

FASB STAFF POSITION

No. SOP 94-6-1

Title: Terms of Loan Products That May Give Rise to a Concentration of Credit Risk

Date Posted: December 19, 2005

Introduction

1. This FASB Staff Position (FSP) has been issued in response to inquiries from constituents and discussions with the SEC staff and regulators of financial institutions. The inquiries received have focused on the following questions:

a. Question 1:

In what circumstances, if any, do the terms of loan products give rise to a *concentration of credit risk* as that term is used in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*?

b. Question 2:

What disclosures or other accounting considerations apply for entities that originate, hold, guarantee, service, or invest in loan products whose terms may give rise to a concentration of credit risk?

Background

2. The FASB staff is aware of loan products whose contractual features may increase the exposure of the originator, holder, investor, guarantor, or servicer to risk of nonpayment or realization. These features may include repayments that are less than the repayments for fully amortizing loans of an equivalent term and high loan-to-value ratios. Examples of features that may increase credit risk include, but are not limited to:

- a. Terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization)
- b. A high loan-to-value ratio
- c. Multiple loans on the same collateral that when combined result in a high loan-to-value ratio

- d. Option adjustable-rate mortgages (option ARMs)¹ or similar products that may expose the borrower to future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit)
- e. An initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends
- f. Interest-only loans.

3. Certain lending products often have features that provide for reduced payment requirements in the early part of the loan's term, which may delay defaults. For these loans, evidence of credit losses may not become apparent until the contractual provisions of the loans cause a change in the required payment because the borrower's ability to make reduced initial payments may delay a creditor's determination that the conditions have been met for the accrual of a loss, and the establishment of an allowance for loan losses, under FASB Statements No. 5, *Accounting for Contingencies*, and No. 114, *Accounting by Creditors for Impairment of a Loan*.

4. Additionally, loan products may have initial payment requirements that are less than or equal to the contractual interest amount. These products include loans commonly called option ARMs, negative amortizing, deferred interest, or interest-only loans. Negative amortization and the deferral of interest increase the loan amount, which can result in an increased loan-to-value ratio and a reduction in the borrower's equity. These features can result in possible future increases in a borrower's loan repayment when the contractually required repayments increase due to interest rate movements, step-up from the initial interest rate, or the required amortization of the principal amount and the severity of the increase is influenced by these and other factors. These payment increases could affect a borrower's ability to repay the loan and lead to increased defaults and losses.

5. Also, some loans have high initial loan-to-value ratios based on anticipated appreciation of the collateral's value, increasing the risk of loss if that appreciation does not materialize and the borrower defaults.

¹ An option ARM is an adjustable-rate mortgage that provides the borrower with the option to choose from several payment amounts each month (for a specified period of the loan term). Typically one of the payment options results in the borrower paying neither the principal nor the entire amount of interest due on the loan.

6. This FSP is intended to emphasize the requirement to assess the adequacy of disclosures for all lending products (including both secured and unsecured loans) and the effect of changes in market or economic conditions on the adequacy of those disclosures.

FASB Staff Position

Question 1

7. The terms of certain loan products may increase a reporting entity's exposure to credit risk and thereby may result in a *concentration of credit risk* as that term is used in Statement 107, either as an individual product type or as a group of products with similar features. Paragraph 15A of Statement 107 requires disclosures about each significant concentration, including "information about the (shared) activity, region, or economic characteristic that identifies the concentration." Possible shared characteristics on which significant concentrations may be determined include, but are not limited to:

- a. Borrowers subject to significant payment increases
- b. Loans with terms that permit negative amortization
- c. Loans with high loan-to-value ratios.

Judgment is required to determine whether loan products have terms that give rise to a concentration of credit risk.

8. Statement 107 also encourages the disclosure of "quantitative information about the market risks of financial instruments that is consistent with the way it manages or adjusts those risks" (paragraph 15C). Furthermore, an entity may disclose how underwriting procedures are designed to control the credit risk that may arise from future payment increases (as described in paragraph 4 of this FSP).

Question 2

9. In addition to the disclosures discussed in Question 1, an entity should consider the applicability of the following accounting literature. The type and extent of information provided shall be determined by whether the entity is the originator, holder, investor, guarantor, or servicer and also by the significance of the loan product(s) to the reporting entity.

10. AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, paragraph .08, requires disclosure of:

. . . risks and uncertainties existing as of the date of those statements in the following areas:

- a. Nature of operations
- b. Use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations.

11. Certain loan products have contractual terms that expose entities to risks and uncertainties that fall into one or more of the categories listed above. For example, paragraph .22 of SOP 94-6 requires the disclosure of “concentrations in revenue from particular products” Additionally, other concentrations should be disclosed if they meet the requirements of paragraph .21, specifically:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

Also, paragraph .13 of SOP 94-6 requires disclosure about a possible change in estimate when information available prior to issuance of the financial statements indicates that both (a) “it is at least reasonably possible² that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events” and (b) “the effect of the change would be material to the financial statements.”

12. Negative amortization results in the recognition of interest income that is added to the principal balance of an outstanding loan before it is received in cash. To the extent that this noncash interest income is significant, it is required to be included in the reconciliation of net

²The term *reasonably possible* is used in SOP 94-6 consistent with its use in Statement 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

income of a business enterprise (or change in net assets of a not-for-profit organization) to net cash flows from operating activities as required by FASB Statement No. 95, *Statement of Cash Flows*.

13. An entity that has recognized a servicing asset relating to loan products whose terms may give rise to a concentration of credit risk is required to consider whether the predominant risk characteristics of the specific product type result in a separate stratum when determining impairment. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires the disclosure of the risk characteristics used to stratify recognized servicing assets for purposes of measuring impairment. Additionally, originators and servicers that have provided guarantees on these loan products should consider the specific risk characteristics when assessing the fair value of those guarantees.

14. The characteristics of each product also shall be considered when assessing the fair value of loan products that an entity classifies as held for sale and when determining the fair value for disclosures required by Statement 107.

15. Entities are reminded that FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires the use of the interest method for recognizing interest income. If a 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. When recognizing interest income on loans with interest rates that increase during the term of the loan (for example, loans with a reduced initial interest rate), an entity shall apply the guidance in Statement 91, paragraph 18(a) and the related implementation guidance.

16. For public entities, additional disclosures may be required by applicable SEC Rules and Regulations (for example, Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Conditions and Results of Operations). For banks and bank holding companies subject to the requirements of SEC Regulation S-X, Rule 9-03, and SEC Industry Guide 3, additional disclosures may be required.

Effective Date and Transition Guidance

17. The guidance in Question 1 of this FSP is effective for interim and annual periods ending after the date the FSP is posted to the FASB website. An entity shall provide the disclosures required by Statement 107 for products that are determined to represent a concentration of credit risk in accordance with the guidance in Question 1 for all periods presented.

18. Question 2 of this FSP references only existing effective literature; therefore, no effective date or transition guidance is required.