sell for purposes of assessing whether a loss is probable, as well as for measuring the amount of loss to be recognized. For example, if it is probable that a loss has been incurred on a loan commitment (because it is probable that the loan will be funded under the terms of the commitment and then held for sale at a loss), then companies generally should measure the loss under FAS 5 based on the current fair value of the commitment. Both interest-rate risk and credit risk would be considered in measuring the fair value (i.e., "exit price") of the commitment. The loss would be recorded in the income statement separate from the provision for credit losses, and a liability would be recorded on the balance sheet separate from the allowance for credit losses. Companies should consider all relevant facts and circumstances to determine whether a loss is probable, including the probability of funding the loan under the existing terms of the commitment.

The premise under both Alternative A and Alternative B is that it is inappropriate to delay recognition of a loss related to declines in the fair value of a loan commitment until the date a loan is funded and classified as held for sale. If it is probable that a loss has been incurred because it is probable that an existing loan commitment will be funded and the loan will be sold at a loss, then the loss on that commitment should be recognized in earnings.

*Loan to be held for investment*

Loan commitments that (1) are not accounted for at fair value under FAS 133, FAS 159, or industry-specific accounting guidance and (2) relate to loans that a company intends to hold for investment (i.e., for the foreseeable future) should be evaluated for possible credit impairment in accordance with FAS 5 and other relevant guidance. Loans that the company intends to hold only "until the market recovers" would not be considered held for investment.

Guidance on accounting for credit losses on commitments includes:

- Paragraph 8(e) of SOP 01-06 indicates that an accrual for credit losses on a financial instrument with off-balance-sheet risk should be recorded separate from a valuation account related to a recognized financial instrument.
- Paragraph 9.35 of the AICPA Audit and Accounting Guide, *Depository and Lending Institutions*, indicates that credit losses related to off-balance-sheet instruments should also be accrued and reported separately as liabilities if the conditions of FAS 5 are met.
- Page 60 of the November 30, 2006, Current Accounting and Disclosure Issues in the Division of Corporation Finance indicates that credit loss provisions on other types of balance sheet and off-balance sheet items that do not affect net interest income should not be included in the provision for loan losses.
- Questions 1 and 4 in Section 2C of the Office of the Comptroller of the Currency's Bank Accounting Advisory Series discuss losses on off-balance sheet commitments and specifically references a bank's estimate of credit losses on such commitments.

If it is probable that a company has incurred a loss, and the amount of loss is reasonably estimable, the loss should be recorded in the income statement separate from the provision for credit losses and a liability should be recorded separately from the allowance for credit losses.

*Changes in Intent*

If a company enters into a commitment with the intention to hold the funded loan for sale, it should account for that commitment under Alternative A or Alternative B (pursuant to a consistently followed accounting policy) described above. If the company subsequently changes its assertion to an intent to hold a loan for investment, it should apply its accounting under Alternative A or B through the date that its intent changed, including recording any loss that would required under Alternative A or B immediately prior to the change in intent; the company should *not* reverse any loss recognized under Alternatives A or B.