

# Statutory Issue Paper No. 37

## Mortgage Loans

### STATUS

Finalized March 16, 1998

**Original SSAP and Current Authoritative Guidance: SSAP No. 37**

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

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

2. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting of mortgage loans and related fees that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

3. For statutory accounting purposes, a mortgage loan shall be defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.) Mortgage loans meet the definition of assets as specified in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

### Initial Investment

4. For mortgage loans originated by the reporting entity, the initial investment in mortgage loans shall be recorded at the principal amount of the loan net of any amounts deferred under the provisions of paragraphs 5 and 7 below. For mortgage loans purchased by a reporting entity, the initial investment shall be recorded as the amount paid to the seller. Accordingly, there may be a premium or discount on such loans resulting from a difference between the amount paid and the principal amount.

### Loan Origination Fees

5. Loan origination fees shall be defined as fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. The term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending transaction. Nonrefundable loan origination fees shall not be recorded until received in cash. Nonrefundable fees representing points shall be deferred as part of the loan balance and amortized over

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

### **Loan Origination, Acquisition, and Commitment Costs**

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

### **Commitment Fees**

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

### **Amortization**

8. Premiums and discounts on acquired loans, and mortgage interest points and commitment fees (if such qualify for amortization as described in the previous paragraph) shall be recognized as an adjustment of yield over the life of the loan (i.e., the period of time until total principal proceeds of the loan are received in cash) so as to produce a constant effective yield each year to maturity. If the reporting entity holds a large number of similar loans for which the prepayments of principal are probable, (probable is used in the same context as in paragraph 4 in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*, which defines probable as the future event or events are likely to occur), and the timing and amount can be reasonably estimated, the reporting entity shall include estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. The amount recognized as an adjustment of yield shall be credited or charged to interest income in the calculation of net investment income.

### **Prepayments**

9. Payments received in advance of due dates may produce prepaid interest which shall be recorded as a liability, Unearned Investment Income, on the reporting entity's balance sheet. The portion of the payments received in advance of due dates that represent prepayments of principal shall be recorded as a reduction in the mortgage loan balance.

10. A mortgage loan may provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

### **Interest Income**

11. Interest income shall be recorded as earned and shall be included in investment income in the Summary of Operations. Interest income shall include interest collected, the change in interest income due and accrued and the change in unearned interest income as well as amortization of premiums, discounts and deferred fees as specified in paragraph 8.

**Accrued Interest**

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

**Impairments**

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

**Construction Loans**

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

**Disclosures**

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

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

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

*Derivative Financial Instruments* (as it relates to disclosure about financial instruments with off-balance-sheet risk),

- b. Concentrations of credit risk in accordance with Issue Paper No. 27,
- c. Description of the valuation basis of the mortgage loans,
- d. Information on the minimum and maximum rates of interest received for new loans made by category,
- e. Maximum percentage of any one loan to the value of security at the time of the loan,
- f. Total carrying amount of mortgages with interest 180 days past due and the amount of interest past due thereon. Disclose the carrying amount and number of mortgage loans where interest has been reduced, by percent reduced and
- g. Taxes, assessments, and amounts advanced not included in the mortgage loan total.

## DISCUSSION

17. The conclusion differs with current statutory guidance in that loan origination fees shall be recorded in the income statement, except for points which will be deferred as part of the loan balance. Also, prepayment penalties are to be recorded as investment income. It rejects *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring and Initial Direct Costs or Leases* (FAS 91) and *FASB Emerging Issues Task Force Issue No. 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*, which provides that certain origination costs be deferred. It adopts FAS 114 and 118 for collateral dependent loans (FAS 114 and FAS 118 apply to loans other than mortgage loans), with the following modifications:

- a. Impairment to be measured based on the fair value of the collateral less costs to obtain and sell, whereas that is just one option under FAS 114; and
- b. The reporting entity is required to record any other than temporary impairment as a realized loss and shall not record subsequent recoveries in fair value.

The conclusion also adopts *FASB Emerging Issue Task Force Issue No. 84-19, Mortgage Loan Payment Modifications*, which considers the effects of accelerated payments. The conclusion rejects *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans*, which provides alternative accounting for the loan balance under the cost recovery method in circumstances where the amounts, and timing of collections and the ultimate collectibility of the acquisition amount of the loan are not probable. This method is not consistent with the impairment provisions established by paragraph 13 of this issue paper.

18. Recording mortgage loans as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similar nature to bonds, recording the mortgage loans at amortized cost is consistent with the principles used to record bonds at amortized cost.

19. Requiring reporting entities to defer commitment fees until the loan commitment terminates is more conservative than the GAAP treatment which allows for income recognition during the commitment period if the likelihood that the commitment will be exercised is remote.

20. Prepayment penalties represent consideration for interest income not received on a loan due to the prepayment. If that interest had been received it would have been recorded as investment income, therefore, it is appropriate to record the prepayment penalties as investment income. This is different from the current statutory guidance which allows a reporting entity to record the penalties as either investment income or realized capital gains.

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

#### **Drafting Notes/Comments**

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

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

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

##### Valuation

Mortgage loans when acquired are recorded in the general ledger at the amount of unpaid principal balance. However, if they are acquired at a discount or premium, entries for the amount of such discount or premium may be made in separate ledger accounts. If so, the net book value of mortgage loans consists of the unpaid balances plus any unamortized premium balances and less any unamortized discount.

Requirements for valuation of investments for reporting purposes indicate that mortgage loans that are not in default (regarding either principal or interest) should be valued at the unpaid principal balance. Further, mortgage loans acquired at a premium or at a discount are to be valued at amortized cost (i.e., net book value).

Premium amortization or discount accretion over the full term of a loan normally implies the use of a method that produces a constant effective yield each year to maturity. However, if the period of amortization or accretion is relatively short, a straight-line method may be used.

For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value may be adjusted for unpaid interest and additional expenses, such as insurance, taxes and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that such amounts are deemed to be recoverable from the ultimate disposition of the property. However, if such interest and costs cannot reasonably be expected to be recovered, they should not be added to the carrying value, and the cost should be expensed.

If, when reporting mortgage loans in default, the values of real estate have declined to less than the unpaid principal balances, an appropriate valuation reserve should be established to reflect the expected uncollectible amount.

Mortgage loans that are in default, or which are under foreclosure proceedings, continue to be classified as mortgage loans. Loans for which foreclosure proceedings have been completed, even to the extent of the court granting title to the mortgages, may temporarily retain their status as mortgage loans, since in some states the mortgagor still has the privilege of redeeming the

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

### Interest

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

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

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

### Payments

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

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

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

### Prepayment penalties

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

### Loan origination fees and costs

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

### Commitment fees

To obtain a commitment from the mortgagee to make funds available at some time in the future, an applicant may pay a "commitment standby" fee to the mortgagee (e.g., an insurance company). This fee is returnable to the applicant if the loan is closed in accordance with the commitment. If the loan is not closed in accordance with the commitment, the fee becomes income to the mortgagee to cover the costs involved in making the funds available at the time the applicant requires the funds.

The applicant also may pay a commitment fee to a mortgagee to obtain a commitment to be able to borrow funds at a specified rate and with specific terms quoted in the commitment. As this commitment has value to the applicant, and the mortgagee has incurred costs in reviewing the applicant's proposal, this fee is not returnable to the applicant unless the commitment is refused.

The commitment fee should be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield. If the commitment expires unexercised, the commitment fee should be recognized in income on the commitment expiration date. If the commitment fee is an insignificant adjustment to the yield, the commitment fee may be recognized in income at the time of the funding of the loan.

23. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans, contains similar wording.

### Generally Accepted Accounting Principles

24. GAAP guidance pertaining to a reporting entity's accounting for mortgage loans is contained in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), as amended by FAS 114. Paragraph 47 of FAS 60, as amended by paragraph 23 of FAS 114 states:

Mortgage loans shall be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for estimated uncollectible amounts relating to mortgage loans shall be included in income as prescribed in *FASB Statement 114, Accounting by Creditors for Impairment of a Loan*.

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

#### Loan Origination Fees and Costs

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

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<sup>2</sup> Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.

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6. Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

#### Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment:

- a. If the enterprise's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,<sup>3</sup> the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.



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

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- b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

#### Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

16. In applying the provisions of this Statement to loans purchased as a group, the purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts shall be used to apply the interest method, except as set forth in paragraph 19. If prepayments are not anticipated pursuant to paragraph 19 and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees and purchase premium or discount shall be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

#### Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

#### Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.<sup>6</sup> Under the provisions of this statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

- a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could

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

- b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)
- c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.<sup>7</sup> (Refer to Appendix B.)

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<sup>6</sup> The "interest" method is also described in paragraph 16 of *APB Opinion No. 12, Omnibus Opinion--1967*, in the first sentence of paragraph 15 of *APB Opinion No. 21, Interest on Receivables and Payables*, and in paragraphs 235-239 of *FASB Concepts Statement No. 6, Elements of Financial Statements*.

<sup>7</sup> A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

- a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

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

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

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

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#### Balance Sheet Classification

21. The unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment of yield pursuant to this Statement shall be reported on the enterprise's balance sheet as part of the loan balance to which it relates.
26. GAAP guidance on the accounting for the impairment of a loan is contained in FAS 114, as amended by FAS 118. Pertinent excerpts, as amended, are as follows:

8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. For a loan that has been restructured in a troubled debt restructuring, the contractual terms of the loan agreement refers to the contractual terms specified by the original agreement, not the restructuring agreement.

13. When a loan is impaired as defined in paragraph 8 of this Statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan<sup>2</sup> (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

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

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

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

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

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

## Disclosures

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

- a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement
- b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded
- c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

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

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

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

## EITF 84-19 ISSUE

The borrower and lender enter into an agreement whereby the borrower increases his mortgage payments for a specified period, at the conclusion of which the lender forgives a portion of the remaining principal on the loan. The borrower may terminate the arrangement at any time but receives no principal reduction if he makes less than 12 consecutive increased payments. The issue is how the lender should account for the portion of principal that may be forgiven.

1. Should the lender assume that the accelerated payments will be made to maturity and discount such accelerated payments using the current interest rate, thus recording a loss?

2. Should the lender assume that only 12 consecutive increased payments will be made and that other payments to maturity will be at the original rate and discount all payments using the current interest rate, thus recording a smaller loss?

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

#### EITF 84-19 DISCUSSION

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

### RELEVANT LITERATURE

#### Statutory Accounting

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

#### Generally Accepted Accounting Principles

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

#### State Regulations

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