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Valuing and Trading Mortgage Servicing Rights: Accounting and Reporting

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ACCOUNTING AND REPORTING

The provisions of the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2015-31, “Interest—Remeasurement of the Carrying Amount of Servicing Rights Upon Exit from or Transfer of Servicing,” is designed to correct a potential misstatement in both the accounting and reporting of servicing rights.

1. Recognizing Impairment

Impairment occurs when the expected cash flows from a servicing right fall below the amortized cost basis of the servicing right. When the servicing right is initially capitalized, the amortized cost basis is the expense (less any recoveries) incurred to acquire or originate the servicing rights. If the servicing right has a remaining economic life, there are two methods for accounting for impairment: (1) the allowance method and (2) the cost method. The allowance method utilizes an allowance for impairment to reduce the amortized cost basis of the servicing right. The cost method is an alternative method where an impairment loss is recognized in the income statement when the realized cash flows are less than the amortized cost basis.

2. Amortization Method

The amortization method is used to recognize the ‘economic life’ of the servicing right. The economic life is defined as the period over which the expected cash flows of the mortgage servicing rights are expected to be realized. The economic life of the servicing right is a function of a number of factors, including the contract terms of the mortgage, the anticipated borrower behavior, the assumed prepayment speeds, and the market rate of interest.

3. Impairment Test

To assess whether an impairment loss exists, the servicer should compare the fair value of the servicing right with its amortized cost basis. If the fair value of the servicing right is less than its amortized cost basis, an impairment loss exists. The impairment loss is the difference between the amortized cost basis and the fair value of the servicing right.

4. Impairment Testing

An impairment test should be performed at least annually, or more frequently if circumstances indicate that an impairment exists. The servicer should review the fair value of the servicing rights at each reporting period to determine if an impairment loss exists.

5. Recoveries

Recoveries of previously impaired servicing rights should be recognized as a reduction of the impairment loss that was charged to the income statement in a prior period. The recoveries should be recognized as an increase to the amortized cost basis of the servicing right.

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