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Accounting for Derivatives

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In mortgage banking, companies use derivatives and hedging as part of an overall strategy to manage exposure to market risk primarily due to fluctuations in interest rates, and to capture improved margins resulting from the mandatory delivery of loans. The following whitepaper discusses the treatment of derivative instruments for financial statement purposes.

Accounting for Derivatives

By: Jennifer Hannah, CPA – Audit Partner | **Josh Ratner** JD, CPA, LLM – Tax Manager

Derivative Financial Instruments

Derivative financial instruments play a key role in managing market risk associated with mortgage lending activities. In mortgage banking, companies use derivatives and hedging as part of an overall strategy to manage exposure to market risk primarily due to fluctuations in interest rates, and to capture improved margins resulting from the mandatory delivery of loans.

Derivative instruments – including options, futures, and forwards – are financial instruments whose fair value is based on observable market data. Derivatives are recognized as either assets (rights) or liabilities (obligations) and are measured at fair value. FASB ASC 820 defines fair value as the price that would be received to sell an asset, or the price paid to transfer a liability, in an arms-length transaction. Derivative assets and liabilities should not be netted in the statement of financial position unless there is a right of offset. Typically, mortgage banking companies account for derivatives as free-standing derivatives, and do not designate them for hedge accounting. As a result, changes in fair value are recognized in current earnings in the period of change.

Disclaimer

This is a highly complex area of accounting and tax that is often not understood by professionals without specialized expertise in the area.

Please feel free to contact us with any questions.

Interest Rate Lock Commitments (IRLCs)

Interest Rate Lock Commitments (IRLCs) are agreements under which a lender commits to extend credit to a borrower, provided certain specified terms and conditions are met, with both the interest rate and the maximum loan amount set prior to funding. Under the agreement, the lender commits to lend funds to a potential borrower (subject to the lender's approval of the loan) on either a fixed- or adjustable-rate basis, regardless of whether interest rates change in the market, or on a floating rate basis. The IRLC does not contractually obligate the borrower to close the loan, regardless of whether or not the lender approves the loan.

FASB ASC 815, Derivatives and Hedging, provides that IRLCs on mortgage loans that will be held for resale in the secondary market are derivatives, and therefore, must be accounted for at fair value. The fair value of the IRLCs is recorded as a derivative asset or liability, and the corresponding gain or loss is recorded in the statement of operations. The derivative asset or liability is adjusted, typically monthly, with adjustments running through the balance sheet and statement of operations. The fair value of IRLCs is determined based on the value of the underlying mortgage loans in the secondary market, quoted MBS prices, estimates of the fair value of the mortgage servicing rights, and the probability that the mortgage loans will fund per the terms of the IRLCs (i.e., pull through), net of estimated direct costs to close the loan.

Forward Mortgage Loan Sales Commitments

To avoid interest rate risk, companies generally enter into forward mortgage loan sales commitments shortly after extending interest rate lock commitments to borrowers. They can enter into mortgage loan sales commitments on either a “mandatory” or “best efforts” basis. Mandatory commitments provide that the loan must be delivered at an agreed-upon price within a specified timeframe; if not, the lender is typically required to pair out of the commitment and may be subject to a pair-off fee. In general, best efforts commitments provide that the loan be delivered *if and when* it closes.

Mandatory delivery commitments are considered derivatives for accounting purposes and must be recorded at fair value. Most companies have taken the position that best efforts commitments are not derivatives because there is no pair-off provision. As a result, they are not required to be recorded at fair value. However, ASC 825-10-25, Fair Value Option, provides companies with the option to elect to record at fair value certain financial instruments that would not otherwise be recognized at inception, such as best efforts lock commitments.

Hedge Instruments

Forward sales of mortgage-backed securities are typically used to approximate the sale and future delivery of loans, and the changes in value of those securities is used to hedge any change in the value of IRLCs between the time the locks are extended to borrowers and the time the loans are committed to an investor or allocated to a trade. The lender may close out of the position by buying and selling a comparable security and either pairing off or rolling forward the position. Forward sales agreements are to be accounted for at fair value. Likewise, hedge instruments, such as forward sales of mortgage-backed securities, are considered derivatives and are required to be recorded at fair value, with the fair value of the open trades being recorded at month-end. The unrealized gains and losses resulting from changes in fair value are recorded in the statement of operations. The derivative asset and liability are adjusted, typically monthly, with adjustments running through the statement of operations.

Pair Offs

Closed trades that have not yet been settled in cash with the securities broker are shown as accounts receivable or payable on the balance sheet, and as a realized gain or loss in the statement of operations. An accounts receivable or payable should be recorded for any pair-offs for which cash settlement has not occurred as of month-end, and the resulting receivable or payable should be included in taxable income.

Notice to Reader:

The information contained herein is of a general nature and based on authoritative guidance that is subject to change. The descriptive and summary statements in this document are not intended to be a substitute for FASB or IRS guidance or requirements, or any other applicable accounting literature. Companies applying U.S. GAAP should apply the texts of relevant laws, regulations, and accounting requirements, considering their particular circumstances, and consult their accounting and legal advisors. The applicability of tax information to specific situations should be determined through consultation with tax advisors.