



**To:** Board Members

**From:** Servicing Rights (Hamilton, ext. 330)

**Subject:** Minutes of the August 4, 2004 Board Meeting      **Date:** August 10, 2004

**cc:** Bielstein, L. Smith, Petrone, Wilkins, Lott, E. Smith, Laurenzano, Hamilton, Varian, Bullen, Donoghue, Lusniak, Gagon, Hoermann, Thompson, Gabriele, Sutay, FASB Intranet

*The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.*

**Topics:** Subsequent measurement of separately recognized servicing rights and disclosure requirements for separately recognized servicing rights

**Basis for Discussion:** Board memorandums dated July 22, 2004 and July 30, 2004.

**Length of Discussion:** 3:00 p.m. to 4:15 p.m.

**Attendance:**

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott

IASB Board/Staff present: Leisenring

Board members absent: None

Staff in charge of topics: Laurenzano

Other Staff at Board table: L. Smith, Lott, Wilkins, E. Smith, Hamilton

Outside Participants: None

#### Summary of Decisions Reached:

The Board decided that enterprises will be allowed an irrevocable one-time election, upon the initial application of the guidance to be included in an amendment to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to subsequently measure each class of servicing rights held at the time of application that is separately reported as assets under Statement 140 at fair value (through earnings) or the lower of carrying amount or market (LOCOM). For this purpose, each of the different classes of servicing rights for which fair value could be elected would include all of an entity's rights to service one major loan type (for example, mortgage loans, credit card receivables, or automobile loans). The Board also requested that further research be performed on disclosure requirements for servicing rights.

#### Objective of the Meeting:

The objective of the meeting was for the Board to decide (1) whether the option to subsequently account for separately recognized servicing rights should be a policy election and (2) the disclosures that should be required for separately recognized servicing.

#### Matters Discussed:

##### **Should the Option to Subsequently Account for Separately Recognized Servicing Rights Be a Policy Decision?**

Mr. Laurenzano introduced three alternatives to applying the election (at fair value or LOCOM) to subsequently account for separately recognized servicing rights:

##### **Item-by-Item**

Mr. Laurenzano stated that an item-by-item election is an irrevocable election upon initial recognition of the servicing right that would allow an enterprise to decide which individual servicing rights will be subsequently measured at fair value. He stated that the benefits of this alternative are that making the election at this level provides enterprises the most flexibility, which may correspond to the level of detail enterprises are using to select servicing rights to be hedged.

The staff observed that comparability problems with this alternative include: (1) enterprises may be following different election models, (2) an enterprise may measure servicing rights with similar characteristics differently, and (3) different types of servicing rights may be measured differently.

### **Class-by-Class**

Mr. Laurenzano stated that this method is an irrevocable one-time election upon adoption to divide the population of servicing rights into classes and elect to value all servicing rights within each class in the same manner. The staff provided the Board with the following four alternatives to be considered for determining the classes:

- Based on the characteristics of the loans
- Based on management structure (similar to defining the operating segments or units used for goodwill impairment)
- Based on any set of objectively determinable criteria for mutually exclusive categories
- Based on the most readily available source of pricing information needed to determine fair value.

The staff has observed that the benefits of selecting the class-by-class alternative are that the level of comparability provided will likely be superior to the item-by-item alternative. The staff pointed out two comparability problems with this alternative: (1) enterprises may be following different election models and (2) an enterprise may measure servicing rights with similar characteristics differently.

### **Enterprise-Wide Policy Election**

Mr. Laurenzano stated that enterprises could be required to establish a policy upon adoption of the statement to remeasure all servicing rights in the same manner; this same treatment would be applied to all subsidiaries. The staff recommended this alternative as it leads to the most comparability among enterprises.

Mr. Trott recommended that an enterprise's irrevocable election upon the initial adoption of the new FASB pronouncement under this project to subsequently

measure all separately recognized servicing rights at fair value be made on a class-by-class basis. Mr. Trott proposed that classes of servicing rights be identified by the following attributes: (1) compensation structure (for example, adequate compensation in excess of servicing costs and adequate compensation) and (2) prepayment risk. He believes that by classifying servicing rights in this manner, entities will be able to effectively allocate the additional resources required to measure servicing rights at fair value. He commented that the servicing rights most commonly hedged are accounted for as assets that have prepayment risk.

Ms. Seidman also recommended that an enterprise's irrevocable election upon the initial adoption of the new FASB pronouncement under this project to subsequently measure all separately recognized servicing rights at fair value be made on a class-by-class basis. However, she supported a broad categorization of classes by major asset type, similar to the identification of classes in paragraph 17(g) of Statement 140.<sup>1</sup> She believes that identification of classes on such a broad level adequately addresses comparability issues while avoiding the potential pitfalls associated with attempting to identify classes of servicing rights based on the rights that are likely to be hedged. She proposed that, if the Board subsequently decides that classes of servicing rights should be more narrowly delineated than major asset type, guidance redefining what constitutes a class of servicing rights be addressed in the Board's fair value option project.

Ms. Schipper indicated that she does not agree with the measurement alternative provided by the fair value option project. She stated that, if forced to choose between the existing options, she would support the staff's recommendation that an enterprise's irrevocable election upon the initial adoption of the new FASB pronouncement under this project to subsequently measure all separately recognized servicing rights at fair value be made as an enterprise-wide policy decision because she believes the election should be required on a broad basis in order to promote comparability.

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<sup>1</sup> Paragraph 17(g) of Statement 140, "If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):"

Mr. Crooch asked the staff to justify its recommendation for an enterprise-wide election over a class-by-class election. Ms. Schipper responded that, when compared with a class-by-class election, an enterprise-wide election would (1) ease the burden of guidance provided by standard setters, (2) ease the burden of implementation for constituents, and (3) provide additional comparability compared to the two other election options presented.

Mr. Trott commented that a constituent's burden (cost) could be increased by requiring an enterprise to subsequently measure servicing rights on an enterprise-wide basis. He observed that the burden of determining the fair value of each class of servicing rights could be greater than that required with a class-by-class election in cases where enterprises hold several different classes of separately recognized servicing rights. Ms. Schipper pointed out that enterprises are already required to subsequently determine the fair value of all separately recognized servicing rights under existing guidance.

Mr. Schieneman asked whether enterprises are appropriately applying existing guidance to subsequently determine the fair value of all separately recognized servicing rights under existing guidance. Ms. Schipper commented that enterprises that report under US GAAP are required to follow this guidance.

Messrs. Batavick, Crooch, and Schieneman expressed support for the class-by-class election option where classes are delineated by major asset type (for example, mortgage loans, credit card receivables, and automobile loans) as presented by Ms. Seidman.

Mr. Herz initially supported the staff recommendation that an enterprise's irrevocable election upon the initial adoption of the new FASB pronouncement under this project to subsequently measure all separately recognized servicing rights at fair value be made as an enterprise-wide policy decision.

Mr. L. Smith asked Ms. Seidman to clarify what constitutes a class of servicing rights. Ms. Seidman suggested that the Board leverage guidance included in paragraph 17(g) of Statement 140 relating to disclosures, which includes as examples of major loan types, mortgage loans, credit card receivables, and automobile loans. Ms. Seidman went on to state that she believes classes of

separately recognized servicing rights should be broadly defined by major asset type where, for example, one class of servicing rights includes conforming and nonconforming loans as well as fixed and variable loans for a major loan type. No Board members objected to Ms. Seidman's description of servicing rights classes.

The Board decided that enterprises will be allowed an irrevocable one-time election, upon the initial application of the new FASB pronouncement under this project, to subsequently measure each class of servicing rights at fair value or LOCOM. Classes of servicing rights for which fair value could be elected include all of an entity's rights to service one major loan type. [Six Board members did not object; one objected: Schipper.]

### **Should Additional Disclosures Related to Separately Recognized Servicing Rights Be Required?**

Mr. Laurenzano stated that the staff has recommended modifying the existing disclosure requirements for servicing rights continued to be recognized under LOCOM in paragraph 17(e) of Statement 140 to require the sensitivity analysis of the hypothetical effect on the fair value of servicing rights of two or more unfavorable variations from expected assumptions used in calculating fair value. This disclosure is presently required by paragraph 17(g)(3) of Statement 140 for retained interests. Mr. Laurenzano commented that since enterprises are able to include this disclosure requirement for servicing rights with other retained interests and do not have to apply this requirement for purchased servicing rights some constituents have stated that disclosure requirements related to servicing rights are not being clearly presented.

Mr. Laurenzano stated that the staff has recommended the following separate disclosures for servicing rights subsequently measured at fair value:

- Management's rationale for its decision to subsequently measure servicing rights at fair value
- The amounts of servicing rights recognized during the period
- The fair value of the recognized servicing rights plus a description of the valuation techniques used in determining fair value

(including the methodology and model validation techniques) as well as quantitative information about the inputs used in the model (discount rates, prepayments)

- The changes in fair value of servicing rights recognized in earnings during the period
- Sensitivity analysis or stress test showing the hypothetical effect on the fair value of servicing rights in two or more unfavorable situations.

The staff also presented for the Board's consideration additional disclosures for servicing rights subsequently measured at fair value relative to the amortization and impairment of the servicing rights during the period. Mr. Laurenzano commented that these disclosures are required for servicing rights not subsequently fair valued. Certain staff members believe that these disclosures should continue to be required for servicing rights subsequently measured at fair value for comparability purposes. Other staff members believe that the comparability issue can be addressed by requiring more disclosures around the fair value of servicing rights not subsequently measured at fair value.

Mr. Laurenzano stated that the proposed disclosure requirements for servicing rights subsequently measured at fair value differ from the proposed disclosure requirements in the Exposure Draft on fair value measurement. That Exposure Draft requires the following disclosures:

- Fair value used at the end of the period
- Fair value as a percent of total assets and liabilities
- How the fair value was determined including the extent to which market inputs were used
- The effect of remeasurements on earnings for the period

Mr. Trott recommended that disclosure of management's rationale for its decision to subsequently measure servicing rights should be required regardless of whether servicing rights are subsequently measured at fair value or at LOCOM (and not limited to servicing rights that are subsequently measured at fair value).

Mr. Trott went on to propose that enterprises be required to disclose, on a quarterly basis, a reconciliation of changes in the value of servicing rights during a period, with separate reconciliations for servicing rights subsequently measured at fair value and servicing rights measured at LOCOM (Refer to the presentation of the proposed reconciliations in Appendix A).

Mr. Trott proposed that the disclosures of servicing rights reconcile the balance of servicing rights at the beginning of a period (inclusive of fair value and those held at LOCOM) to the value at the end of the period, with adjustments for additions (at their initial fair value) and disposals during the period. He recommended that the disposals include two components: (1) disposal of the value of the servicing rights as of the beginning of the period and (2) a gain or loss on any change in fair value of the disposed servicing rights during the period. He also recommended including the change in fair value of servicing rights in order to reconcile the beginning of the period balance to the end of the period balance. Lastly, he recommended disclosure of the servicing right revenue recognized on the income statement for the period. He believes that this reconciliation will provide adequate disclosure information to financial statement users for comparability purposes. Mr. Trott did not support requiring a sensitivity analysis for separately recognized servicing rights.

With respect to servicing rights carried at LOCOM, Mr. Trott proposed, in addition to the disclosure requirements in paragraph 17(e), a similar reconciliation with the exception that the beginning of period and ending of period balances would be the value of the servicing rights held at LOCOM. He stated that disposals would also include amortization of servicing rights during the period. He commented that the only change in value of servicing rights in the reconciliation would be as a result of a decrease in value of servicing rights (as a result of measuring servicing rights at LOCOM).

Mr. L. Smith commented that this reconciliation could present onerous requirements for constituents. He cited a constituent difficulty with a similar reconciliation required for employee benefit plans. Mr. Trott emphasized that he believes the disclosure requirements for the proposed reconciliations would not require new measurement efforts for enterprises. Ms. Seidman commented that the fair value measurement project initially proposed a similar reconciliation and

decided to modify the reconciliation due to the perceived difficulty of measuring the change in fair value of instruments attributable to additions or disposals and the change in value attributable to instruments held during a period. She also asked whether the servicing fee income disclosed in the proposed reconciliation was gross or net, inclusive of related costs associated the servicing rights held during a period.

Ms. Seidman agreed with Mr. Trott's recommendation that enterprises should be required to disclose management's rationale for its decision to subsequently measure servicing rights, regardless of whether the servicing rights are measured at fair value or LOCOM. She proposed that a separate footnote for servicing rights be required in financial statements.

Ms. Seidman stated that, based on comments received at a recent User Advisory Council meeting, sensitivity analyses are beneficial to financial statement users. Enterprises disclose separate sensitivity analyses for separately recognized servicing rights measured at fair value and at LOCOM.

Ms. Seidman also proposed that enterprises measuring servicing rights at LOCOM disclose unrealized gains related to servicing rights held at period end. She believes that disclosure of unrealized gains on servicing rights measured at LOCOM will be adequate disclosure for comparability purposes as there is already comparability between servicing rights held at fair value and servicing rights held at LOCOM when fair value is less than cost. While she recommended this disclosure requirement for servicing rights, she expressed concern that a similar analysis would be required for all projects where there is a fair value election option.

Mr. Schieneman requested that the staff contact enterprises with separately recognized servicing rights to determine whether adequate information is included in the proposed disclosure requirements. He also requested the staff discuss possible disclosure requirements with analysts that cover enterprises with separately recognized servicing rights.

Several Board members asked whether a sensitivity analysis should include hedging instruments related to servicing rights and requested that the staff

provide examples of a sensitivity analysis. Mr Leisenring advised the staff that there are proposed disclosure requirements for sensitivity analysis in an IASB Exposure Draft on financial disclosures.

Follow-up Items:

The staff will perform further research on disclosure requirements for servicing rights and will generate examples of proposed disclosures.

General Announcements:

The staff asked the Board whether the Board would like to reevaluate the scope of the project or the fair value election option. No Board members were in favor of revisiting decisions made in this project.

## Appendix A

### Proposed Servicing Rights Reconciliation

**Tabular disclosure of changes in Servicing Rights Subsequently Measured at Fair Value (FVSRs)**

Balance Sheet Disclosures

Beginning of the period amount of FVSRs	XX
Additions:	
Purchases	XX
Asset Transfers	XX
Subtractions:	
Sales of FVSRs (value at BOP)	(XX)
Change in Value of FVSRs during period	XX/(XX)
Change in Value Recognized	
Due to payment on loans	(XX)
Due to change in valuation	XX/(XX)
Ending Balance of FVSRs	XX

Income Statement Disclosures

Servicing Fee Income Recognized	
During the Period	XX
Other Income Recognized	
During the Period	XX

**Tabular disclosure of changes in Servicing Rights Not Subsequently Measured at Fair Value (SRs)**

Balance Sheet Disclosures	Carrying Value	Fair Value
Beginning of the period amount of SRs	XX	XX
Additions:		
Purchases	XX	
Asset Transfers	XX	
Subtractions:		
Sales of FVSRs (value at BOP)	(XX)	
Change in Value of FVSRs during period	XX/(XX)	
<b>Amortization</b>	<b>(XX)</b>	

## Appendix A

### Proposed Servicing Rights Reconciliation

<b>Application of Valuation Allowance</b>	<b>(XX)</b>	
Change in Value Recognized		
Due to payment on loans		(XX)
Due to change in valuation		XX/(XX)
Ending Balance of SRs	XX	XX
Income Statement Disclosures		
Servicing Fee Income Recognized		
During the Period	XX	
Other Income Recognized		
During the Period	XX	