Valuing and Trading Mortgage Servicing Rights: Accounting and Reporting

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Valuing and Trading Mortgage Servicing Rights

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ACCOUNTING AND REPORTING

The accounting and reporting for mortgage servicing assets as set forth in FASB ASC 860-50 FASB ASC paragraph 860-50-25-1 requires that an entity recognize a servicing asset or servicing liability each time it enters into a servicing obligation which may be qualified as follows:

- If meeting the requirements for sale accounting, a servicer's transfer of any of the following:
  o an entire financial asset,
  o a group of entire financial assets,
  o or a participating interest in an entire financial asset, in which circumstance the transferor shall recognize a servicing asset or a servicing liability only related to the participating interest sold.

- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.

After a loan is sold, assuming the servicing has been retained, the MSR should be capitalized at fair value and subsequently accounted for using either the amortization or fair value method. When the MSR is initially capitalized, an asset is recorded to the balance sheet and income is recorded for the full fair value of the asset.

When accounting for MSRs, the fair value of the asset is best determined by observing actual trade levels for similar assets; however, actual trade benchmarks can be difficult to obtain. Assuming permissible market conditions and a willing pool of buyers and sellers, MSRs can be a liquid asset, but obtaining the exact execution level negotiated between two private entities can be problematic. As a result, the most commonly used method for determining the fair value of MSRs typically involves a combination of observed and unobserved assumptions.

MSRs may be valued on a loan-level basis or stratified into tranches of like portfolio characteristics but regardless of your approach, MSRs can still be a challenging asset to value. Conventional wisdom might suggest that if it costS $125 annually for a firm to service a single MSR then $125 should be the model assumption used when deriving the asset's value. Perhaps that would be the case if fair-market buyers were also using $125 as their annual lifetime cost-to-service estimate, but therein lies the problem! No two firms are created equal when comparing economies of scale, cost of funds, or, as one of many examples, their access to cost-reducing technology. While it may cost one firm $125 annually to service an MSR, a buyer with superior economies of scale may be willing to pass part of their economic benefit to the seller by agreeing to pay a price that takes into consideration a lower cost of servicing.

Other key behavioral assumptions used in estimating the net present value of future servicing income are prepayment speeds, discount rates, and delinquency rates. On the revenue side, firms may include items such as contractual service fees, ancillary income (for example, bounced check fees and pay by phone fees), late fees, and float income.

With no combined shortage of assumptions that go into deriving the underlying MSR value, considerable judgment is required, and being off on just one assumption could materially affect the estimated fair value of the servicing rights.

Amortization Method
After initially recoding MSRs at fair value, when utilizing the amortization method commonly referred to as LOCOM or Lower of Cost or Market, MSRs are amortized over the estimated economic life of the mortgage in proportion to the anticipated future net servicing revenue generated from servicing the loan. Over- or under-amortization is one problem routinely encountered when amortizing MSRs. Ideally the length or term of the amortization should coincide with the *economic useful life* of the MSR asset.

Those who choose to amortize their book value utilizing a straight line amortization technique may fall victim to market fluctuations that can extend or shorten the projected life of a given asset due to fluctuations in primary mortgage rates, which may cause a shift in the "in-the-moneyness". For clarification, "in-the-moneyness" is a reference to an MSR asset or group of MSR assets that, due to a shift in primary mortgage rates, may now have a greater incentive to refinance, thereby increasing prepay projections and shortening the estimated economic life of the asset. For clarification, prevailing mortgage rates may move in either direction, but if a firm is not proactive in recalibrating the rate of amortization, it may be at greater risk of either over-amortization or impairment.

MSRs should be evaluated for impairment on a continual basis or, depending on the size of a firm's MSR asset relative to their firms total net worth, at least every reporting period. MSRs are to be grouped into homogenous risk buckets with the most common breakouts being *product, term, note-rate range*, and sometimes *geography*. Impairment occurs when the remaining book value, net of accumulated amortization, is carried at an amount that is greater than the estimated fair market value of the servicing right.

In instances where the unamortized book value exceeds the estimated fair market value, a valuation allowance must be recorded to bring the asset down to fair value. Unless determined that the asset is permanently impaired, in which case a permanent correction may be necessary, the previously impaired asset can be recovered and the valuation allowance reduced through a recovery to earnings (often related to a rise in primary mortgage rates which may serve to increase the projected economic life of the asset). This recovery cannot be in excess of the previous impairment, meaning that under the amortization method, it is not permissible to record value in excess of a firm's remaining book value net of amortization.

If not already impaired, the amortization method can result in less volatility in earnings, and lessen the need or desire to hedge potential volatility, because any cushion at the homogenous risk cohort level, while not recordable, can serve as a first line of defense when protecting from volatility created by a downward shift in primary mortgage rates. An impairment test can look as follows in the table below — but be advised that risk stratum must be maintained over time.

For instance, just because a particular set of risk buckets are appropriate today, does not mean that this holds true indefinitely. Risk tranches need periodic reevaluation to account for increased product diversity and/or any significant change in primary mortgage rates, which may relegate virtually all new originations into a single risk stratum. Auditors may frown on any embarrassment of riches derived from a shift in risk stratum, but it is equally unadvisable to relegate 95% of firm's assets into a single risk tranche. This can easily occur when a shift in market rates produce a scenario where certain risk tranches are not populated with new production due to a shift in primary mortgage rates, thereby forcing most, if not all, new loan sales into a limited number of risk strata. Over time this can create an imbalance of risk into a single tranche. If you believe this applies to your current situation, professional advice, including but not limited to internal and external audit support, is advisable.

Note that the amortization method, while often perceived as a more conservative method of managing one's balance sheet, is more complex than alternative options.

Read the rest of this chapter in **The Mortgage Professional's Handbook!**

Michael B. Carnes joined MIAC in September 2009 and is a Director within the Capital Markets Group. Michael oversees the Mortgage Servicing Rights Valuation Committee and is responsible for all MSR valuation and modeling. At MIAC, he is responsible for administering MSR valuations totaling over one-trillion per month in Unpaid Principal Balance. He is a seasoned industry expert regarding mortgage banking and mortgage servicing rights with over 22 years of diverse mortgage banking experience.

In addition to MIAC, he has a proven track record of advising companies, including Wells Fargo, Wachovia, Irwin Mortgage, and Bank One Mortgage (now Chase Mortgage) on servicing valuation and overall corporate growth. Michael is experienced in both Static and Option Adjusted Spread valuation techniques and has experience in valuing a wide array of diverse product types. He has extensive valuation, deal making, and negotiation experience with practical business savvy that has dramatically increased the bottom line results of the companies and clients he has served.

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