



FASB Statement on Servicing Rights

FASB Statement 156 allows mark-to-market accounting for servicing rights resulting in reporting that is similar to fair-value hedge accounting, but without the effort and system costs needed to identify effective hedging instruments and document hedging relationships. This enables companies to reduce volatility in reported earnings that would otherwise be caused by mismatched GAAP measurement models.¹

Under previous requirements, in the absence of related derivative instruments that qualified for fair-value hedge accounting, servicing rights were recorded at the lower of their amortized carrying amount or fair value while any related derivative instruments were marked to market through earnings. As a consequence, recognized losses on derivative instruments during periods of rising interest rates were not offset by corresponding gains from increases in the fair value of servicing assets, because those assets were recorded at the lower of their amortized carrying amount or fair value.

Companies have attempted to mitigate this accounting mismatch and related earnings volatility by satisfying the fair-value hedging requirements in Statement 133.² Fair-value hedge accounting allows companies to report through earnings all changes in the fair value of servicing rights resulting from the hedged risks while also recognizing in earnings the changes in the fair value of the related derivative instruments. However, it is often not economically feasible for companies to obtain a combination of derivative instruments that satisfy all of the hedge accounting requirements. Statement 156 eliminates this problem by permitting servicing rights to be accounted for at fair value without demonstrating hedge effectiveness.

The fair-value election for servicing rights, a similar fair-value election in Statement 155 for hybrid financial instruments containing embedded derivatives that require bifurcation, and the FASB's more expansive fair-value-option project demonstrate the FASB's movement toward reporting more fair-value information in financial statements.³ However, unlike the instruments addressed in Statement 155, servicing rights are not considered financial assets and

Applicability and Recognition	2
Initial and Subsequent	
Measurement	2
Presentation and Disclosure	3
Reclassification of AFS Securities	4
Effective Date and Transition	4

©2001-2006 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A21417NYGR

Photo: GettyImages/Iconica/Mark Harwood 200243175-001

¹ FASB Statement No. 156, Accounting for Servicing of Financial Assets, March 2006, available at www.fasb.org.

² FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, amended through May 2003, and related interpretations, available at www.fasb.org.

³ FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, February 2006, and FASB Exposure Draft, The Fair Value Option for Financial Assets and Financial Liabilities, January 2006, both available at www.fasb.org.

liabilities and therefore would not be addressed in the FASB's fair-value-option Statement if it is adopted as proposed.

A company that wishes to apply Statement 156's fair-value-measurement alternative in 2006 must adopt the new Statement when it issues its first quarter interim financial statements, a requirement consistent with Statement 155.

Applicability and Recognition

The requirements in Statement 156 apply to all separately recognized servicing assets and liabilities. A company must recognize a servicing asset or liability if it undertakes a contractual obligation to service financial assets in any of three circumstances.

1. The assets to be serviced are not the company's financial assets or those of its consolidated affiliates.
2. The company transfers the financial assets to be serviced and the transfer meets Statement 140's requirements for sale accounting.⁴
3. The company transfers financial assets to be serviced to a qualifying special-purpose entity (QSPE) in a guaranteed mortgage securitization and the transferring company both retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities under Statement 115.⁵ If the transferor classifies the resulting securities as debt securities held-to-maturity under with Statement 115, the transferring company may either separately recognize a servicing asset or liability or combine the servicing asset or liability together with the asset being serviced.

The first circumstance precludes companies from recognizing a servicing asset or liability

if they are contractually obligated to service their own financial assets or financial assets of one of their consolidated affiliates.

However, a separate servicing asset or liability would be required to be recognized in the standalone financial statements of a subsidiary that meets any of the requirements even if it is contractually obligated to service the financial assets of its parent.

Initial and Subsequent Measurement

All separately recognized servicing assets and liabilities must be initially measured at fair value, if practicable. In those rare instances in which initial measurement at fair value is impracticable, a servicing asset cannot be recorded. However, a servicing liability would be recognized at the greater of the amount that results in no gain on the transaction or the amount that would be recorded as a contingent liability under Statement 5 and Interpretation 14.⁶ These servicing liabilities would be subsequently measured using the amortization method described below.

Choice of Methods. Each class of separately recognized servicing assets and liabilities should be subsequently measured by either:

- Amortizing the rights over the period of estimated net servicing income or net servicing loss, consistent with the existing requirements of Statement 140 (the amortization method) or
- Measuring the rights at fair value at each reporting date, with changes in fair value reported in earnings (the fair-value-measurement method).

Companies that elect the amortization method must assess their servicing assets at each reporting date for impairment and assess

their servicing liabilities at each reporting date for increased obligations.

Identifying Classes of Servicing Rights.

Because each class of separately recognized servicing assets and liabilities is measured using one of the two methods, identifying the classes is an important step. The identification of a class may be based on either or both of the following:

- The availability of market inputs used in determining the fair value of the servicing rights,
- Internal risk management methodologies for the servicing rights.

Companies that elect the fair-value-measurement method for a class of separately recognized servicing rights may do so at the beginning of any fiscal year and may not subsequently change the election. The election should be applied prospectively to all new and existing servicing rights within the identified class. The effect of remeasuring a class of servicing rights at fair value should be recorded as a cumulative-effect adjustment to beginning retained earnings and should be separately disclosed.

Statement 156 affords greater flexibility in identifying classes of servicing assets and servicing liabilities than had originally been proposed.⁷ The proposal would have required the election to be made for "major asset types being serviced," such as mortgage loans, credit card receivables, and automobile loans.

Companies would have been prohibited from electing the fair-value-measurement method for the servicing rights on some, but not all, types of mortgage loans, for example. Under Statement 156, however, a class of servicing

⁴ FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, September 2000, available at www.fasb.org.

⁵ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, May 1993, available at www.fasb.org.

⁶ FASB Statement No. 5, *Accounting for Contingencies*, March 1975, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, September 1976, both available at www.fasb.org.

⁷ FASB Exposure Draft, *Accounting for Servicing of Financial Assets*, August 2005, available at www.fasb.org.

rights may be a subset of mortgage loans, such as commercial mortgage loans.

Hedging. Statement 156’s elective fair-value-measurement method enables companies to report in earnings the offsetting effects of changes in the fair values of investments or derivative instruments and the corresponding servicing rights, even though the economic relationships do not qualify for hedge accounting under Statement 133. For example, with limited exceptions, only derivative financial instruments may be designated as hedging instruments in qualifying fair-value hedges, yet many companies economically hedge their exposure to changes in the fair values of servicing rights using investment securities other than derivatives. Statement 156 allows such companies to achieve results

similar to those from fair-value hedge accounting even though the economic hedging relationships would not qualify for hedge accounting under Statement 133.

In circumstances in which companies’ hedging relationships would qualify for hedge accounting under Statement 133, the fair-value-measurement method allows them to avoid the time, effort, and cost needed to comply with Statement 133. For instance, in order to hedge portfolios of servicing assets or liabilities under Statement 133, individual servicing assets or liabilities in the portfolio must share the risk exposure for which they are being hedged. Moreover, the change in fair value attributable to the hedged risk for each individual item in the hedged portfolio must be expected to respond “in a generally

proportionate manner” to the overall change in fair value of the aggregate portfolio that is attributable to the hedged risk. Under Statement 156, a company will be able to elect fair-value measurement for an entire class of servicing rights without having to demonstrate that the changes in the fair value of the portfolio’s individual servicing assets or liabilities are expected to respond proportionately to the overall change in the portfolio’s fair value.

Presentation and Disclosure

Statement 156 includes extensive presentation and disclosure requirements designed to mitigate noncomparability within and between companies’ reports caused by electing different measurement methods. The accompanying table summarizes the required disclosures for servicing rights.

Required Disclosures	
For <u>all</u> servicing rights	<ul style="list-style-type: none"> • Management’s basis for determining classes of servicing rights • Description of risks inherent in servicing rights and, if applicable, the instruments used to offset the earnings effect resulting from changes in the fair value of those rights (disclosure of quantitative information regarding the hedging instruments is encouraged but not required) • Amount of contractually specified servicing fees, late fees, and ancillary fees for each period presented, including information about where each amount is reported in the income statement • Description of the valuation methodology used to estimate the fair value of servicing rights, including a description of model validation procedures and quantitative and qualitative information about the assumptions used in the model
For servicing rights subsequently measured using the fair-value-measurement method	<ul style="list-style-type: none"> • For each class of servicing rights, a comprehensive rollforward of the balance of servicing assets and liabilities, including information about where changes in fair value are reported in the income statement for each period presented*
For servicing rights subsequently measured using the amortization method	<ul style="list-style-type: none"> • For each class of servicing rights, a comprehensive rollforward of the balance of servicing assets and liabilities, including information about where changes in the carrying amount are reported in the income statement for each period presented, and the fair value of those rights at the beginning and end of the period, if practicable to estimate* • Risk characteristics of underlying financial assets used to stratify recognized servicing assets for impairment purposes • Class-by-class rollforward of any valuation allowance for impairment of recognized servicing assets for each period presented
<p>* Paragraph 4(h)(ii) of Statement 156 illustrates tabular rollforwards under both the fair-value-measurement and amortization methods.</p>	



This is a publication of KPMG's
Department of Professional
Practice—Audit and Risk Advisory
212-909-5600

Contributing authors:

Paul G. Laurenzano
Ryan Richards

Earlier editions are available at:
www.aro.kpmg.com

Defining Issues® is a registered trademark of KPMG LLP. © 2001-2006 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A21417NYGR

Companies that elect the fair-value-measurement method for a class of servicing rights are required to report the carrying amounts of those servicing assets and liabilities separately from the carrying amounts of servicing assets and liabilities that are subsequently measured using the amortization method. The carrying amounts may be displayed in separate balance sheet line items or the carrying amounts for which fair-value measurement has been elected may be aggregated with those measured using the amortization method and parenthetically disclosed on the balance sheet.

Reclassification of AFS Securities

A company that uses available-for-sale securities to economically hedge or offset risks inherent in a class of servicing rights may reclassify them to trading securities if it elects the fair-value-measurement method for that class when Statement 156 is adopted. This one-time reclassification is designed to address the mismatch that would occur if the class of servicing rights is subsequently measured at fair value with changes in fair value recognized in earnings but the securities used to economically hedge those servicing rights are subsequently measured at fair value with changes in fair value recognized in other comprehensive income.

The one-time reclassification of available-for-sale securities to trading securities will not call into question the classification of other available-for-sale securities, provided the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in the fair value of servicing rights that a company elects to subsequently measure at fair value.⁸ Any gains and losses associated with the reclassified securities that are included in accumulated other comprehensive income should be eliminated with an offsetting cumulative-effect adjustment to beginning retained earnings.

Effective Date and Transition

Statement 156 is effective for fiscal years beginning after September 15, 2006. Companies should apply the requirements for recognition and initial measurement of servicing rights prospectively after that date. When Statement 156 is adopted, the difference between the fair value and the carrying amount of existing servicing assets and liabilities for which the fair-value-measurement method is elected, including any adjustments for the reclassification of available-for-sale securities, should be recorded as a cumulative-effect adjustment to beginning retained earnings. Consistent with Statement 155, which offered a similar fair-value election, early adoption is permitted as of the beginning of a company's fiscal year unless the company has already issued interim financial statements during that fiscal year.

The descriptive and summary statements above are not intended to be a substitute for the text of FASB Statements 156, 5, 115, 133, 140, and 155; FASB Interpretation No 14, or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for servicing rights and complying with SEC filing requirements should refer to the texts of the applicable documents that set out GAAP and SEC requirements and consult their accounting and legal advisors.

⁸ Paragraph 15 of Statement 115 indicates that transfers into or from the trading category should be rare. A pattern of reclassifying securities from available-for-sale to the trading category would, absent the special reclassification election discussed above, call into question the original classification and treatment of those securities as well as other available-for-sale securities.