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Office of Thrift Supervision
Department of the Treasury
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John F. Downey
Executive Director, Supervision

December 23, 1996

Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

MEMORANDUM FOR: Chief Executive Officers

FROM: John Downey
Executive Director, Supervision

John F. Downey

SUBJECT: Regulatory Capital Treatment and Regulatory Reporting of Servicing Assets

The Office of Thrift Supervision (OTS) is adopting the recommendations set forth in the attached Federal Financial Institutions Examination Council (FFIEC) interim guidance. This guidance relates to the regulatory capital treatment and regulatory reporting of servicing assets and certain nonsecurity financial instruments (CNFIs) (defined below). This guidance is issued in response to changes in the accounting treatment of servicing assets under Statement of Financial Accounting Standard No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS 125). The OTS and the other Federal banking agencies, consistent with a recommendation of the FFIEC Task Force on Supervision, are developing a Notice of Proposed Rulemaking (NPR) in anticipation of a final rule to implement these changes.

Savings associations should follow the guidance for reporting servicing assets and CNFIs on their Thrift Financial Reports (TFRs) for periods ending on or after March 31, 1997. Under this guidance, savings associations should report servicing assets on mortgage loans and non-mortgage loans as well as CNFIs, on separate line items. CNFIs include interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

Pending issuance of a final rule, savings associations may include all servicing assets (mortgage and non-mortgage) in regulatory capital, subject to the 50 percent of core (Tier 1) capital limitation and the 90 percent of fair value limitation currently applied to mortgage servicing rights. However, the inclusion in regulatory capital of non-mortgage servicing assets is further limited (along with purchased credit card relationships, or "PCCRs") to 25 percent of Tier 1 capital and 90 percent of fair value. The guidance also generally allows associations to fully include CNFIs in regulatory capital without any explicit limitation, although their treatment in the final rule is uncertain.

If you have any questions about this issue, please contact your OTS regional accountant.

Attachment

Federal Financial Institutions Examination Council

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Press Release

For immediate release   December 18, 1996

APPLICABILITY OF FAS 125 FOR REPORTING PURPOSES IN 1997 AND THE TREATMENT OF SERVICING ASSETS FOR REGULATORY CAPITAL PURPOSES

The Reports Task Force of the Federal Financial Institutions Examination Council (FFIEC) is reminding banks and savings associations (collectively, banking organizations) about the applicability for regulatory reporting purposes of a new financial accounting standard governing servicing assets and any related interest-only strips receivable that takes effect in 1997. In addition, the FFIEC's Task Force on Supervision, acting under delegated authority, is announcing its recommendations to the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the Agencies) regarding appropriate interim guidance for the regulatory capital treatment of servicing assets and any related interest-only strips receivable. A discussion of the appropriate regulatory reporting treatment and the recommended interim capital guidance is attached.

The need for this guidance arises because the Financial Accounting Standards Board's (FASB) Statement No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125), becomes effective January 1, 1997. FAS 125 supersedes

Statement No. 122, "Accounting for Mortgage Servicing Rights" (FAS 122), which was effective prospectively for fiscal years beginning after December 15, 1995. FAS 125 applies an accounting treatment similar to that outlined in FAS 122 for mortgage servicing rights and extends it to servicing assets on all financial assets.

The Task Force on Supervision is also recommending that this interim capital guidance remain in effect until a final rule amending the Agencies' capital guidelines becomes effective.

Attachment

Interim Guidance for Purposes of Reporting and Regulatory Capital

Background

Servicing rights are the contractual obligations undertaken by an institution to provide servicing for loans and other financial assets owned by others, typically for a fee. Over the last two years, the accounting treatment for servicing rights has changed significantly.

The Financial Accounting Standards Board's (FASB) Statement No. 122, "Accounting for Mortgage Servicing Rights" (FAS 122), eliminated the distinction between purchased mortgage servicing rights (PMSRs) and originated mortgage servicing rights (OMSRs) and required that these assets, together known as mortgage servicing rights (MSRs), be treated as a single asset for financial statement purposes, regardless of how the servicing right was acquired.[1] Under FAS 122, MSRs reflected only normal servicing fees. Excess servicing fees receivable (ESFRs) continued to be recognized separately from MSRs.[2] On August 1, 1995, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the Agencies) issued an interim capital rule and request for comments that amended the Agencies' capital adequacy guidelines. The interim rule limits the total of all MSRs and purchased credit card relationships (PCCRs) that may be recognized for regulatory capital purposes to no more than 50 percent of Tier 1 capital. In addition, the interim rule applies a 90 percent of fair value limitation (that is, a 10 percent haircut) to all MSRs and PCCRs.

FASB Statement No. 125, "Accounting for Transfers and Servicing of Financial Assets

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[1] Purchased servicing rights are servicing rights purchased from others. Originated servicing rights generally arise when an institution originates and subsequently sells financial assets but retains the rights to service those assets.

[2] Excess servicing fees receivable represent the right to receive servicing cash flows that exceed the fee rate that is representative of rates most commonly used in comparable servicing agreements covering similar types of assets.

and Extinguishments of Liabilities" (FAS 125), effective January 1, 1997, will apply an accounting recognition of MSRs similar to that outlined in FAS 122 and extend it to servicing rights on all kinds of financial assets. In addition, FAS 125 will eliminate the distinction between servicing rights based on normal servicing fees and ESFRs and will generally reclassify the cash flows associated with those assets into two new types of assets: (1) servicing assets and (2) certain related interest-only financial assets in non-security form, referred to as "interest-only (I/O) strips receivable." Servicing assets will represent the cash flows from the contractually specified fees received for the actual servicing of the financial assets. The I/O strips receivable will represent the cash flows, if any, received by the servicer on the serviced assets in excess of the contractually specified servicing fees. These I/O cash flows would be retained by the servicer even if the related servicing asset is sold. Under FAS 125, these I/Os are not treated as servicing assets. Rather, they are treated as separate financial assets and are subsequently measured at fair value in a manner similar to investments in debt securities classified as available-for-sale or trading under FAS 115, "Accounting for Certain Investments in Debt and Equity Securities."

Applicability of Statement No. 125 for Regulatory Reporting Purposes.

For purposes of the bank Reports of Condition and Income (Call Report) and the Thrift Financial Report (TFR), all insured banks and savings associations must adopt the provisions of FAS 125 for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, with the exception of any provisions deferred for implementation by FASB. Banking organizations must also apply the provisions of FAS 125 governing the accounting and reporting for servicing contracts in existence before January 1, 1997, and certain other financial assets held on January 1, 1997, that are subject to substantial prepayment risk. FAS 125 does not permit early adoption. The March 31, 1997, Call Report and TFR will be the first regulatory reports to be completed in accordance with the provisions of FAS 125 for which FASB has not delayed implementation.

Regulatory Reporting Treatment for 1997

In the Call Report, banks should report the carrying value of all mortgage servicing assets (MSAs) in Schedule RC-M, item 6.a, which will be renamed "Mortgage servicing assets," and on the balance sheet in Schedule RC, item 10, "Intangible assets." The fair value of mortgage servicing assets would be reported in a proposed new item in Schedule RC-M, item 6.a (1), "Fair value of mortgage servicing assets." In addition, banks should report the carrying value of servicing assets related to financial assets other than mortgages in Schedule RC-M, item 6.b.(2), "All other identifiable intangible assets." The characterization of servicing assets as intangible assets for bank regulatory reporting purposes will remain in effect until any change occurs in their characterization for regulatory capital purposes. Any interest-only strips receivable not in security form that arise out of transfers of financial assets will be reported on the balance sheet in Schedule RC, item 11, "Other assets." In Schedule RC-F -- Other Assets, two proposed new items would provide further information on interest-only strips receivable in nonsecurity form recognized pursuant to FAS 125 and an existing item in this schedule on "Excess residential mortgage servicing fees receivable" would be eliminated.

In the TFR, savings associations should report servicing assets on mortgage loans on Schedule SC, line SC642, "Servicing assets on mortgage loans," and should report servicing assets related to financial assets other than mortgages (non-mortgage loans) on Schedule SC, line SC644, "Servicing assets on non-mortgage loans." In addition, certain nonsecurity financial instruments should be reported on Schedule SC, line SC655, "Interest-only strip receivables and certain other instruments." These certain nonsecurity financial instruments include interest-only strip receivables, loans receivable, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

Interim Guidance on the Regulatory Capital Treatment

The FFIEC's Task Force on Supervision, acting under delegated authority, is recommending that the Agencies issue interim guidance that will specify the appropriate regulatory capital treatment of servicing assets and any related interest-only strips receivable under the current capital framework. This interim guidance is intended to address the Agencies' concerns regarding excessive concentrations in these newly reported and created assets until the Agencies issue their final rules. This guidance reflects the Agencies' general view of what would constitute safe and sound banking practice.

Under the interim guidance, the aggregate amount of mortgage servicing assets (MSAs) and PCCRs that may be recognized for regulatory capital purposes (i.e., not deducted from assets and capital) by institutions would be limited to no more than 50 percent of Tier 1 (core) capital (Tier 1 capital). Institutions will continue to be subject to the restriction limiting the amount of MSAs and PCCRs that may be recognized for Tier 1 capital purposes to the lesser of 90 percent of fair value or 100 percent of book value (net of any valuation allowance), commonly referred to as the 10 percent haircut.[3]

Purchased servicing assets related to financial assets other than mortgages that were previously capitalized under generally accepted accounting principles (GAAP) should continue to be treated as "all other identifiable intangible assets" by banks and deducted when calculating banks' Tier 1 capital. With the adoption of FAS 125, institutions must also capitalize originated servicing assets related to such financial assets. Therefore, under the interim guidance, all servicing assets related to financial assets other than mortgages should also be treated by banks as "all other identifiable intangible assets" and deducted in computing Tier 1 capital.[4] The Agencies, in an upcoming proposal, will solicit

[3]For purposes of determining the amount of MSAs (or non-mortgage servicing assets) that would be deducted (or disallowed) in computing Tier 1 capital, institutions may choose to reduce the otherwise disallowed MSAs (or non-mortgage servicing assets) by the amount of any associated deferred tax liability.

[4]See footnote 3.

industry comment on whether non-mortgage servicing assets should be subject to this dollar-for-dollar deduction in computing a banking organization's Tier 1 capital.

For savings associations, ESFRs on loans other than mortgages (i.e., non-mortgage loans) recognized under GAAP are reported as assets on the balance sheet and are not deducted in computing Tier 1 capital under current and prior practice. Under this interim guidance, savings associations may include non-mortgage servicing assets in regulatory capital, but should subject them to the same 25 percent of Tier 1 capital sublimit and 90 percent of fair value limitation as PCCRs in the interim period. Furthermore, the 50 percent of Tier 1 capital limitation and the 90 percent of fair value limitation should apply in the aggregate to all servicing assets -- both mortgage and non-mortgage loans. The Office of Thrift Supervision, however, can provide no assurance of the capital treatment of such assets under any final interagency rule on servicing assets.[5]

Prior to implementation of FAS No. 125, the rights to future interest income from serviced assets in excess of the contractually specified fees (i.e., interest-only strips receivable arising out of servicing activities) were a component of either servicing rights or ESFRs under GAAP, but were not categorized as a separate financial asset. Until a final rule amending the Agencies' capital guidelines is issued, interest-only strip receivables, which will be reported as "other assets" in the bank Call Report and the TFR, generally will not be deducted in computing Tier 1 capital. At this time, however, the Agencies can provide no assurance regarding what the capital treatment of such assets will be under any final capital rule on servicing assets.

[5]See footnote 3.