TWENTY YEARS OF Servicing Valuations

— by DEAN BROWN —

This veteran at valuing servicing assets recalls how a shift to riskier mortgage originations in the early 2000s blindsided those minding the servicing store.

I recall a story about a prominent mortgage banker taking great pride in attaining a $1 billion servicing portfolio. It was sometime around 1986, and this accomplishment only took the firm about 15 years to achieve. ¶ Over the next two years, the portfolio doubled to $2 billion. Then over the next six years, the firm would experience a 400 percent growth to a $10 billion servicing portfolio. ¶ Over this same period, it became increasingly difficult for small and midsize mortgage bankers to acquire and grow their servicing portfolios. Even at $10 billion in servicing, it was becoming less cost-effective to maintain and support the servicing platform when weighed against the large megaservicers that were growing rapidly. ¶ With far more capital at their disposal, these megaservicers were able to drive down their cost of servicing, gaining tremendous economies of scale. The end result was that the bigger servicers kept getting bigger while the small and mid-tier banks and mortgage bankers were squeezed out of this market space.

But while growing servicing portfolios may not have been a viable option in the late 1990s and the first part of this century, mortgage bankers were rewarded handsomely in terms of the service release premiums (SRPs) they received for selling their loans into the secondary mortgage markets.

During the 1980s and 1990s, mortgage originations were fairly consistent. By and large, lenders offered conventional and government fixed-rate mortgage loans guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. In 1986, the conventional loan limit for a single-family residence was $133,250. Any loan greater than that amount was considered non-conforming or jumbo product, and typically was reserved for private investors or large depository institutions with portfolio capability.

Due to the homogeneity of the product and the ease of servicing, the valuation process was stable and easy to measure. Mortgage life was simple.

Much like the hard-money lending industry, mortgage servicing also began as a cottage industry reserved for just a few ultra-large lenders.

Introduction of credit scoring in originations

But the late 1990s and early 2000s brought about the beginning of significant change. In the mid-1990s, Fair, Isaac & Co. (renamed FICO in 2009) introduced its concept of credit scoring.

Eventually, government agencies and mortgage originators began to parse out their loans and assign credit risk ratings based on credit scores; risk-based pricing had arrived.

Statistical data has documented that loans made to borrowers with higher credit scores statistically perform better than loans to borrowers with lower credit scores. Furthermore, when you include the amount of equity the borrower has in the property at the time of origination, statistics document that loans with lower loan-to-value (LTV) ratios also tend to perform better.

In the most simplified analysis, and in terms of loss severity, statistics show that borrowers with lower credit scores and less equity in their property at the time of origination tend to have a higher rate of default with significantly greater losses for the lender in the event of foreclosure. And clearly, these loans also carry with them a higher cost to service. Yet in the beginning, many servicing valuation models remained unchanged, failing to take into consideration the changing demographics of the new servicing portfolios.

Why is this important?

Understanding the historical evolution of the mortgage origination market and the subtle implications it had on the mortgage servicing rights (MSR) asset is critical to understanding not only changes in the expected performance of evolving servicing portfolios, but also the implied changes to the valuation of those very same portfolios.

It is critical to understand that as the servicing markets grew and matured, lending standards became increasingly more lax.

Creative period in mortgage lending

Circa 2003, we saw the emergence of alternative-A and subprime lending as loans to less-creditworthy borrowers—as determined by lower FICO® credit scores—began to become more and more popular. For the next five years, what was once a cottage industry known as hard money lending became increasingly mainstream.

Lenders lowered their minimum credit-score standards and allowed higher LTV ratios, giving less-creditworthy borrowers access to capital that they could barely afford and with little to no equity. Yet the barriers to entry into the servicing space for small and mid-tier servicers continued to propagate due to the rapid growth already seen by the megaservicers.

As the subprime markets grew, these megaservicers continued to acquire more and more servicing rights. But did they fully understand the changing origination standards of the underlying collateral?

Surely they had more efficient servicing platforms and were able to keep their costs down, but were they really ready for the additional touches and incrementally greater costs associated with servicing this changing portfolio mix?

We contend that history has proven that servicers were not focused on establishing procedures to handle the changing demographics of their servicing asset—nor did they adjust their MSR valuation processes accordingly. In addition to the rise of subprime lending, this era also saw the growth of more new and innovative loan products ranging from 2/28 adjustable-rate mortgages (ARMs) to pay-option ARMs. These new products resulted in rising servicing costs and greater loss severity in the event of foreclosures.

Much like the hard-money lending industry, mortgage servicing also began as a cottage industry reserved for just a few ultra-large lenders. It wasn't until the mortgage industry was in the midst of a full-blown market meltdown that we understood not only the gravity of the situation, but how ill prepared many existing megaservicers were for the exponentially increasing rate of defaults and subsequent foreclosures.

Part of the reason for this was that servicers were unaware of the changing demographics of their servicing portfolios. They still were structured to service the homogenous portfolio of agency and government fixed-rate loans with a small spattering of variable-rate and/or bank-owned portfolio mortgages. Likewise, servicers did not take into consideration the changing demographics of their servicing portfolios.

Post-fallout—the regulatory period

In 2013, the servicing environment changed again as state and local governments added regulations on top of the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These regulations impact risk retention, operational responsibilities and even interaction with consumers—all of which adds operational and litigation costs for the servicers and erodes margins.

The Dodd-Frank Act largely took effect in January 2014, and combined with banks limited by Basel III reform measures that restrict them from holding more than 10 percent of Tier 1 capital in mortgage servicing rights, regulatory compliance will be a top-of-mind concern for any business that services residential mortgages in 2014.

The current regulatory environment definitely has contributed to the servicing industry coming nearly full circle. Now in present day, while there still are several megaservicers, the economics are such that small and mid-tier mortgage lenders feasibly can enter the servicing arena and grow a respectable mortgage servicing rights portfolio.

Furthermore, because of the 2008 mortgage crisis, today's mortgage products—and therefore the servicing portfolios—are once again much more standardized, consistent and predictable. Borrowers with low FICO scores and high-LTV loans on risky variable-rate products no longer are present.

Today's new mortgage servicing portfolios consist of conventional conforming fixed-rate mortgages (FRMs), with a small percentage of variable-rate or interest-only loans. Over the past five years, we have seen a significant rise in the number of small and mid-tier mortgage lenders acquiring and growing their servicing portfolios. Gone are the days of dominance and control of the servicing market by just a few megaservicers.

Old methodologies fall short in the current climate

This rise of new mortgage servicers increases the need for greater awareness and understanding of the complexities of accurately valuing the MSR asset. To begin with, lets analyze a few of the shortcomings of past methodologies that servicers employed to value the pre-mortgage-crisis servicing portfolios.

Such strategies typically relied on a net present value (NPV) calculation that incorporated a static cost to service. Based on the historical portfolio complexion, this model failed to properly value the float and potential variations in income and prepayment speeds based on such variables as product, coupon and age of the loans valued. In addition, often the old methods of servicing valuations were the same type of valuation done by proxy for quarterly audit and/or regulatory requirements.

Still today, there are some firms that may continue to employ these archaic methods for valuing their MSRs. Rather than calculating true values for the MSRs, lenders instead rely on market valuations interpolated based on recent sales of similar, but not identical, MSR portfolios. Such valuations, which intrinsically are based on owners contacting their preferred servicing broker for a current valuation, are similar to a homeowner contact a Realtor® for a broker price option.

Rather than basing a valuation on expected prepayment speeds for the targeted assets and calculating a value based on the demographics of the underlying loans, the values are obtained prices if the owner were to sell the asset, yet they fail to calculate the actual, intrinsic value of the MSR asset.

OAS modeling—moving beyond the prepayment model

A much better way to value today's MSRs is with a sophisticated option-adjusted spread (OAS) model. In an OAS-based model, cash flows derived from the servicing fee—net of costs collected for each loan—are analyzed to arrive at an actual servicing value for each loan.

This technique requires customizing the model for each client by incorporating each customer's unique average cost to service per product type, and a desired spread to the Treasury yield curve for setting discount rates.

This valuation allows owners to know what the portfolio is worth to them now and what it will be worth if rates go up or down, and compare the valuation with what someone else might pay for it.

Still, there are many other factors that servicers should consider when valuing a portfolio. A few of these factors include foreclosure costs, portfolio foreclosure rates, foreclosure period, delinquency rate per time period, late fees, ancillary income and trust fund balances. The result is a customized model that is more reflective of the servicer's unique portfolio and profile.

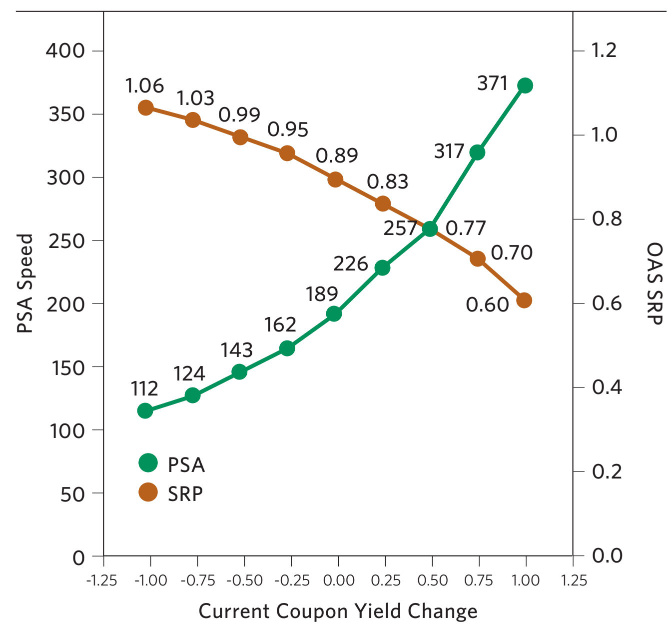
Reporting to understand the nuances

A good MSR valuation package also will provide the owner with standardized, comprehensive reports to help the owner understand all the nuances of their portfolio, because the old adage, "if you can't measure it, you can't manage it," applies to servicing rights and MSR valuation packages as well.

Having these types of reports allows the astute MSR investor to avoid repeating many of the ills that affected servicing shops that failed to fully understand the complexion of their servicing portfolios and how those portfolios changed from

FIGURE 1

SERVICING PORTFOLIO VALUE VS. SPEED



NOTES: PSA is a prepayment model by the Bond Market Association (formerly known as the Public Securities Association [PSA]) that assumes increasing prepayment rates for the first 30 months of the lifetime of the loan and constant rates thereafter. OAS = option-adjusted spread and SRP = service release premium.

SOURCE: Mortgage Capital Management

the 1980s and 1990s into the 21st century.

At Mortgage Capital Management, one unique report available to clients is the shock analysis valuation, which illustrates the portfolio's valuation sensitivity given a +/-100 basis-point movement in the yield curve.

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The shock valuation analysis allows the investor to better estimate targeted loan performance, prepayment speeds, changes in default rates and costs to service. In addition, the shock valuation analysis can generate reports on myriad potential outcomes, allowing servicers to have numerous strategies in place designed to maintain stability of income and cash flow and mitigate potential losses.

In Figure 1, the value of servicing or OAS SRP (in basis points) increases or decreases based on the current coupon yield changes of the portfolio versus market yields. So, if the yield of the portfolio is 25 basis points in yield higher than the current yield in the market, then there would be a corresponding drop in value of the portfolio on an OAS adjusted basis. Or, stated another way, if the current coupon yield drops below the yield of the servicing portfolio by 0.25, thereby making the servicing portfolio 25 basis points in yield higher than the market current yield, the model predicts the corresponding change in PSA speeds from 189 to 226 and the corresponding decrease in OAS SRP from 0.89 to 0.83.

Over the past 30 years we have seen the rise, fall and rebirth of small and midsized mortgage servicers. With that evolution, we clearly see the need for mortgage servicers of all sizes to take an accurate inventory of their MSR asset and make certain that they employ an MSR valuation technique that fairly and accurately assesses its true current fair market value. Along with the valuation, the astute investor or owner of mortgage servicing rights must have the most current detailed reports to measure and manage this most valuable asset. **MB**

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