Draft
Proposed Practice Aid

Derivative Loan Commitments Task Force
Illustrative Disclosures on
Derivative Loan Commitments

Prepared by a Task Force of the
American Institute of Certified Public Accountants

NOTICE TO READERS

Derivative Loan Commitments Task Force Illustrative Disclosures on Derivative Loan Commitments was 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. Its conclusions reflect what the developers believe are best practices. However, this Practice Aid has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA or the Financial Accounting Standards Board and has no official or authoritative status.

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Summary

This practice aid is intended to provide illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in SEC Staff Accounting Bulletin No. 105 ("SAB 105"), *Application of Accounting Principles to Loan Commitments*.

- SAB 105 was issued on March 9, 2004 and is applicable to all registrants who issue derivative loan commitments that relate to the origination of fixed- and variable-rate mortgage loans that will be held for sale. The provisions of SAB 105 must be applied to loan commitments accounted for as derivatives that are entered into subsequent to March 31, 2004. For reference to specific guidance, the full text of SAB 105 has been included in Appendix A to this practice aid.

- SAB 105 emphasizes that SEC registrants should disclose their accounting policy for interest rate lock commitments that are accounted for as derivatives ("derivative loan commitments") in accordance with the requirements of Accounting Principles Board Opinion No. 22 ("APB Opinion No. 22"), *Disclosure of Accounting Policies*. Additional disclosures under SAB 105 include methods and assumptions used to estimate fair value and any associated hedging strategies as required by: (1) Statement of Financial Accounting Standards No. 107 ("SFAS 107"), *Disclosures about Fair Value of Financial Instruments*; (2) Statement of Financial Accounting Standards No. 133 ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities*; and, (3) Items 303 and 305 of Regulation S-K.

- The Derivative Loan Commitments Task Force has developed its illustrative disclosures for each of the requirements cited in the SAB and follows the specific requirements in GAAP and the SEC regulations. The illustrative disclosures are intended to be used by both public issuers (both GAAP and SEC disclosures) and private issuers (GAAP disclosures).

- SAB 105 reflects the SEC Staff's view regarding loan commitments accounted for as derivative instruments. SAB 105 does not address the form of the derivative contract, and thus, does not require that loan commitments be accounted for as written options.

- The SEC guidance and illustrative MD&A disclosures included in this document are recommended for SEC registrants and would be appropriate for non-registrants to review. The GAAP guidance and illustrative footnote disclosures included in this document are recommended for both SEC registrants and non-registrants.[1] It is recommended that both registrants and non-registrants review the disclosures in this document since this practice aid is intended to provide illustrative disclosures for entities engaged in mortgage banking activities.

[1] **Disclosure Scope Exception for Some Non-Registrants.** Non-registrants should disclose their accounting policy for derivative loan commitments pursuant to APB Opinion No. 22. However, certain disclosures applicable to registrants about the fair value of financial instruments, as required by SFAS 107, may be optional for certain non-registrants.

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SECTION I

Introduction and Background

This "practice aid" is intended to provide illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure requirements cited in SEC Staff Accounting Bulletin No. 105 ("SAB 105"), *Application of Accounting Principles to Loan Commitments*. SAB 105 is applicable to all registrants that issue derivative loan commitments that relate to the origination of mortgage loans that will be held for sale. The "practice aid" addresses each of the disclosure requirements cited in SAB 105 and provides illustrative disclosures for those requirements.[2]

SAB 105 emphasizes that registrants should disclose their accounting policy for derivative loan commitments in accordance with Accounting Principles Board Opinion No. 22, ("APB 22") *Disclosure of Accounting Policies.* Those disclosures would include registrants' methods and assumptions used to estimate the fair values of derivative loan commitments and any associated hedging strategies as required by: (1) Statement of Financial Accounting Standards No. 107 ("SFAS 107") *Disclosures about Fair Value of Financial Instruments*; (2) Statement of Financial Accounting Standards No. 133 ("SFAS 133") *Accounting for Derivative Instruments and Hedging Activities*; and, (3) Items 303 and 305 of Regulation S-K.

Loan commitments for the origination of mortgage loans that will be held for sale (discussed in Statement of Financial Accounting Standards No. 65, *Accounting for Mortgage Banking Activities*) refers to commitments to originate both residential and commercial mortgage loans. The scope of SAB 105 primarily applies to the origination of mortgage loans that will be held for sale. Through their wholesale channels, many mortgage bankers also enter into commitments to purchase residential prime and sub-prime mortgage loans that will be held for sale. The wholesale channel typically encompasses one or more of the following elements: a broker network and relationships with "correspondent" lenders[3] whereby loans are purchased from them outright or through table-funding arrangements. These commitments to purchase residential mortgage loans need to be assessed to determine whether they meet the definition of a derivative under paragraph 6 of SFAS 133 (as amended). Commitments to purchase commercial mortgage loans must also be evaluated separately, based on the specific facts and circumstances, to determine if they meet the definition of a derivative.

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[2] As entities consider their disclosures for derivative loan commitments, they should refer to the discussion within SEC Staff Accounting Bulletin No. 99 ("SAB 99"), *Materiality*, to determine the extent of information they may be required to disclose. As stated in SAB 99, "Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important."

[3] Mortgage brokers and correspondent lenders are distinguished from each other in that the latter group generally has met certain qualifying conditions to originate and/or service loans directly on behalf of one or more investors.

The provisions of SAB 105 are to be applied to loan commitments accounted for as derivatives that were entered into subsequent to March 31, 2004.

Derivative Loan Commitments

Loan commitments involving loan originations are agreements by lenders to extend credit to a mortgage loan applicant under certain pre-specified terms and conditions in which the interest rate on the loan, which may be fixed or adjustable, is set prior to funding. The loan commitment binds the lender (subject to the creditworthiness of the borrower) for a specific period to lend funds to a potential borrower at a specified interest rate, regardless of whether interest rates change between the commitment date and funding of the loan.[4] Lenders enter into loan commitments to originate loans through their retail and wholesale channels (as discussed above). Loan commitments generally have terms of up to 60 days before they expire. They do not bind the potential borrower to obtain the loan. Generally, they guarantee that the lender will approve the potential borrower for the loan once the creditworthiness of the borrower and the value of the property have been determined.

Derivatives Implementation Group ("DIG") Implementation Issue No. C13 ("Issue C13"), *Scope Exceptions: When a Loan Commitment is Included in the Scope of Statement 133*, asked the question, "in what circumstances must a loan commitment be included in the scope of Statement 133 and accounted for as a derivative instrument?" Issue C13 concluded that loan commitments related to the origination of mortgage loans that will be held for resale (as discussed in paragraphs 21 and 23 of Statement 65, as amended), must be accounted for as derivative instruments in accordance with SFAS 133.

This guidance is reflected in FASB Statement of Financial Accounting Standards No. 149 ("SFAS 149"), *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. Specifically, paragraph 3 of SFAS 149, added the following language to paragraph 6 of SFAS 133 after subparagraph (c):

> Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for resale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

[4] Lenders also enter into loan commitments under which the potential borrower chooses to wait until a future date, either prior to or at the funding of the loan, to set the interest rate on the loan, which may be fixed or adjustable. Because the interest rate on such a commitment "floats" on a daily basis with market interest rates until the rate is set, the fair value of this derivative loan commitment should be zero.

Paragraph 7(e) of SFAS 149 also added a new scope exception as paragraph 10(i) of SFAS 133:

> *Loan Commitments*. The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement. Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of Statement 65, are not subject to this Statement. In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement.

Consistent with the guidance in SFAS 133, as amended, derivative loan commitments must be recorded at fair value on the balance sheet. However, subsequent to the release of Issue C13, questions arose in practice regarding how the fair values of derivative loan commitments should be determined and, more specifically, when any estimated values associated with the commitments as of the commitment date should be recognized in earnings. These questions led to diversity in practice.

SAB 105

In a speech at the AICPA National Conference on SEC Developments in December 2003, the SEC staff expressed its concerns about the diversity in practice and articulated a view on these issues. The SEC staff indicated it would memorialize its views on this topic in a Staff Accounting Bulletin. On March 9, 2004, after further research and discussion with various groups, the SEC staff issued SAB 105 to address this diversity and clarify its position. The staff's position regarding the recognition of derivative loan commitments is reflected in the first of three questions addressed in the SAB:

"In recognizing the loan commitment, may Bank A consider the expected future cash flows related to the associated servicing of the loan?"

In responding, the staff concluded that "incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. However, servicing assets are to be recognized only once the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained". The staff concluded also that no other internally-developed intangible assets, such as customer relationship intangibles, should be recorded as part of the derivative loan commitment (recognition of such assets is only appropriate in the event of a third party transaction).

The Task Force believes that the application of SAB 105 generally has resulted in no income being recognized as of the commitment date[5] for a derivative loan commitment.

[5] The recording of a zero value at the inception of a derivative loan commitment is consistent with the guidance contained in Emerging Issues Task Force Issue 02-3 ("EITF 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 includes guidance in footnote 3, which presents an FASB staff

SAB 105 is silent, however, with respect to the valuation of derivative loan commitments thereafter. Consequently, lenders have generally continued to recognize changes in the values of their derivative loan commitments, due to changes in interest rates and estimates of projected fallout[6], in earnings subsequent to the commitment date.[7]

To ensure investors and others are fully apprised of differences in companies' derivative loan commitment valuation practices and other accounting practices related thereto, SAB 105 references disclosures related to derivative loan commitments.

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view that the recognition of unrealized gains or losses at inception is essentially precluded for derivative contracts unless the fair value of these derivative contracts is determinable by reference to quoted market prices or current market transactions for similar contracts.

[6] An important assumption used in the determination of the fair value of a derivative loan commitment is the expected *fallout*. *Fallout* represents the likelihood that a derivative loan commitment will not ultimately result in a funded loan. Many factors influence the expected fallout rate, including (but not limited to) the type of loan, the channel of origination (e.g., retail, wholesale, or correspondent), the level of interest rates, and the term of the commitment (e.g., as a commitment gets closer to the end of its term, it becomes less sensitive to other factors).

[7] When a loan is ultimately funded through exercise of the loan commitment, the carrying value of the derivative loan commitment should be recorded as part of the basis of the loan. The commitment ceases to exist as a separate asset or liability and is exchanged in consideration for the loan. This basis adjustment that is made to the loan should not be amortized; rather, when the loan is sold, the basis adjustment should be recognized as part of the gain or loss on the sale that is recorded in the income statement. Occasionally, a loan is transferred to a held-for-investment portfolio; when that is the case, the basis adjustment associated with the loan should be amortized as an adjustment to the yield, in accordance with SFAS 91. When a loan is ultimately funded through exercise of the loan commitment, an entity must record (1) direct costs related to the loan's origination and (2) fees collected from the borrower, in accordance with SFAS 91.

SECTION II

Illustrative Disclosures and Relevant Financial Reporting Literature

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Interpretive Response to Question 2 of SAB 105 ("What disclosures should Bank A provide with respect to loan commitments accounted for as derivatives?") states: "Bank A should disclose its accounting policy for loan commitments pursuant to APB 22. Bank A should provide disclosures related to loan commitments accounted for as derivatives, including methods and assumptions used to estimate fair value and any associated hedging strategies, as required by Statements 107 and 133, and S-K Item 305. Additionally, Bank A should provide disclosures required by S-K Item 303 and any related interpretive guidance."

While SAB 105 does not add new or additional disclosure requirements, the Task Force believes that entities engaged in mortgage-banking activities should consider disclosing changes in a derivative loan commitment's fair value for each period presented, along with information that is necessary to understand how the fair values are computed. Also, enterprises should consider disclosing the name of the asset or liability related to the subsequent changes in interest rates that an entity reports in its financial statements each period. The Task Force believes that an enterprise's disclosures about its derivative loan commitments should be as thorough and transparent as possible since analysts and investors have been giving these items significant attention.

The Task Force has developed the following illustrative disclosures for each of the requirements cited in the SAB. Each illustrative disclosure follows the specific requirements in GAAP and SEC regulations and each has been drafted to be a free-standing and complete disclosure separate from other disclosures presented in this section. As a result, the Task Force recognizes that there are some redundancies within the following illustrative disclosures. The Task Force expects registrants and other filers to combine or streamline applicable disclosures where appropriate, in order to eliminate redundancies.

There are differing views about how to estimate the fair value of derivative loan commitments. The Task Force includes disclosures of a methodology that a company might use to estimate the fair value of its derivative loan commitments (included within sections II-a, II-c, II-d, and II-e). The Task Force disclosures are intended to show example disclosures only and are not intended to provide valuation guidance. All entities should confirm with their independent accountants that their methodology is in accordance with GAAP.

The Task Force also recommends that entities refer to SEC Staff Accounting Bulletin No. 99, *Materiality*, to determine the extent of information to disclose relative to derivative loan commitments. The following SEC guidance and illustrative management's discussion and analysis disclosures are recommended for SEC registrants and would be appropriate for non-registrants to review. The GAAP guidance and illustrative footnote

disclosures are recommended for both SEC registrants and non-registrants. It is recommended that both registrants and non-registrants review the disclosures in this document since they are intended to provide illustrative disclosures for entities engaged in mortgage banking activities.

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SECTION II - a

Illustrative Disclosures and Relevant Financial Reporting Literature – Regulation S-K Item 303

Regulation S-K Item 303 (S-K Item 303), *Management's Discussion and Analysis of Financial Condition and Results of Operations*, requires that management's discussion and analysis (MD&A) provide material historical and prospective textual disclosure to enable investors to assess the financial condition and results of operations of the registrant. It requires that reporting entities describe their significant components, which in management's judgment, should be described in order to understand the company's results of operations. MD&A of financial condition and results of operations presents an opportunity for management to tell a company's story. Relative to derivative loan commitments, MD&A should discuss why and how the company entered into derivative loan commitments, and how they impact the company's financial statements.

As stated in paragraph (A) to S-K Item 303:

> (A) Discuss registrant's financial condition, changes in financial condition and results of operations. The discussion shall provide information as specified in paragraphs (a)(1) through (5) (i.e., liquidity, capital resources, results of operations, off-balance sheet arrangements, and tabular disclosure of contractual obligations) and shall provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.

Paragraphs 1, 2, and 3 of S-K Item 303 describe the MD&A analysis as follows:

1. The registrant's discussion and analysis shall be of the financial statements and of other statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition and results of operations.
2. The purpose of the discussion and analysis shall be to provide to investors and other users information relevant to an assessment of the financial condition and result of operations of the registrant as determined by evaluating the amounts and certainty of cash flows from operations and from outside sources.
3. The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

Additionally, SEC S-K Item 303 Interpretations and Guidance states:

Registrants should disclose information about their critical accounting policies. A critical accounting policy is one that is both very important to the portrayal of a company's financial position and its results of operations and requires management's most difficult, subjective or complex judgments. The purpose of disclosing information about critical accounting policies is to:

- Communicate to investors the level of imprecision inherent in the financial statements;
- Provide an understanding about how management forms its judgments about future events; and
- Explain how these judgments and future events could affect the financial statements.

The key points to identify for investors in these disclosures are:

- Types of assumptions that underlie the most significant and subjective estimates;
- Sensitivity of those estimates to deviations of actual results from management's assumptions; and
- Circumstances that have resulted in revised assumptions in the past.

The following illustrative disclosure for S-K Item 303 is applicable to SEC registrants.

Based on the preceding guidance as discussed by S-K Item 303, the Task Force recommends that the following factors be considered by an entity in its MD&A disclosure of derivative loan commitments. Each entity should determine which of the following factors apply to the facts and circumstances of their specific derivative loan commitments including, but not limited to, the following:

- Entities should disclose information about their critical accounting policies. Derivative loan commitments should be included as a critical accounting policy if it is both material to the portrayal of an entity's financial position and its results of operations and requires management to make difficult, subjective or complex judgments. In its discussion related to its critical accounting policy, the entity may include information that communicates to investors the level of imprecision inherent in the financial statements related to derivative loan commitments, provides an understanding about how the management forms its judgments about derivative loan commitments, and how these judgments could affect the financial statements.
- A description of any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the entity's liquidity increasing or decreasing in a material way resulting from entering into derivative loan commitments.
- A description of any known trends or uncertainties that have had or that the entity reasonably expects to have a material favorable or unfavorable impact on revenues or income resulting from derivative loan commitments.
- A description of any significant components of revenues or expenses that, in the entity's judgment, should be described in order to understand its results of

operations or material changes presented in its results of operations (e.g., where valuation of derivative loan commitments represent a material component of revenues or expenses).

- A description of the key terms, risks and uncertainties associated with derivative loan commitments and the use of derivative financial instruments used by the entity to economically hedge derivative loan commitments. Discussion may include a broad perspective and the business purposes of derivative loan commitments, why the entity enters into them, their key terms and conditions of their commitments, and potential exposures resulting from these commitments. Discussion may also include a description of economic hedging and how it impacts the entity's financial statements and volatility.
- A general description of derivative loan commitments that allows a reader to understand what they represent, how they're entered into, with whom they're entered into (e.g., with residential borrowers), how they obligate both the entity (lender) and the borrower, and the length of time of which they obligate the parties to the transaction.
- A description of the authoritative guidance which governs the accounting for derivative loan commitments (e.g., paragraph 6 of SFAS 133 (as amended), DIG Issue C13, or other applicable guidance).
- A description of how the derivative loan commitment transactions are measured on an entity's statement of position and in its results of operations.
- A discussion of the types of assumptions used in the accounting and valuation for derivative loan commitments that underlie the significant estimates used to measure fair value. In addition, the entity should consider discussing the sensitivity of these estimates to deviations of possible and actual results from management's assumptions and any circumstances that have affected these assumptions in the past. These assumptions may include descriptions of the loan amounts, interest rates used, fees for benefits of servicing in excess of expected servicing fees (excess servicing fees), fees paid which serve as a guarantee of interest and principal payments to the investor (guarantee fees), any costs to originate the loans, and fallout rates. An entity should also consider describing any changes in assumptions that may have a material effect on fair value or changes in fair value of derivative loan commitments.
- The entity should disclose how it calculates the fair value of its derivative loan commitments.
- Additionally, an entity may want to disclose the fact that under SAB 105, the fair value associated with the expected servicing fees is to be excluded from the entity's calculation of the fair value of its derivative loan commitments and is to be recognized only once the servicing asset has been contractually separated from the loan that would result from the exercise of that loan commitment by sale or securitization.

Task Force Illustrative Disclosures Under S-K Item 303

The following illustrates an example disclosure that may fulfill the requirements of S-K Item 303 and the factors discussed above for a reporting entity that enters into derivative

loan commitments. As an entity drafts its disclosures, it should ensure their disclosures include all applicable material information that allows financial statement users to gain an understanding of its own financial position and results of operations. The example below should not be viewed as a "safe harbor" disclosure as it is expected that companies would need to customize their disclosure to be congruent with their respective facts and circumstances.

Section: Management's Discussion and Analysis

Critical Accounting Policies

Our significant accounting policies (described in Note 1 (Summary of Significant Accounting Policies) to Financial Statements) are fundamental to understanding our results of operations and financial condition. Some of these accounting policies require that we use estimates and assumptions that may affect the value of our assets or liabilities and financial results. Our policy in accounting for derivative loan commitments is critical because it requires the Company's management to make difficult, subjective and complex judgments about matters that are inherently uncertain and because it is likely that materially different amounts would be reported under different conditions or using different assumptions. Management has reviewed and approved this critical accounting policy and has discussed this policy with the Audit and Examination Committee.

Derivative Loan Commitments

In connection with the Company's mortgage banking activities, the Company enters into commitments to fund residential mortgage loans at specified times in the future. The Company enters into these commitments through retail and broker channels and also purchases loan commitments from correspondent lenders. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 60 days after inception of the rate lock. Such a commitment is referred to as a derivative loan commitment if the loan that will result from exercise of the commitment will be held for sale upon funding under Statement of Financial Accounting Standards No. 133 ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 149 ("SFAS 149"), *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. As such, loan commitments that are derivatives must be recognized at fair value on the consolidated balance sheet with changes in their fair values recorded as part of income from mortgage banking operations.

In determining the fair value of its derivative loan commitments for economic purposes, the Company considers the value that would be generated when the loan arising from exercise of the loan commitment is sold in the secondary mortgage market. That value generally includes the following components: (1) the price that the loan is expected to be sold for in the secondary mortgage market, (2) points expected to be collected from the borrower, (3) the value of any excess servicing, and (4) direct fees and costs associated

with the origination of the loan, (5) the value of the net normal servicing cash flows, (6) costs associated with the acquisition of the right to service the resulting loan, and (7) the value of any internally-developed intangible assets.

For accounting purposes, the Company's model excludes from its calculation of fair value, at inception and throughout the life of the derivative loan commitment: (1) the value of net normal servicing cash flows (servicing cash flows associated with the expected servicing fee plus ancillary fee income, float income, and late charges less costs to service, interest costs on servicing advances, and default costs), (2) costs associated with the acquisition of the right to service the resulting loan, and (3) the value of any internally-developed intangible assets. The model's initial fair value (IFV) is calculated using the remaining four assumptions. The Company then indexes the IFV for the derivative loan commitment to zero at inception, consistent with the concepts embodied in EITF 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities. Subsequent to inception*, the Company estimates the updated fair value (UFV) based on those remaining four assumptions and the UFV is compared to the IFV calculated at inception to measure the change in fair value. A positive change in fair value is recorded as an asset and a negative change in fair value is recorded as a liability.

The four key assumptions are described in more detail as follows:

The price that the loan arising from exercise of the loan commitment could be sold for in the secondary mortgage market is determined by estimating the gross gain or loss expected to be realized from the sale of the mortgage-backed security into which the loan is expected to be securitized.

Points collected from the borrower represent income expected to be received from the borrower when the loan is funded, and represent a fundamental component in the overall gain or loss that will be realized when a loan is sold. Points are paid by borrowers to obtain lower interest rates on their loans, which will affect the ultimate gain or loss realized when the loans arising from exercise of the loan commitments are securitized and sold.

The projected value of excess servicing is the value of the remaining strip of cash flows from the loan arising from exercise of the loan commitment after the Company has considered the interest rate that the mortgage-backed security will bear, the normal servicing fee, and the guarantee fee. The value of the excess servicing is derived by discounting the expected contractual cash flows for the loans, adjusted for estimates of prepayments, delinquencies and defaults. Prepayment speed estimates are derived from the XYZ model, which is a third-party prepayment model that is widely used in the mortgage industry. Estimates of delinquencies and defaults are derived from the Company's historical experience as adjusted for current economic trends, and these estimates approximate assumptions used by other market participants in the mortgage industry. The discount rate used reflects the Company's estimate of its marginal risk-

adjusted borrowing rate in all future periods, and is based on the ten-year Treasury rate plus a margin.

The Company incurs costs to originate the loan and collects fees from the borrower, which represents administrative costs that are associated with the derivative loan commitments. The Company determines the direct cost per loan based on an analysis of the actual direct costs incurred related to loans originated during the period, and updates this analysis at least annually.

In estimating their fair values, the Company also assigns a probability to a loan commitment based on an expectation that it will not be exercised and the loan will not be funded. This probability is commonly referred to as fallout.

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. To protect against this price risk, the Company utilizes forward loan sales commitments and other derivatives, including options and U.S. Treasury futures, to economically hedge the risk of potential decreases in the values of the loans that would result from the exercise of the loan commitments. The Company expects that these derivative financial instruments will experience changes in fair value opposite to the change in fair value of the derivative loan commitments.

The Company sells the vast majority of its loans to the Federal Home Loan Mortgage Corporation (“FHLMC” or “Freddie Mac”). These loans are either 15-year or 30-year maturity loans.

SECTION II - b

Illustrative Disclosures and Relevant Financial Reporting Literature – Regulation S-K Item 305

Regulation S-K Item 305 (S-K Item 305), *Quantitative and Qualitative Disclosures About Market Risk,* addresses the adequacy of registrant disclosures related to market risk. Specifically, paragraph (a) under S-K Item 305 states that registrants shall provide quantitative information about market risk as of the end of the latest fiscal year. Paragraph (b) under S-K Item 305 requires qualitative information about market risk. Additionally, paragraph (b) requires the registrant to describe to the extent material: (i) the registrant's primary market risk exposures; (ii) how those exposures are managed, including descriptions of the objectives, general strategies, and instruments, if any, used to manage those exposures; and (iii) changes in either the registrant's primary market risk exposures or how those exposures are managed, when compared to what was in effect during the most recently completed fiscal year and what is known or expected to be in effect in future reporting periods.

The following are excerpts included from the 'General Instructions' to paragraphs (a) and (b) of S-K Item 305:

> 1. The disclosures called for by paragraphs 305(a) and 305(b) are intended to clarify the registrant's exposures to market risk associated with activities in derivative financial instruments, other financial instruments, and derivative commodity instruments.
>
> 2. In preparing the disclosures under paragraphs 305(a) and 305(b), registrants are required to include derivative financial instruments, other financial instruments, and derivative commodity instruments.
>
> 3. For purposes of paragraphs 305(a) and 305(b), derivative financial instruments, other financial instruments, and derivative commodity instruments (collectively referred to as "market risk sensitive instruments") are defined as follows:
>
> A. Derivative financial instruments has the same meaning as defined by generally accepted accounting principles (see e.g., FASB, Statement of Financial Accounting Standards No. 119 "Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments," ("FAS 119") paragraphs 5 - 7 (October 1994)), and includes futures, forwards, swaps, options, and other financial instruments with similar characteristics;
>
> B. Other financial instruments means all financial instruments as defined by generally accepted accounting principles for which fair value disclosures are required (see e.g., FASB, Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments," ("FAS 107") paragraphs

3 and 8 (December 1991)), except for derivative financial instruments, as defined above;

C. (i) Other financial instruments include, but are not limited to, trade accounts receivable, investments, loans, structured notes, mortgage-backed securities, trade accounts payable, indexed debt instruments, interest-only and principal-only obligations, deposits, and other debt obligations;

D. Derivative commodity instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics that are permitted by contract or business custom to be settled in cash or with another financial instrument. For purposes of this paragraph, settlement in cash includes settlement in cash of the net change in value of the derivative commodity instrument (e.g., net cash settlement based on changes in the price of the underlying commodity).

5.A. Under paragraphs 305(a) and 305(b), a materiality assessment should be made for each market risk exposure category within the trading and other than trading portfolios.

B. For purposes of making the materiality assessment under instruction 5.A. of the General Instructions to Paragraphs 305(a) and 305(b), registrants should evaluate both:

i. The materiality of the fair values of derivative financial instruments, other financial instruments, and derivative commodity instruments outstanding as of the end of the latest fiscal year; and

ii. The materiality of potential, near-term losses in future earnings, fair values, and/or cash flows from reasonably possible near-term changes in market rates or prices.

iii. If either paragraphs B.i. or B.ii. in this instruction of the General Instructions to Paragraphs 305(a) and 305(b) are material, the registrant should disclose quantitative and qualitative information about market risk, if such market risk for the particular market risk exposure category is material.

SFAS 119 (which has been superseded by SFAS 133, as amended) encouraged, but did not require, disclosure of quantitative information about the market risk exposures inherent in market risk sensitive instruments. Item 305(a) is designed to make disclosures about market risk more comprehensive by requiring disclosures of quantitative information about market risk, similar to those previously encouraged by SFAS 119. In preparing quantitative information, registrants should categorize market risk sensitive instruments into instruments entered into for trading purposes and instruments entered into for purposes other than trading. Within both the trading and other than trading portfolios, separate quantitative information should be presented for each market risk exposure category when material.

Based on the preceding guidance as discussed by S-K Item 305, the Task Force recommends that the following factors be considered by an entity in its quantitative and qualitative disclosures about market risk on derivative loan commitments. Each entity

should determine which of the following factors apply to the facts and circumstances of their specific derivative loan commitments including, but not limited to, the following:

- A discussion that clarifies the entity's exposures to market risks associated with derivative loan commitments. This discussion may describe the specific risks (e.g., price risk, interest rate risk) and how these risks expose the entity to losses.
- A description of the entity's risk management strategies, methodologies, derivative financial instruments, and transactions used to economically hedge the market risks associated with derivative loan commitments. This discussion may also provide a description of economic hedging and how it impacts the entity's financial statements.
- Disclosures should include a detailed discussion of the derivative financial instruments used to economically hedge the derivative loan commitments.
- Quantitative information should include a categorization of market risk sensitive instruments broken into categories including those instruments entered into for trading purposes and those entered into for purposes other than trading. Separate quantitative information should be presented for each market risk exposure category when material within both the trading and other than trading portfolios.
- A general description of derivative loan commitments that allows a reader to understand what they represent, how they're entered into, with whom they're entered into (e.g., with residential borrowers), how they obligate both the entity (lender) and the borrower, and the length of time over which they obligate the parties to the transaction. This description may also include a broad perspective of and the business purposes of derivative loan commitments.
- A description of the authoritative guidance which governs the accounting for derivative loan commitments (e.g., paragraph 6 of SFAS 133 (as amended), DIG Issue C13, or other applicable guidance).
- A description of how the derivative loan commitment transactions are measured on an entity's statement of position and in its results of operations. The entity should also disclose how it calculates the fair value of its derivative loan commitments in this section if not included elsewhere within the Management's Discussion and Analysis.
- A discussion of the types of assumptions used in the accounting and valuation for derivative loan commitments that underlie the significant estimates used to measure fair value. These assumptions may include descriptions of the loan amounts, interest rates used, fees for benefits of servicing in excess of expected servicing fees (excess servicing fees), fees paid which serve as a guarantee of interest and principal payments to the investor (guarantee fees), costs to originate the loans, and fallout rates. An entity should also consider describing any changes in assumptions that may have a material effect on fair value or changes in fair value of derivative loan commitments.
- If significant, the entity should include a discussion of the range of weighted-average lives of derivative loan commitments and forward loan sale commitments.

Task Force Illustrative Disclosures Under S-K Item 305

The following illustrates an example disclosure that may fulfill the requirements of S-K Item 305 and the factors discussed above for a reporting entity that enters into derivative loan commitments. As an entity drafts its disclosures, it should ensure their disclosures include all applicable material information that allows financial statement users to gain an understanding of its own financial position and results of operations. The example below should not be viewed as a "safe harbor" disclosure as it is expected that companies would need to customize their disclosure to be congruent with their respective facts and circumstances.

Section: Management's Discussion and Analysis – Derivatives and Risk Management Activities

The Company is exposed to price risk due to the potential impact in changes in interest rates associated with its mortgage banking business due to the potential impact of changes in interest rates on its derivative loan commitments (unfunded loans) and loans held for sale (funded loans). Derivative loan commitments are mortgage loan commitments in which the Company is committed to fund a loan at a specified rate and within a specified period of time, generally up to 60 days from inception of the rate lock. The Company's total of outstanding derivative loan commitments is referred to as the "mortgage pipeline" whereas the Company's total loans held for sale are referred as the "mortgage warehouse." With regard to derivative loan commitments, the Company is exposed to price risk from the time a derivative loan commitment is made to a mortgage applicant to the time the related mortgage loan is funded ("mortgage pipeline price risk") and from the time the related mortgage loan is funded until the loan is sold ("mortgage warehouse price risk").

If the loan that would result from the exercise of the loan commitment will be held for sale upon funding, the loan commitment is a derivative instrument under SFAS 133 (as amended). Pursuant to that Statement, the commitment must be recognized at fair value in the Company's consolidated financial statements, with changes in the derivative loan commitment's values reflected in current period earnings. Consistent with the concepts embodied in SAB 105, the Company records a zero value for a derivative loan commitment at its inception.

Subsequent to inception, the Company recognizes a derivative loan commitment's fair value based on estimated changes in the fair value of the commitment's loan that would result from the exercise of that commitment and on changes in the probability that the loan will not be funded within the terms of the commitment. The value of that loan is affected primarily by changes in interest rates and the passage of time. The Company applies a fallout factor to the valuation of a derivative loan commitment for the probability that the loan will not be funded within the terms of the commitment. The change in fair value of a derivative loan commitment is measured from inception of the rate lock to the exercise of the commitment (i.e., funding of the loan).

Managing the price risk related to derivative loan commitments is complicated because the percentage that is exercised by mortgage applicants fluctuates. In general, the percentage of applications in the mortgage pipeline that will close within the terms of the derivative loan commitment increases if mortgage rates rise and decreases if mortgage rates fall. This is due primarily to the relative attractiveness of current mortgage rates compared to the applicants' committed rates. The percentage of loans that are expected not to be funded within the terms of the commitment is commonly referred to as "fallout". Fallout is also influenced by the source of the applications (broker, correspondent or in-house), proximity to rate lock expiration, purpose for the loans (purchase or refinance), product type and the application approval status. The Company's fallout estimates also take into account renegotiations of rate and point commitments that tend to occur when mortgage rates fall. The Company's fallout estimates are revised periodically using the most current historical data. Additionally, once a loan is closed and funded, the risk of fallout is eliminated and the associated mortgage loan is classified as a loan receivable-held for sale. At the time of loan funding, the value of the derivative is rolled into the basis of the loan.

The Company utilizes various derivative instruments to manage the price risk associated with its outstanding derivative loan commitments. These derivative instruments are expected to experience changes in fair value opposite to the change in fair value of the loan commitments, thereby minimizing earnings volatility related to the recognition of changes in the fair values of the derivative loan commitments in earnings. The instruments used to economically hedge the fair value of the derivative loan commitments include forward loan sales commitments and other free-standing derivative instruments including options and U.S. Treasury futures. A forward loan sales commitment protects the Company in a rising interest rate environment, as the sales price and delivery date of the loan are already established. A forward loan sales commitment does, however, obligate the Company to deliver a loan to the third party on the agreed-upon future date, even if rates were to fall. The Company takes into account various factors and strategies in determining the portion of the mortgage pipeline (derivative loan commitments) it wants to hedge economically.

Notional Amount of Derivatives

Information pertaining to the notional amounts of the Company's derivative financial instruments is as follows (in millions). In 200x, the fair values of these derivative financial instruments were recorded in the Company's consolidated balance sheet in accordance with Statement 133.

	December 31, 200x		December 31, 200x	
	Notional Amount	Credit Risk (1)	Notional Amount	Credit Risk (1)
Interest rate swaps – borrowings	$ --,---	$ -,---	$ --,---	$ -,---
Interest rate swaps hedging MSRs	--,---	-,---	--,---	-,---
Principal only swaps	--,---	-,---	--,---	-,---
Interest rate floors	--,---	-,---	--,---	-,---
Interest rate swaptions	--,---	-,---	--,---	-,---

Forward loan sale commitments	--,---	-,---	--,---	-,---
Derivative loan commitments	--,---	0	--,---	0
Total	$ --,---	$ -,---	$--,---	$ -,---

(1) Credit risk represents the amount of unrealized gains included in derivative assets which is subject to counterparty credit risk. It reflects the effect of master netting agreements and excludes $-- million and $-- million cash collateral held by the Company at December 31, 200x and 200x, respectively.

Derivative financial instruments used for other-than-trading purposes at December 31, 200x are scheduled to mature as follows (in millions):

	Notional Amounts						
	200x	200x	200x	200x	200x	Thereafter	Total
Interest rate swaps - borrowings	$ ---	$ ---	$ ---	$ ---	$ ---	$ ---	$ ---
Interest rate swaps - hedging MSRs	---	---	---	---	---	---	---
Principal only swaps	---	---	---	---	---	---	---
Interest rate floors	---	---	---	---	---	---	---
Interest rate swaptions	---	---	---	---	---	---	---
Forward loan sale commitments	---	0	0	0	0	0	---
Derivative loan commitments	---	0	0	0	0	0	---
Total	$ ---	$ ---	$ ---	$ ---	$ ---	$ ---	$ ---

For year-end fair values of derivative instruments used for other-than-trading purposes at December 31, 200x and 200x, see note X.

Changes in interest rates could materially affect the fair value of derivative loan commitments on the Company's consolidated financial statements. Although one would assume other assumptions might change, if the Company were to assume a 25 basis point parallel shift increase in the Freddie Mac 15-year and 30-year current coupon rates while keeping all other assumptions constant, the fair value of the Company's derivative loan commitments would decrease by $-- and $-- million, respectively. Correspondingly, the value of the Company's forward loan sales commitments and other derivatives used to economically hedge the derivative loan commitments would increase by $-- and $-- million, respectively. If the Company were to assume a 25 basis point parallel shift decrease in the Freddie Mac 15-year and 30-year current coupon rates while keeping all other assumptions constant, the fair value of the Company's derivative loan commitments would increase by $-- and $-- million, respectively. Correspondingly, the value of the Company's forward loan sales commitments and other derivatives economically hedging the derivative loan commitments would decrease by $-- and $-- million, respectively. In reality, one would not expect all other assumptions to remain constant. Changes in one factor may result in changes in another (for example, changes in interest rates could result in changes in the fallout factor), which might magnify or counteract the sensitivities. This is because the impact of an interest rate shift on the fallout ratio is non-symmetrical and non-linear.

SECTION II - c

Illustrative Disclosures and Relevant Financial Reporting Literature – APB No. 22

In Accounting Principles Board Opinion No. 22 ("APB 22"), *Disclosure of Accounting Principles*, the Board concluded that information about the significant accounting policies adopted by a reporting entity is essential for financial statement users and that this information should be presented as an integral part of a Company's financial statements. The Board also believes that the disclosure should be given in a separate "Summary of Significant Accounting Policies" preceding the notes to financial statements or as the initial note under the same or similar title. The following are excerpts from APB 22 that apply to the disclosure requirements:

> Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:
> a. A selection from existing acceptable alternatives;
> b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;
> c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

Based on the preceding guidance as discussed by APB 22, the Task Force recommends that the following factors be considered by an entity in its significant accounting policy disclosure of derivative loan commitments including, but not limited to the following:

- A statement of the authoritative guidance which governs the significant accounting policy for derivative loan commitments (e.g., paragraph 6 of SFAS 133 (as amended), DIG Issue C13) and a description of other literature which may have an affect on the accounting policy for derivative loan commitments (e.g., SAB 105 indicates that servicing assets are to be recognized only once the servicing asset has been contractually separated from the loan arising from exercise of the loan commitment by sale or securitization of the loan with servicing retained).
- A description of derivative loan commitments to allow a reader to understand what they represent, who they're entered into with (e.g., residential borrowers),

what they consist of, how long they obligate the parties to the transaction (e.g., number of days they obligate the lender), etc.

- A description of how the derivative loan commitment transactions are accounted for including how they are measured on an entity's statement of position and in its results of operations.
- A description of how the entity calculates the fair value of its derivative loan commitments. The entity may also describe any unusual or innovative applications of accounting principles for derivative loan commitments unique to the entity.
- A description of the basic and/or unique material components that are (or are not) included in measuring the derivative loan commitment's changes in fair value. This may include items that are material to the entity and would be valuable to a reader to understand fully how changes in fair value are measured by the particular entity including, but not limited to: a description of expected servicing fees, fees paid which serve as a guarantee of interest and principal payments to the investor (guarantee fees), fees for benefits of servicing in excess of expected servicing fees (excess servicing fees), and fallout rate.
- Descriptions of how and when changes in the fair value of derivative interest rate lock commitments are recognized.
- A description of the balance sheet and income statement classifications for derivative loan commitments.

Task Force Illustrative Disclosures Under APB 22

The following illustrates an example disclosure that may fulfill the requirements of APB 22 and the factors discussed above for a reporting entity that enters into derivative loan commitments. As an entity drafts its disclosures, it should ensure their disclosures include all applicable material information that allows financial statement users to gain an understanding of its own financial position and results of operations. The example below should not be viewed as a "safe harbor" disclosure as it is expected that companies would need to customize their disclosure to be congruent with their respective facts and circumstances.

Section: Footnotes to Financial Statements; Summary of Significant Accounting Policies – Mortgage Banking Derivative Loan Commitments

In connection with its mortgage banking activities, the Company enters into loan commitments to fund residential mortgage loans at specified interest rates and within specified periods of time, generally up to 60 days from the time of rate lock. A loan commitment whose loan arising from exercise of the loan commitment will be held for sale upon funding is a derivative instrument under Statement of Financial Accounting Standards No. 133 ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities*, (as amended), which must be recognized at fair value on the consolidated balance sheet in other assets and other liabilities with changes in its value recorded in income from mortgage banking operations.

In determining the fair value of its derivative loan commitments for economic purposes, the Company considers the value that would be generated when the loan arising from exercise of the loan commitment is sold in the secondary mortgage market. That value generally includes the following components: (1) the price that the loan is expected to be sold for in the secondary mortgage market, (2) points expected to be collected from the borrower, (3) the value of any excess servicing, and (4) direct fees and costs associated with the origination of the loan, (5) the value of the net normal servicing cash flows, (6) costs associated with the acquisition of the right to service the resulting loan, and (7) the value of any internally-developed intangible assets.

For accounting purposes, the Company's model excludes from its calculation of fair value, at inception and throughout the life of the derivative loan commitment: (1) the value of the net normal servicing cash flows (servicing cash flows associated with the expected servicing fee plus ancillary fee income, float income, and late charges less costs to service, interest costs on servicing advances, and default costs), (2) costs associated with the acquisition of the right to service the resulting loan, and (3) the value of any internally-developed intangible assets. The model's initial fair value (IFV) is calculated using the remaining four assumptions. The Company then indexes the IFV for the derivative loan commitment to zero at inception, consistent with the concepts embodied in EITF 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*. Subsequent to inception, the Company estimates the updated fair value (UFV) based on those remaining four assumptions and the UFV is compared to the IFV calculated at inception to measure the change in fair value. A positive change in fair value is recorded as an asset and a negative change in fair value is recorded as a liability.

The four key assumptions are described in more detail as follows:

The price that the loan arising from exercise of the loan commitment could be sold for in the secondary mortgage market is determined by estimating the gross gain or loss expected to be realized from the sale of the mortgage-backed security into which the loan is expected to be securitized.

Points collected from the borrower represent income expected to be received from the borrower when the loan is funded, and represent a fundamental component in the overall gain or loss that will be realized when a loan is sold. Points are paid by borrowers to obtain lower interest rates on their loans, which will affect the ultimate gain or loss realized when the loans arising from exercise of the loan commitment are securitized and sold.

The projected value of excess servicing is the value of the remaining strip of cash flows from the loan arising from exercise of the loan commitment after the Company has considered the interest rate that the mortgage-backed security will bear, the normal servicing fee, and the guarantee fee. The value of the excess servicing is derived by

discounting the expected contractual cash flows for the loans, adjusted for estimates of prepayments, delinquencies and defaults. Prepayment speed estimates are derived from the XYZ model, which is a third-party prepayment model that is widely used in the mortgage industry. Estimates of delinquencies and defaults are derived from the Company's historical experience as adjusted for current economic trends, and these estimates approximate assumptions used by other market participants in the mortgage industry. The discount rate used reflects the Company's estimate of its marginal risk-adjusted borrowing rate in all future periods, and is based on the ten-year Treasury rate plus a margin.

The Company incurs costs to originate the loan and collects fees from the borrower, which represents administrative costs that are associated with the derivative loan commitments. The Company determines the direct cost per loan based on an analysis of the actual direct costs incurred related to loans originated during the period, and updates this analysis at least annually.

In estimating their fair values, the Company also assigns a probability to a loan commitment based on an expectation that it will not be exercised and the loan will not be funded. This probability is commonly referred to as fallout.

SECTION II - d

Illustrative Disclosures and Relevant Financial Reporting Literature – SFAS 133

Statement of Financial Accounting Standards No. 133, ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities* (as amended), establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. Financial statement preparers should refer to the guidance in SFAS 133 (as amended) which defines those contracts that should be considered as a derivative. SFAS 133 (as amended) requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. The accounting for changes in the fair value of a derivative (i.e., gains and losses) depends on the intended use of the derivative and the resulting designation.

For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

Paragraph 44 of SFAS 133 (as amended) describes the disclosure requirements for instruments accounted for as derivatives:

> An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) shall disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and all other derivatives. The description also shall indicate the entity's risk management policy for each of those types of hedges, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description shall indicate the purpose of the derivative activity. Qualitative disclosures about an entity's objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity's overall risk management profile. If appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

Paragraph 45 of SFAS 133 (as amended) further states:

> The quantitative disclosures about derivative instruments may be more useful and less likely to be perceived to be out of context or otherwise misunderstood, if similar

information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. Accordingly, in those situations, an entity is encouraged, but not required, to present a more complete picture of its activities by disclosing that information.

Based on the preceding guidance as discussed by SFAS 133 (as amended), the Task Force recommends that the following factors be considered by an entity in its derivatives disclosure of derivative loan commitments including, but not limited to, the following:

- A description of how the accounting guidance prescribed by SFAS 133 (as amended) affects the valuation, accounting, and recording of derivative loan commitments.
- The entity should disclose its objectives for holding or issuing derivative loan commitments, the context needed to understand those objectives, and its strategies for achieving those objectives.
- A description of the entity's risk management policy for derivative loan commitments including a description of the items or transactions for which the associated risks are economically hedged.
- A description of the key terms, risks, and uncertainties associated with derivative loan commitments and the derivative financial instruments used by the entity to economically hedge the derivative loan commitments. This description may include a broad perspective of and the business purpose of derivative loan commitments, why the entity enters into them, their key terms and conditions of their commitments, and potential exposures resulting from these commitments. Discussion may include a description of economic hedging and how it impacts the entity's financial statements and volatility.
- Quantitative disclosures indicating gains or losses recognized into income from derivative loan commitments as well as the derivative financial instruments used to economically hedge the derivative loan commitments
- A description of other accounting literature for derivative loan commitments (e.g., SAB 105) and how that literature inter-relates with the guidance within SFAS 133 (as amended).
- A general description of derivative loan commitments that allows a reader to understand what they represent, how they're entered into, with whom they're entered into (e.g., with residential borrowers), how they obligate both the entity (lender) and borrower, and the length of time of which they obligate the parties to the transaction.
- A discussion of the types of assumptions (as required by 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*, and AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) used in the accounting and valuation for derivative loan commitments that underlie the significant estimates used to measure fair value. In addition, the entity should consider discussing the sensitivity of these estimates to deviations of possible and actual results from management's assumptions and any circumstances that have affected these

assumptions in the past. These assumptions may include descriptions of the loan amounts, interest rates used, fees for benefits of servicing in excess of expected servicing fees (excess servicing fees), fees paid which serve as a guarantee of interest and principal payments to the investor (guarantee fees), costs to originate the loans, and fallout rates. An entity should also consider describing any changes in assumptions that may have a material effect on fair value or changes in fair value of derivative loan commitments.

- A description of how the derivative loan commitment transactions are measured on an entity's statement of position and its results of operations.
- The entity should disclose how it calculates the fair value of its derivative loan commitments.
- An entity may want to also disclose the fact that under SAB 105, the fair value associated with the expected servicing fees is to be excluded from the entity's calculation of the fair value of its derivative loan commitments and is to be recognized only once the servicing asset has been contractually separated from the loan that would result from exercise of that loan commitment by sale or securitization of the loan.
- The description should distinguish derivative loan commitments from other derivative instruments when they are material to the entity.

Task Force Illustrative Disclosures Under SFAS 133

The following illustrates an example disclosure that may fulfill the requirements of SFAS 133 and the factors discussed above for a reporting entity that enters into derivative loan commitments. As an entity drafts its disclosures, it should ensure their disclosures include all applicable material information that allows financial statement users to gain an understanding of its own financial position and results of operations. The example below should not be viewed as a "safe harbor" disclosure as it is expected that companies would need to customize their disclosure to be congruent with their respective facts and circumstances.

Section: Footnotes to Financial Statements; Derivatives

Loan commitments whose loans arising from exercise of the loan commitment will be held for sale upon funding of the loan are derivative instruments as defined by SFAS 133 (as amended). Pursuant to that Statement, they are recognized on the consolidated balance sheet in other assets and other liabilities at fair value with changes in their fair values recognized in current period earnings as a component of mortgage banking operations.

In determining the fair value of its derivative loan commitments for economic purposes, the Company considers the value that would be generated when the loan arising from exercise of the loan commitment is sold in the secondary mortgage market. That value generally includes the following components: (1) the price that the loan is expected to be sold for in the secondary mortgage market, (2) points expected to be collected from the borrower, (3) the value of any excess servicing, and (4) direct fees and costs associated

with the origination of the loan, (5) the value of the net normal servicing cash flows, (6) costs associated with the acquisition of the right to service the resulting loan, and (7) the value of any internally-developed intangible assets.

For accounting purposes, the Company's model excludes from its calculation of fair value, at inception and throughout the life of the derivative loan commitment: (1) the value of net normal servicing cash flows (servicing cash flows associated with the expected servicing fee plus ancillary fee income, float income, and late charges less costs to service, interest costs on servicing advances, and default costs), (2) costs associated with the acquisition of the right to service the resulting loan, and (3) the value of any internally-developed intangible assets. The model's initial fair value (IFV) is calculated using the remaining four assumptions. The Company then indexes the IFV for the derivative loan commitment to zero at inception, consistent with the concepts embodied in EITF 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.* Subsequent to inception, the Company estimates the updated fair value (UFV) based on those remaining four assumptions and the UFV is compared to the IFV calculated at inception to measure the change in fair value. A positive change in fair value is recorded as an asset and a negative change in fair value is recorded as a liability.

The four key assumptions are described in more detail as follows:

The price that the loan arising from exercise of the loan commitment could be sold for in the secondary mortgage market is determined by estimating the gross gain or loss expected to be realized from the sale of the mortgage-backed security into which the loan is expected to be securitized.

Points collected from the borrower represent income expected to be received from the borrower when the loan is funded, and represent a fundamental component in the overall gain or loss that will be realized when a loan is sold. Points are paid by borrowers to obtain lower interest rates on their loans, which will affect the ultimate gain or loss realized when the loans arising from exercise of the loan commitments are securitized and sold.

The projected value of excess servicing is the value of the remaining strip of cash flows from the loan arising from exercise of the loan commitment after the Company has considered the interest rate that the mortgage-backed security will bear, the normal servicing fee, and the guarantee fee. The value of the excess servicing is derived by discounting the expected contractual cash flows for the loans, adjusted for estimates of prepayments, delinquencies and defaults. Prepayment speed estimates are derived from the XYZ model, which is a third-party prepayment model that is widely used in the mortgage industry. Estimates of delinquencies and defaults are derived from the Company's historical experience as adjusted for current economic trends, and these estimates approximate assumptions used by other market participants in the mortgage industry. The discount rate used reflects the Company's estimate of its marginal risk-

adjusted borrowing rate in all future periods, and is based on the ten-year Treasury rate plus a margin.

The Company incurs costs to originate the loan and collects fees from the borrower, which represents administrative costs that are associated with the derivative loan commitments. The Company determines the direct cost per loan based on an analysis of the actual direct costs incurred related to loans originated during the period, and updates this analysis at least annually.

In estimating their fair values, the Company also assigns a probability to a loan commitment based on an expectation that it will not be exercised and the loan will not be funded. This probability is commonly referred to as fallout.

The Company is exposed to price risk due to the potential impact of changes in interest rates on the values of the derivative loan commitments from the time a derivative loan commitment is made to an applicant to the time the loan that would result from the exercise of that loan commitment is funded. Managing price risk is complicated by the fact that the ultimate percentage of derivative loan commitments that will be exercised (i.e., the number of loan commitments that will be funded) fluctuates. The probability that a loan will not be funded within the terms of the commitment is driven by a number of factors – in particular, the change, if any, in mortgage rates subsequent to inception of the rate lock. However, many borrowers continue to exercise derivative loan commitments even when interest rates have fallen.

In general, the probability of funding increases if mortgage rates rise and decreases if mortgage rates fall. This is due primarily to the relative attractiveness of current mortgage rates compared to the applicant’s committed rate. The probability that a loan will not be funded within the terms of the derivative loan commitments also is influenced by the source of the applications (retail, broker or correspondent channels), proximity to rate lock expiration, purpose for the loans (purchase or refinance), product type and the application approval status. The Company has developed fallout estimates using historical observed data that take into account all of these variables, as well as renegotiations of rate and point commitments that tend to occur when mortgage rates fall. These fallout estimates are used to estimate the number of loans that it expects to be funded within the terms of the derivative loan commitments and are updated periodically to reflect the most current data. Once a loan is closed, it is classified as a loan receivable-held for sale.

The Company utilizes various derivative instruments to economically hedge the price risk associated with its outstanding derivative loan commitments. Management expects these derivatives will experience changes in fair value opposite to changes in fair value of the derivative loan commitments, thereby reducing earnings volatility related to the recognition in earnings of changes in the values of the commitments. The instruments used to economically hedge the fair value of the derivative loan commitments include forward loan sales commitments and other free-standing derivatives such as options and U.S. Treasury futures. A forward loan sales commitment protects the Company from

losses on sales of the loans arising from exercise of the loan commitments by securing the ultimate sales price and delivery date of the loans. The Company takes into account various factors and strategies in determining the portion of the mortgage pipeline (derivative loan commitments) it wants to hedge economically.

[Task Force Recommended disclosure]
Risk management results related to the economic hedging of derivative loan commitments with forward loan sale commitments or other free-standing derivatives are summarized below and are included in the caption titled "Mortgage Banking Operations" in the consolidated statement of income for 200x (in millions):

Gain (loss) on forward loan sale commitments recognized in income	$ -,---
Gain (loss) on derivative loan commitments recognized in income	(-,---)
Net gain (loss) on derivatives	$(-,---)

SECTION II – e

Illustrative Disclosures and Relevant Financial Reporting Literature – SFAS 107

Statement of Financial Accounting Standards No. 107 ("SFAS 107"), *Disclosures about Fair Value of Financial Instruments*, requires all companies to disclose the fair value of all financial instruments (on and off-balance sheet), both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimation of fair value is not practicable, SFAS 107 requires disclosure of descriptive information pertinent to estimating the value of a financial instrument.

SFAS 107 describes the disclosures required about the fair value of financial instruments as follows:

> An entity shall disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. An entity also shall disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments."
>
> "Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

Appendix A of SFAS 107 contains examples of procedures for estimating fair value.

Based on the preceding guidance as discussed by SFAS 107, the Task Force recommends that the following factors be considered by an entity in its fair value disclosure of derivative loan commitments including, but not limited to, the following:

- A description which addresses the initial measurement of the derivative loan commitment and a description of the accounting literature (e.g., paragraph 6 of SFAS 133 (as amended), DIG Issue C13) which guides the accounting treatment for derivative loan commitments.
- A quantitative disclosure of the fair value of derivative loan commitments. This may be included within the entity's SFAS 107 table which should include both the carrying value and fair value.
- The entity should disclose the method(s) and significant assumptions used to estimate the fair value of derivative loan commitments. These assumptions may include descriptions of the loan amounts, loan interest rates, fees for benefits of

servicing in excess of expected servicing fees (excess servicing fees), fees paid which serve as a guarantee of interest and principal payments to the investor (guarantee fees), costs to originate the loans, and fallout rates. An entity should also consider describing any changes in assumptions that may have a material effect on fair value or changes in fair value of derivative loan commitments.

- Additionally, an entity may want to disclose the fact that under SAB 105, the fair value associated with the expected servicing fees is to be excluded from the entity's calculation of the fair value of its derivative loan commitments and is to be recognized only once the servicing asset has been contractually separated from the loans that would result from the exercise of the loan commitments by sale or securitization of the loan.

Task Force Illustrative Disclosures Under SFAS 107

The following illustrates an example disclosure that may fulfill the requirements of SFAS 107 and the factors discussed above for a reporting entity that enters into derivative loan commitments. As an entity drafts its disclosures, it should ensure their disclosures include all applicable material information that allows financial statement users to gain an understanding of its own financial position and results of operations. The example below should not be viewed as a "safe harbor" disclosure as it is expected that companies would need to customize their disclosure to be congruent with their respective facts and circumstances.

Section: Footnotes to Financial Statements; Fair Value of Financial Instruments

In determining the fair value of its derivative loan commitments for economic purposes, the Company considers the value that would be generated when the loan arising from exercise of the loan commitment is sold in the secondary mortgage market. That value generally includes the following components: (1) the price that the loan is expected to be sold for in the secondary mortgage market, (2) points expected to be collected from the borrower, (3) the value of any excess servicing, and (4) direct fees and costs associated with the origination of the loan, (5) the value of the net normal servicing cash flows, (6) costs associated with the acquisition of the right to service the resulting loan, and (7) the value of any internally-developed intangible assets.

For accounting purposes, the Company's model excludes from its calculation of fair value, at inception and throughout the life of the derivative loan commitment: (1) the value of net normal servicing cash flows (servicing cash flows associated with the expected servicing fee plus ancillary fee income, float income, and late charges less costs to service, interest costs on servicing advances, and default costs), (2) costs associated with the acquisition of the right to service the resulting loan, and (3) the value of any internally-developed intangible assets. The models initial fair value (IFV) is calculated using the remaining four assumptions. The Company then indexes the IFV for the derivative loan commitment to zero at inception, consistent with the concepts embodied in EITF 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.*

Subsequent to inception, the Company estimates the updated fair value (UFV) based on those remaining four assumptions and the UFV is compared to the IFV calculated at inception to measure the change in fair value. A positive change in fair value is recorded as an asset and a negative fair value is recorded as a liability.

The four key assumptions are described in more detail as follows:

The price that the loan arising from exercise of the loan commitment could be sold for in the secondary mortgage market is determined by estimating the gross gain or loss expected to be realized from the sale of the mortgage-backed security into which the loan is expected to be securitized.

Points collected from the borrower represent income expected to be received from the borrower when the loan is funded, and represent a fundamental component in the overall gain or loss that will be realized when a loan is sold. Points are paid by borrowers to obtain lower interest rates on their loans, which will affect the ultimate gain or loss realized when the loans arising from exercise of the loan commitment are securitized and sold.

The projected value of excess servicing is the value of the remaining strip of cash flows from the loan arising from exercise of the loan commitment after the Company has considered the interest rate that the mortgage-backed security will bear, the normal servicing fee, and the guarantee fee. The value of the excess servicing is derived by discounting the expected contractual cash flows for the loans, adjusted for estimates of prepayments, delinquencies and defaults. Prepayment speed estimates are derived from the XYZ model, which is a third-party prepayment model that is widely used in the mortgage industry. Estimates of delinquencies and defaults are derived from the Company's historical experience as adjusted for current economic trends, and these estimates approximate assumptions used by other market participants in the mortgage industry. The discount rate used reflects the Company's estimate of its marginal risk-adjusted borrowing rate in all future periods, and is based on the ten-year Treasury rate plus a margin.

The Company incurs costs to originate the loan and collects fees from the borrower, which represents administrative costs that are associated with the derivative loan commitments. The Company determines the direct cost per loan based on an analysis of the actual direct costs incurred related to loans originated during the period, and updates this analysis at least annually.

In estimating their fair values, the Company assigns a probability to a loan commitment based on an expectation that it will not be exercised and the loan will not be funded. This probability is commonly referred to as fallout.

The aggregate fair value of forward loan sales commitments on the consolidated balance sheet at December 31, 200x and 200x was $-- million and $-- million, respectively; and

the aggregate fair value of derivative loan commitments on the consolidated balance sheet at December 31, 200x and 200x was $-- million and $-- million, respectively.

The following table is a summary of the company's financial instruments, as defined by Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*.

	December 31, 200x		December 31, 200x	
	Carrying amount	Estimated fair value	Carrying amount	Estimated Fair value
FINANCIAL ASSETS				
Mortgages held for sale	$ --,---	$ --,---	$ --,---	$ --,---
Loans held for sale	--,---	--,---	--,---	--,---
Loans, net	--,---	--,---	--,---	--,---
Nonmarketable equity investments	--,---	--,---	--,---	--,---
Derivative loan commitments	--,---	--,---	--,---	--,---
FINANCIAL LIABILITIES				
Deposits	--,---	--,---	--,---	--,---
Long-term debt	--,---	--,---	--,---	--,---
Forward loan sale commitments	--,---	--,---	--,---	--,---

APPENDIX A

SEC Staff Accounting Bulletin No. 105: *Application of Accounting Principles to Loan Commitments*

SEC Staff Accounting Bulletin:
No. 105 – Application of Accounting Principles to Loan Commitments

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 105]

Staff Accounting Bulletin No. 105

AGENCY: Securities and Exchange Commission

ACTION: Publication of Staff Accounting Bulletin

SUMMARY: This staff accounting bulletin summarizes the views of the staff regarding the application of generally accepted accounting principles to loan commitments accounted for as derivative instruments.

DATE: March 9, 2004

FOR FURTHER INFORMATION CONTACT: John James, Greg Cross or Eric Schuppenhauer, Office of the Chief Accountant (202) 942-4400, or Louise Dorsey, Division of Corporation Finance (202) 942-2960, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jill M. Peterson
Assistant Secretary

Date: March 9, 2004

Part 211 - (AMEND)

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 105 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN NO. 105

The staff hereby adds Section DD to Topic 5 of the Staff Accounting Bulletin Series. Topic 5: DD provides guidance regarding loan commitments accounted for as derivative instruments.

TOPIC 5: MISCELLANEOUS ACCOUNTING

* * * * * * *

DD. Loan Commitments Accounted for as Derivative Instruments

Facts: Bank A enters into a loan commitment with a customer to extend a mortgage loan at a specified rate. Bank A intends to sell the mortgage loan after it is funded. Under Statement No. 133, such a loan commitment should be accounted for as a derivative instrument and measured at fair value.[1] Bank A expects to receive future cash flows related to servicing rights from servicing fees (included in the loan's interest rate or otherwise), late charges, and other ancillary sources, or from selling the servicing rights into the market.

Question 1: In recognizing the loan commitment, may Bank A consider the expected future cash flows related to the associated servicing of the loan?

Interpretive Response: No. The staff believes that incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. However, servicing assets are to be recognized only once the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.[2]

Further, no other internally-developed intangible assets (such as customer relationship intangible assets) should be recorded as part of the loan commitment derivative. Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a loan commitment either individually, in a portfolio, or in a business combination).

Question 2: What disclosures should Bank A provide with respect to loan commitments accounted for as derivative instruments?

Interpretive Response: Bank A should disclose its accounting policy for loan commitments pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies.* Bank A should provide disclosures related to loan commitments accounted for as derivatives, including methods and assumptions used to estimate fair value and any associated hedging strategies, as required by Statement No. 107,[3] Statement No. 133 and Item 305

of Regulation S-K. Additionally, Bank A should provide disclosures required by Item 303 of Regulation S-K and any related interpretive guidance.

Question 3: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?
Interpretive Response: The staff will not object if registrants that have not been applying the accounting described in this bulletin continue to use their existing accounting policies for loan commitments accounted for as derivatives entered into on or before March 31, 2004. For loan commitments accounted for as derivatives and entered into subsequent to that date, the staff expects all registrants to apply the accounting described in this bulletin. Financial statements filed with the Commission before applying the guidance in this bulletin should include disclosures similar to those described in SAB Topic 11:M.

Endnotes

[1] Paragraph 3 of FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amended paragraph 6(c) of Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* to add: "...loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender)." Similar guidance is provided in Statement 133 Implementation Issue No. C13, *Scope Exceptions: When a Loan Commitment Is Included in the Scope of Statement 133.*

[2] See paragraph 61 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

[3] FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments.*

APPENDIX B

REFERENCES

Following are titles of authoritative financial reporting literature referenced in this document.

Statements of Financial Accounting Standards

- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*
- 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. 119, *Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments* (superseded by FASB Statement No. 133)
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (amended by FASB Statement No. 149)
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*
- FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

Derivatives Implementation Group Issues

- DIG Statement 133 Implementation Issue No. C13, *Scope Exceptions: When a Loan Commitment is Included in the Scope of Statement 133* (amended by FASB Statement No. 149)

Accounting Principles Board Opinions

- APB Opinion No. 22, *Disclosure of Accounting Principles*

AICPA Statement of Positions

- SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

Emerging Issues Task Force Issues

- EITF 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*

SEC Rules and Regulations

- SEC Staff Accounting Bulletin No. 99, *Materiality*

- SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*
- Regulation S-K, Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*
- Regulation S-K, Item 305, *Quantitative and Qualitative Disclosures about Market Risk*

APPENDIX C

GLOSSARY OF TERMS

Economic Hedge. A hedging relationship in which the purpose is to offset changes in the fair value of a hedged item with changes in the fair value of hedging instruments but the relationship is not designated as a hedge pursuant to SFAS 133, as amended by SFAS 149 and, consequently, does not follow hedge accounting.

Fallout Risk. The risk that a holder, or borrower, will not exercise a loan commitment.

Forward loan sale commitment. A legally binding contract in which a mortgage lender commits to sell a loan to a buyer at a predetermined future date and price.

Free-standing derivative. A contract that meets the definition of a derivative under SFAS 133 (as amended) that is not designated as a hedging instrument pursuant to that statement.

Guarantee Fee. A fee paid to a guarantor as compensation for their commitment to advance interest and principal payments on defaulted mortgage loans to holders of mortgage-backed securities backed by the loans.

Hedge. A financial instrument which mitigates financial risk

Notional amount. A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument.

Secondary mortgage market. A market where existing (already funded) mortgages are bought and sold. It contrasts with the primary market where mortgages are funded.

Table-funding arrangements. An arrangement whereby an enterprise provides the original funding for a mortgage loan "at the table" when a mortgage broker or correspondent firm and borrower close the loan. Concurrent with the loan closing, the mortgage banking enterprise acquires the loan and the related loan servicing right from the mortgage broker or correspondent firm.

Underlying. A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.