

# Mortgage Accounting: What's the Score?

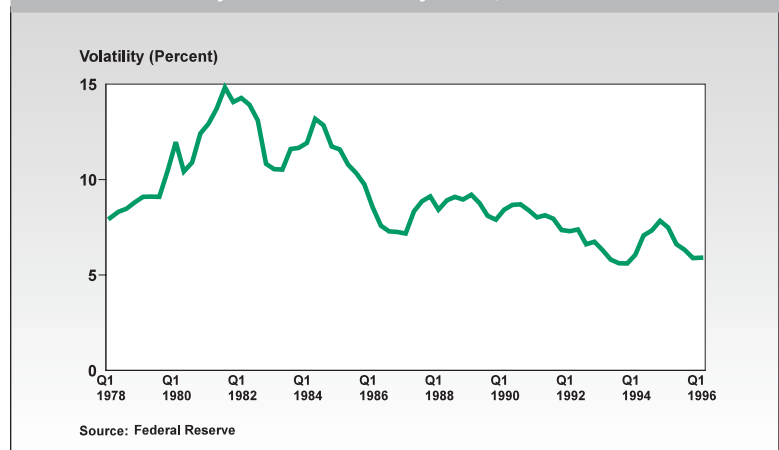
by *Mustafa Chowdhury and Ellen P. Roche*

IN THE FAST-BREAKING WORLD of mortgage securities trading, knowing the score—that is, the value of a security—is vital to all the players competing in the high-stakes game.

Recently, the sports commissioners of the finance world, that is, the members of the Financial Accounting Standards Board (FASB), replaced several pages of the rule book. Their objective is to make scorekeeping more precise for the financial markets in general and the mortgage arena in particular. At least six teams of players have an interest in the way mortgage securities are scored: companies that issue the securities, investors who buy and hold the securities, stockholders who invest in the security issuers, stockholders who invest in the security holders, lending firms that originate the underlying loans and mortgage borrowers.

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FIGURE 1: Volatility of 10-Year Treasury Rates, 1978-1996



To improve how the game is played, FASB (see “What Is FASB?” page 21) is moving to make the value of securities more apparent. The new rules, however, have introduced a different distortion. By implementing the revisions in stages, FASB has created new winners and losers plus saddled several of the players with additional costs.

## The Old Rules Foul Out

Over the years, government regulators, stockholders and Wall Street analysts have grown increasingly uncomfortable with the long-standing practice of accounting for interest-rate-

sensitive securities by their book value. This measure reflects the original cost of either an asset or a liability at the time it first appears on a company's financial statement. Uneasiness over book value stems from the increasing divergence between the reported historic values of many financial instruments and the more current estimates of market value.

The book-value approach worked quite well until the fixed-income market, like many others, changed significantly over the past two decades. Interest rates became more volatile, as the growing gyrations in the rates of 10-year treasury bonds demonstrate (Figure 1). A flood of new financial instruments that are considerably more sensitive

to interest-rate change also arrived on the scene. Both developments led to a tremendous increase in financial-market volatility during the 1980s.

Switching away from book-value accounting requires access to good market-value information. The relatively recent emergence of a liquid secondary market for the majority of fixed-income instruments, including mortgage securities, now makes that more feasible. Previously, market prices were either unavailable or unreliable.

Three years ago, FASB took the first step to bring accounting standards in line with modern-day realities by requiring companies to disclose on a “mark-to-market” basis the values of the securities they hold. This valuation technique reflects the price at which a security would sell currently on the open market.

The complete conversion of the marketplace to market-value accounting will take several years. So far, FASB has applied market pricing only to the asset side of the balance sheet; the liabilities side remains untouched. This piecemeal approach means that corporate balance sheets and income statements, particularly those of financial institutions, display increased volatility as some items are carried at market value and others at book value.

### Know the Score

In 1993, FASB adopted an accounting rule to improve valuation disclosures for securities sensitive to interest-rate changes. The Statement of Financial Accounting Standards (SFAS) No. 115 divides securities into three categories and assigns an accounting treatment to each. The classifications reflect the length of time a company expects to hold the security: The longer the expected holding period, the less important the distinction becomes between differences in book value and market value at any given time.

When a company buys a security, it must declare the intended disposition of the instrument as one of the following:

**Hold.** A security falls into the “hold-to-maturity” category when a company possesses both the intent and the ability to hold the acquisition to maturity. For example, a passthrough security based on 30-year mortgages would go into this bucket if a company plans to hold it for the remaining life of the underlying loans. Accountants report securities in this category by book value. Consequently, increases or decreases in interest rates do not factor into the reported value of the security, nor do the changes alter a company’s balance sheet or earnings as a result. However, if a company sells a held-to-

## What Is FASB?

The Financial Accounting Standards Board (FASB), based in Norwalk, CT, consists of seven members appointed by the board of trustees of the Financial Accounting Foundation, a private organization. Typically, the standards board consists of three representatives from public accounting, two from business, one from financial analysis and one from academia. Each member is eligible to serve two five-year terms.

FASB establishes standards for financial accounting and reporting used in the preparation of financial reports. Specifically, the board issues rules and guidelines known as Statements of Financial Accounting Standards (SFAS). The Securities and Exchange Commission requires publicly held companies to conform to these standards. The American Institute of Certified Public Accountants also recognizes FASB conventions.

The accounting standards devised by FASB are essential to the efficient functioning of a securities market predicated on the free flow of uniform and accurate information. Stockholders, in the course of making investment decisions, rely extensively on financial information about the operations and financial positions of individual companies prepared in accordance with FASB pronouncements.

maturity security early, then its entire portfolio of held-to-maturity securities may be considered tainted. If so, future financial statements must report the portfolio at market value. With portfolio gains and losses declared quarterly, the volatility of earnings increases, an outcome generally regarded unfavorably by management.

**Trade.** A security acquired by a company intending to resell it in the near term qualifies as a “trading” security. The company must post the market price of the investment on its balance sheet, recalculating the value with each quarterly statement. Any unrealized (paper) gains and losses also go on a company’s income statement. As the values of trading securities move with interest rates, the earnings and value of a company similarly fluctuate.



**Sell.** A security which may be sold before maturity but does not belong to a short-term trading portfolio would go into this final “for-sale” category. A company carries a for-sale security on its balance sheet at its market price, but does not include unrealized gains and losses in its income statement. Rather, the fluctuations show up directly on the balance sheet as a separate component of stockholders’ equity. Therefore, variances in the market value of a for-sale security would affect the reported value of stockholder investments in the company but would not influence the company’s reported earnings.

### **When the Whole Exceeds the Sum of Its Parts**

Last year, FASB began treating originated mortgage-servicing rights the same as purchased mortgage-servicing rights. Under SFAS No. 122, a depository that swaps originated mortgages into a security must split the security value into two parts, loan repayments and servicing rights. It then declares principal and interest payments at book value and servicing income at market value. The value of the servicing-rights asset falls whenever interest rates drop, causing the company to report a loss on its financial statement.

### **Who’s Ahead at the Half?**

Both FASB rulings already are influencing which products and financial players emerge as the winners and losers in the mortgage finance arena. However, no end is in sight for this particular game until FASB completes the transition to market-value accounting.

In fact, FASB transforms the terrain each time it moves the process forward. Recently, FASB reversed course on an earlier proposal to impose mark-to-market accounting on securities funded through dollar rolls. This mechanism raises funds through the simultaneous sale and repurchase of the security. As originally proposed, FASB intended to treat dollar rolls as sales transactions requiring

mark-to-market treatment, but it now views them as loans reported at book value. The mortgage securitization industry generally applauds the about-face because otherwise it faced higher short-term funding costs to switch from dollar rolls to more expensive repurchases (“repos”).

Who wins and who loses, then, depends largely on the field position of each player.

Mortgage security issuers compete at a disadvantage under several scenarios that arise from the phased changes. SFAS No. 115 gives financial institutions a reason to hold mortgage originations in portfolio rather than convert them to securities. Despite some ambiguous language, financial institutions commonly interpret the ruling as meaning that unsecuritized mortgages classified as held-to-maturity can be sold early without jeopardizing their book-value status. Securitized mortgages cannot. Consequently, a lender may decide not to securitize in order to gain an accounting advantage without regard to the underlying economics of the choice.

The originated mortgage-servicing rule, SFAS No. 122, also favors holding mortgages in portfolio over swapping mortgages into securities. Depositories well may decide to create fewer mortgage securities to minimize their balance-sheet volatility. By choosing to hold

mortgage loans in portfolio, institutions do not have to treat loan repayments and servicing income differently.

When depositories do opt to securitize, they increasingly are turning to hedging instruments, such as interest-rate floors and “swaptions” (options to enter into interest-rate swaps). Higher product demand is driving up hedging costs for mortgage security issuers and others.

The favorable treatment accorded portfolio executions also hurts mortgage bankers. After all, these companies are in the business of selling all of their originations on the secondary market.

At first blush, stockholders in companies investing in or issuing mortgage securities appear to benefit from more precise valuation reporting, but the resulting information is imperfect. Until FASB requires market-value accounting for liabilities as it does now for assets, the unequal treatment of equity and debt securities will promote instability within the financial markets.

Mortgage borrowers, for their part, may see steeper mortgage rates as the lending industry passes along the higher costs of managing interest-rate risk.

Obviously, this is one game with no clear winners until FASB blows the final whistle.<sup>SMM</sup>