Cutler Consulting, Inc.

Strategic Mortgage Partners

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The Price Is Right

In our Spring 2009 issue we discussed the price differential between mandatory and best efforts execution. We showed you how to make an extra 50 basis points switching from "best efforts" to mandatory delivery. Want to make even more money? Consider selling your loans servicing retained. Climbing delinquencies, historically low interest rates, and industry consolidation have combined to sink mortgage servicing values to one of the lowest points in history. Many lenders are considering retaining servicing to improve their selling execution and increase their profit margins. Keep reading to determine if a servicing retained strategy is right for your company.

Servicing Retained - the Right Choice?

The lack of buyers actively seeking to purchase servicing has depressed servicing prices.

Aggregators have reduced their base loan pricing to offset higher than market servicing values listed on their SRP schedules.

As a result, many lenders are considering retaining servicing. There are a number of valid reasons to implement a servicing retained execution:

- To increase gain on sale of loans due to improved all-in execution.
- To eliminate aggregator imposed product and process restrictions via direct secondary marketing executions.
- To provide a steady long-term income stream regardless of fluctuating production levels.

To effectively execute a servicing retained strategy:

- Volume levels should be at least $15 - $20 million per month in conventional conforming 30 year business.
- The lender should possess the financial strength to be approved as a Fannie or Freddie Seller Servicer.
- The lender should have or commit to a secondary marketing strategy that utilizes mandatory delivery as well as best efforts commitments.
- The company must be comfortable putting mortgage servicing assets on its books. The internal Mortgage Servicing Rights (MSR) value added to the base price should provide a higher rate of profitability than the lender's current servicing released execution.

In addition, lenders need to recognize the costs to service loans. Additional technology and staffing expenses will be incurred. Accounting policies and procedures must be implemented. Risks such as volume spikes, training and managing staff, and proper disposition of problem loans must be considered. ARMs, Interest Only loans and other special products which require payment adjustments must be serviced properly. Failure to service loans correctly could result in increased regulatory scrutiny, reputation risk and cancellation of servicing contracts.

If your company has the requisite volume levels and secondary marketing expertise but does not want to set up a servicing operation, explore the feasibility of a sub-servicer relationship. You may be able to enjoy the benefits of a servicing retained execution without incurring the costs necessary to set up a servicing operation.

Getting Started

Once you have decided to start servicing loans, you need to determine what types of loans to service.

Conventional Loans

The agencies are realistically the only outlets for servicing retained loan sales. Conventional loans should be sold to Fannie and Freddie using best efforts, mandatory and MBS delivery options.

Lenders who wish to begin servicing loans should retain Fannie and Freddie servicing. Agency pricing plus the lender's internal MSR value should allow the lender to retain servicing and beat aggregator all–in pricing (base pricing plus SRP).

Retaining servicing should not negatively impact the lender's rate sheet pricing.

Government Loans

Government servicing should continue to be sold released via best efforts, mandatory or AOT to the aggregators. Government loans are more expensive to service, delinquencies are higher and special servicing expertise is required. In addition, Ginnie Mae MBS is the only servicing retained option for government loans.

Private Investor Loans

Private Investor and State Housing loans should be sold released. Servicing small portfolios for different investors is expensive.

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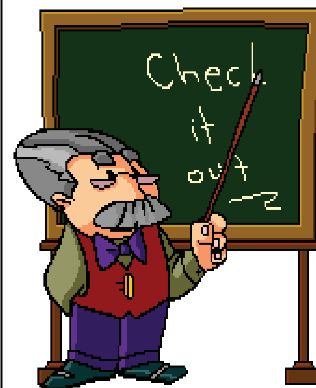


Professor Mort Gage

Housing Prices in 2010

Government stimulus programs, including the $8,000 first-time buyer tax credit, Home Affordable refinance and modification plans, and the Federal Reserve's purchases of mortgage-backed securities have helped stabilize home prices. These programs have reduced the number of foreclosed houses reaching the market , reduced interest rates and incented first time homebuyers to buy homes. As these programs wind down, housing prices could take another hit unless the employment situation makes a dramatic improvement.

Technically Speaking

Familiarity with hedging interest rate risks, mark-to-market accounting and basic servicing valuation methodology are prerequisites to retaining servicing.

Lenders who have not previously hedged their pipelines can sell loans best efforts to Fannie or Freddie and retain servicing. Lenders who lack pipeline hedging capability should acquire needed expertise or hire someone to train current personnel to hedge the mortgage pipeline.

Lenders with small servicing portfolios (several billion dollars) and conservatively booked MSRs do not need to hedge their servicing portfolios.

Mark-to-Market

With proper policies and procedures, secondary marketing and accounting can mark the servicing portfolio to market. PSA speeds can be obtained from Bloomberg. Other factors such as discount rates, the cost to service loans, and percentage of loans with escrow can be determined internally and input into the lender's valuation model.

Valuation Models

Some companies use internally developed models while others choose outside vendors. The objective is to achieve a realistic valuation. When using an internal model, the lender must utilize external market intelligence to verify its model assumptions. Regardless of the model used:

- The model must be fully documented;
- Findings must be reviewed by knowledgeable individuals not associated with the model's input; and
- Results must be continuously monitored and compared to other MSR prices in the marketplace.

Mortgage Servicing Rights

Values for retained servicing portfolios should be validated annually by a servicing broker. Values for retained MSRs are based on market data for servicing portfolios with like characteristics selling in the market. The result will be a conservative internal MSR value when compared to aggregator SRP schedule values.

Excess Servicing

Lenders hedging their pipelines using MBS must determine the maximum amount of excess servicing they are comfortable retaining and assign it a value. Generally, lenders are comfortable assigning a conservative value to 25 basis points in base servicing, but struggle with booking additional MSR values for the excess.

Lenders who are not comfortable booking excess servicing can sell excess servicing to Fannie or Freddie using their buy-up / buy-down grids.

Lenders should expect to service loans to term, assuming conservative prepayment assumptions. The resale market for servicing portfolios is volatile, and values for aged servicing are typically lower than values for newly originated servicing.

"If the change inside your company is slower than the change outside your company, the end is in sight."

– Jack Welch

Accounting Policies and Procedures for MSRs

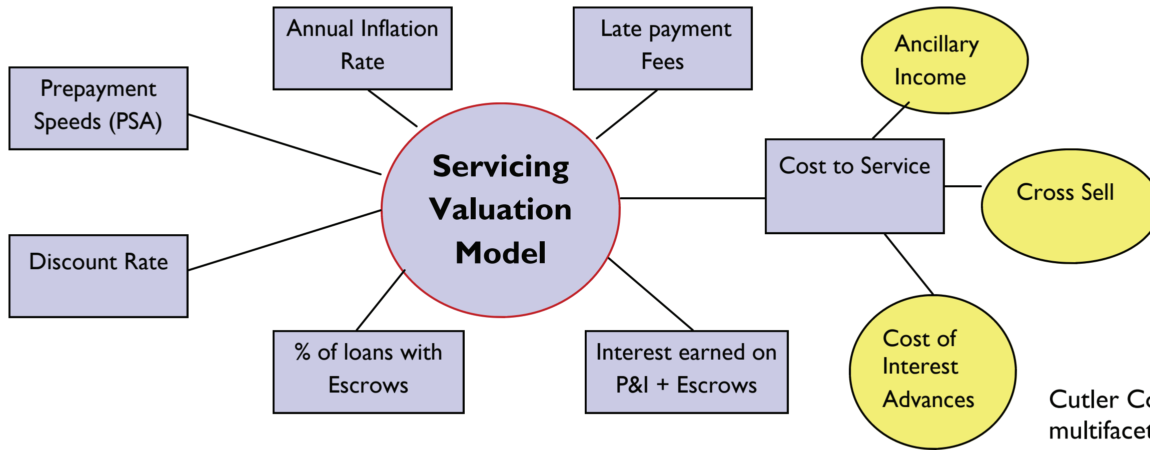
Accounting Guidance

- ◊ Initially record servicing Assets at fair value (purchase price if purchased or allocated carrying amount if retained in sale.
- ◊ Amortize the servicing asset in proportion to net servicing income over anticipated life of the asset.
- ◊ Stratify the servicing assets based on one or more of the predominant risk characteristics of the assets, assess the strata for impairment based on fair value and report them on the balance sheet at the lower of amortized cost or fair value.
- ◊ Amortization expense on MSRs is reflected as a reduction in mortgage income.

Procedures

- ◊ MSRs are recorded at the time the mortgage held for sale is sold in the secondary market and the servicing is retained by the lender.
- ◊ Generally MSRs are calculated on a loan level basis. Once the valuation is completed, the result will be compared to various market data to test for reasonableness. Such factors as the future direction of interest rates and prepayment speeds may be considered. Once the analysis is complete, the resulting value will be booked.
- ◊ MSRs may be stratified based on the investor type (conventional, government, private investor), interest rate bands and whether the loan is a fixed or variable rate.
- ◊ Once the information is verified, amortization expense is recorded as a direct reduction in the cost basis of the MSRs asset.
- ◊ At least quarterly, MSRs are tested for impairment based on the established stratification by an individual independent of the mortgage department. Assumptions used in the initial valuation of the assets will be updated to calculate any impairment or recapture of amortization expense.
- ◊ Accounting is responsible for the proper recordation and any subsequent adjustments to the MSR assets, including decision to seek a 3rd party opinion of values and modeling assumptions.

Components of a MSR Valuation Model

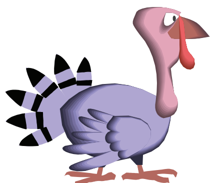


Profitability Analysis

This example of a pro-forma comparison of servicing released versus servicing retained executions is based on market conditions and pricing as of 10/28/09. Servicing released assumes best efforts delivery to an aggregator. Servicing retained is a best efforts delivery to Fannie or Freddie. As shown here, the servicing costs and lower MSR for the servicing retained option are more than offset by the higher gain on sale. The higher GOS is indicative of the difference between base aggregator and agency pricing.

Fully loaded profitability comparison - 30 year conventional fixed rate product

Revenue and Expenses	Servicing Released			Servicing Retained		
Loan Size	$ 150,000			$ 150,000		
Origination Fee	1.00%	$	1,500	1.00%	$	1,500
MSR	1.95%	$	2,925	1.25%	$	1,875
Gain on Sale	0.25%	$	375	1.50%	$	2,250
Interest Margin (2% for 30 days) ($150,000 x 2% = $3,000 / 360 days = $ 8.33 per day x 30 days = $250	0.17%	$	250	0.17%	$	250
Other (fee income)	0.30%	$	450	0.30%	$	450
Total Revenue	3.67%	$	5,500	4.22%	$	6,325
Processing Expense	0.99%	$	1,485	0.99%	$	1,485
Commissions Paid	0.42%	$	630	0.42%	$	630
Hedge Costs	0.05%	$	75	0.05%	$	75
Concessions (price subsidy to production)	0.50%	$	750	0.50%	$	750
Servicing Expense	0.00%			0.06%	$	87
Allocated Expense (corporate overhead)	0.23%	$	345	0.23%	$	345
Total Expense	2.19%	$	3,285	2.25%	$	3,372
Net Contribution	1.48%	$	2,215	1.97%	$	2,953



Happy Thanksgiving

At Cutler Consulting we want to express our appreciation to all of you for your support and business during 2009. Please call us if we can be of any service to you and your company.

Thanksgiving, after all, is a word of action - WJ Cameron

Cutler Consulting is a multifaceted financial services consulting company specializing in the mortgage and housing markets. As a strategic mortgage partner, we offer our clients senior management experience, in -depth functional knowledge and skills, and an expansive network of industry resources. We work in close partnership with our clients to deliver solutions designed to increase profitability, improve performance, and gain competitive advantage. In this rapidly changing mortgage lending environment, Cutler Consulting assists clients with the critical decisions and tasks impacting the direction and success of their businesses.

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