COMMENT/BY IRA G. KAWALLER AND WALTER TEETS

Commitments: Coalescing On Accounting Treatment

A professional accounting fellow from the Securities and Exchange Commission's Office of the Chief Accountant acknowledged in a December speech that the accounting treatment for mortgage commitments — particularly commitments that relate to mortgages intended for resale — was being applied inconsistently.

Eric Schuppenhauer went on to say that the SEC expects these commitments to be carried as liabilities on the balance sheet, not as assets, as some have done. He also indicated the agency would look to the Financial Accounting Standards Board for guidance on the measurement of these liabilities.

We agree with the SEC analysis as to why these commitments start life as liabilities, but not with the suggested resolution of FASB providing additional measurement guidance for these commitments as liabilities.

Rather, we recommend that FASB expand its scope exception for certain loan commitments to all loan commitments — for prospective borrowers and prospective lenders alike. This would shift the timing of when income would be recorded, but only for those cases when loans are issued at off-market interest rates. (When mortgage rates are stable throughout the relatively short commitment period, no differential income effect would arise.)

The currently prescribed procedures will foster income effects for off-market mortgages at or before the point when these loans are issued. Our suggestion, on the other hand, would result in realizing these income effects over the life of the loans.

We believe that this outcome is a reasonable representation of the transaction's underlying economics. Our recommendation has the ancillary benefits of eliminating the difficulty associated with valuation and dramatically simplifying the accounting — thereby fostering consistency.

The SEC's conclusion that the commitment is an option contract is irrefutable. It is a *put option* — held by the prospective borrower and written by the prospective lender. It provides the prospective borrower with the right (but not the obligation) to sell the loan to the originator; hence the prospective borrower has an asset while the prospective lender has a liability.

While it is true that the lender will end up with an asset — the loan — if this put option is exercised, this outcome isn't relevant when the commitment is made.

Assuming the mortgage commitment qualifies as a derivative, one piece of the accounting is clear: The commitment must be carried on the balance sheet at fair value.

But again, opinion differs as to how these valuations should be determined. Moreover, it's likely that industry will develop better and better methodologies.

Confusion about the initial value of these options arises because most commitments are issued without a concurrent payment being realized by the originator, leading some to conclude that these options are worthless. In fact, these options do have value, reflected by the originator's expectation to be compensated for his or her efforts later — but only if the loan closes.

It is reasonable to consider the initial value of the put option (that is, at its inception) to be equal to a fraction of some future revenue stream that is *expected* to be realized subsequent to the exercise of the option by the borrower.

Further complicating the valuation is the fact that the participants in this marketplace often seem to behave "uneconomically." That is, in some cases prospective borrowers fail to exercise options that are in the money; in others, they exercise out-of-the-money options.

In option parlance, the fact that this option might be exercised when it is out of the money means that the option value — normally thought of as being bounded by zero — may become negative.

This additional concern, however, may end up being more theoretical than material; the prospect of borrowing at above-market rates will clearly serve to discourage borrowers from exercising. As a consequence, while the commitment may have a negative value, its magnitude will likely be constrained.

Because of the measurement and definitional problems, we agree that further FASB guidance is needed and suggest a broader scope exception, applied to all loan commitments, for both holder and issuer. At a minimum, the standards board needs to clearly resolve any confusion that issuers of commitments have sold put options. Redefining these short puts as assets would be inventing new language for well-established market mechanisms.

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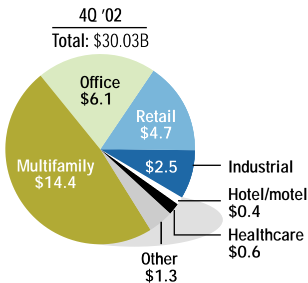
Originations

For commercial mortgages. Dollars in billions

BY PROPERTY TYPE



4Q '03
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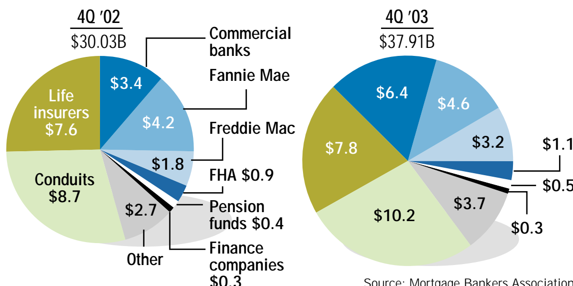
$5.8
$15.2
$3.2
$0.9
$3.5
$0.8

BY INVESTOR TYPE



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