Statutory Issue Paper No. 37

Mortgage Loans

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 37

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance requires mortgage loans to be recorded on a reporting entity's balance sheet at the unpaid principal balance plus any unamortized premium or origination fees or less any unaccreted discount. The carrying value of loans that are in default may be adjusted for unpaid interest and additional expenses incurred to protect the investment, providing that such amounts are deemed to be recoverable from the ultimate disposition of the asset. Costs to acquire or originate mortgage loans are expensed as incurred. Origination fees, including points, are deferred.

the life of the loan in accordance with paragraph 8 of this issue paper. Nonrefundable fees other than points shall be recorded in the income statement upon receipt.

Loan Origination, Acquisition, and Commitment Costs

6. All costs incurred in connection with originating a loan, acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Commitment Fees

7. Commitment (or commitment standby) fees are fees paid to the reporting entity that obligate the reporting entity to make or acquire a loan or to satisfy an obligation of another party under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan is granted. If the loan is not granted, then the fees shall be recorded as investment income by the reporting entity when the commitment is no longer available. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 8 of this issue paper over the life of the loan as an adjustment to the investment income on th

Accrued Interest

12. When a loan is determined to be in default (per the contractual terms of the loan), the accrued interest on the loan shall be recorded as investment income due and accrued if deemed collectible. If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued.

Impairments

13. A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. According to the contractual terms means that both the contractual principal payments and contractual interest payments of the mortgage loan will be collected as scheduled in the mortgage agreement. A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to unrealized gain or loss. Subsequent to the initial measurement of the impairment, if there is a significant change (increase or decrease) in the net value of the collateral, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. For reporting entities required to maintain an asset valuation reserve (AVR), the unrealized gain or loss on impairments shall be included in the calculation of the AVR. If the impairment is other than temporary, a direct write down shall be recognized as a realized loss, and a new cost basis is established. This new cost basis shall not be changed for subsequent recoveries in value. Mortgage loans for which foreclosure is probable shall be considered permanently impaired.

Construction Loans

14. A construction loan shall be defined as a mortgage loan of less than three years in term, made for financing the cost of construction of a building or other improvement to real estate, which is secured by the real estate. The principal amount of a construction loan shall be the amount of funds disbursed to the borrower. If, in accordance with the terms of the contract, interest is deferred until the maturity of the loan, the accrued interest shall be included in the balance of the loan outstanding. The impairment test in paragraph 13 should be applied to all construction loans, regardless of whether there are any actual or anticipated defaults. Accordingly, construction loans shall not be reported at an amount greater than the fair value of the property. The percentage of completion of the property shall be considered in determining fair values of property securing construction loans.

Disclosures

15. The reporting entity shall make the disclosures for impaired loans as required by paragraph 20 of *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114), as amended by paragraph 6(1) of *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114* (FAS 118) in the annual audited statutory financial reports only. This is included in the Relevant GAAP Guidance section below.

16. The following additional disclosures shall also be made in the financial statements:

a. Fair values in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk* (Issue Paper No. 27), *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments and Issue Paper No. 85—*

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21. By requiring reporting entities to reflect impairments in the value of a loan, the conclusion above is consistent with other issue papers on invested assets (e.g., bonds, common stock, preferred stock), which also require a reporting entity to record any impairment of an invested asset. It is also more conservative than allowing the reporting entity to continue to carry the impaired loan at amortized cost, when it is probable that the reporting entity will not receive the invested funds in accordance with the terms of the original agreement.

Drafting Notes/Comments

- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for foreclosed assets is addressed in *Issue Paper No. 36—Troubled Debt Restructurings*.
- Loan-backed and structured securities are addressed in *Issue Paper No. 43—Loan-Backed and Structured Securities*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The Accounting Practices and Procedures Manual for Life and Accident and Health contains the statutory guidance for the accounting for mortgage loans. Excerpts from Chapter 3, Mortgage Loans, are as follows:

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mortgage during a stated redemption period. During this period, the loan may remain classified as a mortgage loan until the insurance company obtains clear title. The asset is then transferred to the real estate account.

Interest

Interest income on mortgage loans is recorded when earned during any reporting period. An "inventory" of due and accrued interest must be determined at the end of each reporting period. Interest income includes adjustments for amortization or the accrual of discount.

A portion of the interest due and accrued on mortgage loans may require treatment as a nonadmitted asset for reporting purposes. In general, amounts over one year past due are nonadmitted. In practice, some companies consider that interest past due for periods of less than one year indicates future uncollectibility, and may make a provision against operations for such amounts to establish an appropriate reserve. Alternatively, some companies may cease accrual of interest on loans that default on any payment. Therefore, the amount of due and accrued interest that is considered to be a nonadmitted asset depends on the policy regarding accrual determination, and whether reserves have been established by charges to operations. In the case of mortgage loans on which foreclosure action is pursued, delinquent interest may be recovered from the amount, if any, by which the proceeds on the eventual sale of the property exceed the unpaid principal balance.

Contingent interest represents income generated through the occurrence of specific economic events in relation to the borrower. For example, contingent interest may become payable upon the attainment of a given level of cash flow or income. Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Payments

Payments on mortgage loans may be received in advance of due dates. Such payments may produce prepaid interest which is considered unearned and is recorded as a liability in the annual statement.

Companies that use servicing agents for their mortgage loans should report the "Interest Due and Accrued" asset on the balance sheet consistently with the income statement treatment of the charge for servicing costs. If interest income is reported net of servicing costs, which is usual when the servicing agent fee is based on a percentage retention of each interest payment, then the interest receivable in the balance sheet should be net of the related servicing costs. If interest is reported gross, with the servicing costs reported as an expense item, then interest due and accrued should be reflected as an asset at the gross amount, with an appropriate liability to reflect the related servicing cost accrual.

Amounts paid to the insurance company by the mortgagor to cover future tax payments, insurance premiums, and other costs related to the property requires the creation of escrow accounts in the general ledger to record these liabilities. If such amounts are held by the servicing agents, they should be reported on the insurance company's balance sheet both as an asset and as a liability when they produce income for the insurance company. This may occur if the servicing agent invests the escrow funds and is required to remit the income (or portion thereof) to the insurance company.

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Prepayment penalties

Some mortgage loans provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Prepayment charges are intended to compensate the lender for expenses incurred in granting the loan as well as the potential loss of future earnings. Prepayment penalties may be reported as realized capital gains or investment income.

Loan origination fees and costs

Brokerage commissions, finders' fees, fees to cover loan processing and the like that are paid when acquiring mortgage loans usually are not significant and may be charged to operations when incurred. Points are additional fees and usually are expressed as a percentage of the funds disbursed. Points represent an adjustment of the loan interest rate to the current market. They should be deferred and amortized in the same manner as a premium paid on the mortgage.

Commitment fees

25. The guidance for the accounting for loan origination costs and commitment fees is contained in FAS 91. Pertinent excerpts are as follows:

> Loan Origination Fees and Costs
>
> 5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield[2] (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.

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[2] Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an

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[3] The term remote is used here, consistent with its use in *FASB Statement No. 5, Accounting for Contingencies*, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

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b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous

settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future peri

b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.[8]

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[8] For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

Balance Sheet Classification

21. The unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment of yield pursuant to this Statement shall be reported on the enterprise's balance sheet as part of the loan balance to which it relates.

[2] The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.

14. If a creditor bases its measure of loan impairment on a present value amount, the creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan).[3] The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. If the loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraph 8. The creditor's choice shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor. Projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

[3] A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.

15. If a creditor bases its measure of loan impairment on a present value calculation, the estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a creditor estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes shall be considered in determining the best estimate of expected future cash flows.

16. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor shall recalculate the impairment by applying the procedures specified in paragraphs 12-15 and by adjusting the valuation allowance. Similarly, a creditor that measures impairment based on the observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan shall adjust the valuation allowance if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan.

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Disclosures

20. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an impaired loan in paragraph 8 of this Statement:

a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 20(a) and 20(c) in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 20(a) and 20(c) to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB No. 5, Accounting for Contingencies, and with this Statement.

27. *FASB Emerging Issue Task Force Issue No. 84-19, Mortgage Loan Payment Modifications* is adopted. Pertinent excerpts are as follows:

EITF 84-19 ISSUE
The borrower and lender enter into an agreement whereby the borrower increases his mortgage payments for a specified period, at the conclusion of which the lender forgives a portion of the remaining principal on the loan. The borrower may terminate the arrangement at any time but receives no principal reduction if he makes less than 12 consecutive increased payments.
The issue is how the lender should account for the portion of principal that may be forgiven.
1. Should the lender assume that the accelerated payments will be made to maturity and discount such accelerated payments using the current interest rate, thus recording a loss?
2. Should the lender assume that only 12 consecutive increased payments will be made and that other payments to maturity will be at the original rate and discount all payments using the current interest rate, thus recording a smaller loss?

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3. Should the discount only be recorded as a loss when the borrower has made all the payments required or should the discount be accrued as a loss pro rata over the 12-month period?

EITF 84-19 DISCUSSION
The Task Force reached a consensus that, assuming it is probable that the borrower will continue to make the increased payments for the specified period, the expense relating to the partial forgiveness should be accrued over the period of increased payments. Task Force members indicated that this approach to the accounting has already been consistently applied in practice.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 3, Mortgage Loans
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans
- *Issue Paper No. 34—Investment Income Due and Accrued*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114*
- *FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications*
- *FASB Emerging Issues Task Force Issue 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*
- *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans*

State Regulations

- State regulations contain numerous references to mortgage loans. Due to the volume, specific references to each state regulation have not been reproduced in this issue paper.

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