

Supporting SFAS 133 Accounting

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The Statement of Financial Accounting Standards No. 133 (SFAS 133) *Accounting for Derivative Instruments & Hedging Activities* (Released June 1998) has been the source of much consternation in the mortgage banking industry. The specter of having loan production activities accounted for at the lower of cost or market and having the servicing portfolio subject to potential significant earnings volatility has many firms concerned.

The fact is the SFAS 133 is now a Generally Accepted Accounting Principle. Those companies that prepare GAAP financials will need and want to comply.

The Mortgage Bankers Association of America has published an Industry Q&A Guide for SFAS 133. The guide among other things identifies key aspects that must be fulfilled to achieve compliance. The first item identified is that a documented risk management policy be in place prior to the beginning of a hedge period. This policy among other things should describe how a company will measure and assess the effectiveness of hedging relationships at inception and on an ongoing basis. The guide goes on to recommend that a company consult with their independent accountants before documenting a risk management policy.

Later the guide describes how interest rate lock commitments (IRLCs) could in some cases be considered a derivative for purposes of SFAS 133. An IRLC is an unclosed loan application with a locked in mortgage rate. The closed loan inventory (warehouse) might typically be considered as an asset.

The guide indicates that if IRLCs are derivatives, they shall be accounted for as freestanding derivatives with changes in their values reported in earnings. Any derivatives associated with the IRLCs would also be accounted for as freestanding derivatives with changes in their values reported in earnings.

This would then lead one to focus on monitoring and assessing the effectiveness of hedges versus the closed loan inventory. The balance of this article will describe an approach to group loan inventory into similar asset buckets, stress test those similar asset buckets, then collect daily value changes of the buckets and associate hedge value changes to those buckets for subsequent assessment.

In creating similar asset buckets you will want to find a common thread, such as all the assets being deliverable into a common instrument and coupon rate. Once you have made the bucket assignments you will stress test the buckets over a range of interest rate changes. A successful test will indicate that all the assets in the bucket tend to move in common. This has generally been interpreted as a move between 80% and 125% of the group's average.

Each day you would calculate the difference in value of the loan inventory at the beginning of the day and the end of the day. This contemplates the same set of loans being valued at each point. Also, the change in value of non-option hedges would be calculated.

The volume of the loan inventory and non-option trades would be converted to a common benchmark denomination. The value change of the trades relating to a benchmark volume equivalent to the benchmark volume of the loan inventory would be set aside for allocation.

Finally, a pro rata share of the set aside trade value change would be distributed to each similar asset bucket based upon each bucket's benchmark weighted volume. The daily results and

allocations to the similar asset buckets are stored in an archive table. This allows for assessments to be made at any time in the future for any time frame.

This approach while requiring a software system that could accommodate the process is simple to maintain and provides a consistent collection level of data at a granularity that is manageable yet informative.

Again, this is one approach to handling the collection / assessment requirement of SFAS 133. You should consult your independent accountants to see if it is suitable for your company before implementing this strategy.