PROPOSED FASB STAFF POSITION

No. SOP 94-6-a

Title: Nontraditional Loan Products

Comment Deadline: November 11, 2005

Introduction

1. This FASB Staff Position (FSP) is 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:

      Do nontraditional loan products represent 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 and other accounting considerations are required for entities that originate, hold, guarantee, service, or invest in nontraditional loan products, including option adjustable-rate mortgages (ARMs)?

Definition of Nontraditional Loan Products

2. The FASB staff acknowledges that there is no generally accepted definition of the term *nontraditional loan products*. For the purposes of this FSP, nontraditional loan products are those that expose the originator, holder, investor, guarantor, or servicer to higher risk than traditional products. Features of nontraditional loan products that create higher risk may include interest and/or principal repayments that are less than the repayments for fully amortizing mortgages of an equivalent term, or high loan-to-value ratios. Products that meet this definition include, but are not limited to:

   a. Loans with the contractual ability to negatively amortize
   b. Loans with a high loan-to-value ratio
c. Home equity lines of credit, second mortgages, or other products that result in a high loan-to-value ratio when combined with other mortgages on the same collateral

d. Option ARMs or similar products that may expose the borrower to future increases in repayments in excess of changes 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. Loans with below market or teaser interest rates

f. Interest-only loans.

**Background**

3. Certain lending products have features that may expose the loan originator, holder, investor, guarantor, or servicer to greater credit, interest rate, prepayment, or impairment risk than is present in many traditional lending products, such as 30-year fully amortizing mortgages. These features often provide for reduced payment requirements in the early part of the loan’s term, which may delay defaults. For these nontraditional loans, credit losses may become evident later in the term of the loan than for traditional lending products, because the borrower’s ability to make reduced initial payments often delays 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. Some of these 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 thus reduce borrower’s equity. These features can result in significant payment shocks\(^1\) to borrowers in future periods 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. These payment shocks could affect a borrower’s ability to repay the loan and lead to increased defaults and losses.

\(^1\)Payment shocks refer to the possible future increase in a borrower’s loan repayment. The severity of the payment shock is influenced by interest rate movements, step-up from teaser rates, required amortization of principal, prior negative amortization, the loan balance, and other factors.
5. Also, some lending may be done with high 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.

6. While this FSP focuses on disclosures for nontraditional loan products, it is not intended to be applicable to only these products; rather, it is intended to emphasize the requirement to assess the adequacy of disclosures for all lending products and the effect of changes in market or economic conditions on the adequacy of those disclosures.

**FASB Staff Position**

**Question 1**

7. Certain nontraditional loan products expose a reporting entity to greater credit risk than traditional mortgage products. Therefore, these products may result in *concentration of credit risk* as that term is used in Statement 107. 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.” While determination of the shared characteristics will depend on an entity’s specific circumstances, possible shared characteristics on which significant concentrations may be determined include, but are not limited to:

   a. Borrowers subject to significant payment shocks
   b. Loans with the contractual ability to negatively amortize
   c. Loans with high loan-to-value ratios.

8. Statement 107 also encourages the disclosure of “quantitative information about the market risks of financial instruments that is consistent with the way [the reporting entity] manages or adjusts those risks” (paragraph 15C). For example, an entity may disclose how underwriting procedures are designed to control the credit risk in relation to future payment shocks experienced by borrowers.

**Question 2**

9. In addition to the disclosures discussed in Question 1, an entity that has or expects to have significant exposures to nontraditional loan products shall comply with the following accounting literature in disclosing information about these exposures. The type and extent of information
provided shall be determined by whether the entity is the originator, holder, investor, servicer, or guarantor, and also by the significance of the 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. Many nontraditional loan products 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. A concentration exists at the date of the financial statements.
   b. The concentration makes the entity 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 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 possible\(^2\) 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 not received in cash, but rather, is added to the principal balance of an outstanding loan. To the extent that this noncash interest income is significant, it is required to be included in the reconciliation of net

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\(^2\)The 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 to net cash flows from operating activities as required by FASB Statement No. 95, *Statement of Cash Flows*.

13. AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, paragraph 13(e), requires the disclosure of “major categories of loans … separately either in the balance sheet or in the notes to the financial statements.” Nontraditional loans likely would be considered a major category for some entities. Additionally, the FASB staff is aware that entities often disclose major categories consistent with the categories required to be disclosed under SEC Regulation S-X, Rule 9-03. This rule requires an entity to “state separately any other loan category regardless of relative size if necessary to reflect any unusual risk concentration.”

14. The required disclosure of accounting policies for credit losses and doubtful accounts in SOP 01-6 includes “the factors that influenced management’s judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments” (paragraph 13(b)). That disclosure shall include economic conditions or risk factors that influence management’s judgment related to the determination of the allowance for loan losses for nontraditional products, to the extent that these products are a significant category.

15. An entity that has recognized a servicing asset for the servicing of nontraditional products 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 nontraditional loan products should consider the specific risk characteristics when assessing the fair value of those guarantees.

16. The characteristics of each product also shall be considered when assessing the fair value of nontraditional loans that an entity classifies as held for sale.
17. 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).

18. 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 the Securities Act Industry Guide 3, additional disclosures may be required.

**Effective Date and Transition Guidance**

19. This FSP references only existing effective literature; therefore, no effective date or transition guidance is required.