

Take The Pain Out Of Your Gain! Switch To Match-Up Accounting

How do you explain P&L accounting losses when you know for certain you had gains? It's all how you account for it. Here's the best way . . .

BY DEAN A. BROWN

How many times have you, as secondary marketing manager, been put into a position of having to explain the apparent discrepancy between your accounting gain on sale P&L and what has actually happened economically after periods of market volatility?

Every other month? Every month?

Often is the case that your hedging gains and losses do not match up with your loan gains and losses, due to either one or more of the following factors:

- accounting treatment,
- investor's delaying settlements, and/or
- trading opportunities.

Usually, the mismatch occurs



BROWN

Dean A. Brown is president of Mortgage Capital Management Inc., San Diego, a mortgage consulting firm specializing in secondary marketing, interest rate risk management, trading, valuation, and product and builder business development.

through no fault of your own. You matched your hedge position by program, by coupon, by delivery month throughout the processing cycle, and yet, to no avail, the month's accounting gain on sale reports either a large loss (the boss is in your office the next morning) or a large gain (a pleasant nod by the cappuccino machine).

This article discusses the increasingly troublesome accounting methodology termed "settlement based accounting" as it relates to secondary marketing, and suggests ways to at least live with it - if not have it replaced.

Unsettling 'settlement' method

In almost all other areas of a mortgage company's business and in other businesses, the accrual method of accounting has been accepted as the de facto standard or "preferred method."

However, due to the complex nature of the trading activity in secondary marketing, a cash basis of accounting method referred to as "settlement based accounting" has been adopted by most firms.

A settlement P&L for secondary purposes classifies cash receipts from all sources according to when the cash is disbursed or received.

For example, when a wire (cash) is received from an investor on the purchase of a pool of loans, the gain

or loss on the loans is booked in the month the cash is received. This situation sounds very simple and straightforward if the activity is fairly represented.

However, due to various complexities - such as timing delays between investor purchases, and wires from dealers, hedging according to best execution, and designations according to best delivery - the two rarely match up in the same month or months.

During periods of relatively low market price volatility, the mismatch is overlooked as loans designated in prior months are settled, and the income or loss is recognized along with the pair-offs and hedge gains or losses executed during the current month.

This situation has become the exception, not the rule as market prices have become increasingly volatile.

What has been frequently occurring across Mortgageland is this: You have been hedging your pipeline diligently and should have broken even, given your competitive pricing before considering servicing income. However, your last month's gain on sale was significantly negative and you are asked to explain it once again to the management team.

If you have the tools and/or the information required to do the job, consider yourself ahead of the game - most do not.

FIGURE 1: DESIGNATION TRACKING REPORT

DESIGNATION DATE: 28-Aug-96 POOL NUMBER: 99456821
 SETTLEMENT DATE: 02-Oct-96 PROGRAM: CONV30

LOANS:

LOAN #	BORROWER	PROGRAM	BALANCE	RATE	DISCOUNT	SERV FEE
2082062719	McDonald	FHLMC30	207,000	7.750	-1.125	1.4000
2032098861	Duran	FHLMC30	202,350	7.750	1.750	1.5000
2362099554	Carcellero	FHLMC30	200,000	7.750	1.375	1.2000
2362102390	Chandrasekhar	FHLMC30	206,000	7.875	0.250	1.6000
2362102395	Saputo	FHLMC30	161,650	7.875	0.250	1.6000
2362102444	Williamson	FHLMC30	165,000	7.875	0.250	1.6000
2362102330	Burkle	FHLMC30	164,000	7.875	0.250	1.6000
TOTAL OR W.A. #'s			10,000,000	7.800	0.846	1.648

TRADES:

TRADE #	DEALER	SECURITY	AMOUNT	COUPON	PRICE
45678	PW	FHLMC30	5,000,000	7.500	103.500
45679	SB	FHLMC30	5,000,000	7.500	102.500
TOTAL OR W.A. #'s			10,000,000	7.500	103.000

SOURCE: Mortgage Capital Management

DISCOUNT

BUY PRICE:	100.84623	
SELL PRICE:	103.00000	
NET DISCOUNT:	2.15377	
TOTAL DISCOUNT	\$215,377.25	2.15%

EXCESS YIELD

WTD AVG RATE:	7.8001	
SERVICING:	0.2500	
GUARANTEE FEE:	0.2000	
COUPON:	7.5000	
BUYUP:	0.0000	
BUYUP FACTOR:	4.0000	
BUYDOWN:	-0.1498	
BUYDOWN FACTOR:	5.5000	
EXCESS BPS:	0.0000	
EXCESS TOTAL:	(\$82,440.53)	0.82%

NET INTEREST **\$13,445.11**

MARKETING P&L **\$146,381.82** 1.46%

SERVICING P&L

W.A. SERV FEE:	1.6479	
TRANSFER FEES:	\$4,800	
MISC. FEES:	\$750	
TOTAL SERV MARGIN:	1.5924	
SERVICING TOTAL:	\$159,243.65	1.59%

GRAND TOTAL **\$305,625.47** 3.06%

Accrual method better

A better way to coordinate your accounting gain on sale with the activity during a given month would be to use an accrual method of accounting.

The accrual accounting method for

calculating gain on sale profitability is termed the "designation based accounting" method. The designation method smooths the unavoidable timing mismatches and coordinates your secondary marketing P&L with the activity during a given month.

The concept is to book gain on sale P&L - or at least track it on an "as pooled" or "as designated" basis. Hence, when loans are designated to specific trades for settlement, a P&L on the transaction would be calculated and booked.

A specific example of this is provided in **FIGURE 1**, where a \$10 million pool was formed and the gain calculated. Within the transaction example, the \$10 million sale produced a \$146,381 gain on sale with a \$159,243 profit from the servicing sale. In total, the transaction produced \$305,625 of revenue or roughly 3 points before expenses.

As this transaction is booked, the loans and the trade could be taken off of the pipeline risk position and placed in a "to be settled" report, where shipping would take over for delivery and settlement.

If this transaction was booked on the day it was produced - and not two to three months later when the investor decided it was time to pay according to a settlement based methodology - the cash received would correspond to any pair-offs associated with the pool.

An example...

For example, assume that the trades the loans were securitized into were FHLMC 7.5s, executed on the day before the loans were pooled

FIGURE 2: DESIGNATION GAIN ON SALE ESTIMATE

PRODUCT	MONTH TO DATE			TOTAL	DESIGS	MKT%	SERV%	TOT%
	CASH	EXCESS	SERV					
FHA/VA 30YR	0	0	0	0	0	0.00%	0.00%	0.00%
FHA/VA 15YR	0	0	0	0	0	0.00%	0.00%	0.00%
CONV 30YR	228,822	(82,441)	159,244	305,625	10,000,000	1.46%	1.59%	3.06%
CONV 15YR	0	0	0	0	0	0.00%	0.00%	0.00%
CONV 7YR	0	0	0	0	0	0.00%	0.00%	0.00%
CONV 5YR	0	0	0	0	0	0.00%	0.00%	0.00%
CONV ARMs	0	0	0	0	0	0.00%	0.00%	0.00%
JUMBO 30YR	0	0	0	0	0	0.00%	0.00%	0.00%
JUMBO 15YR	0	0	0	0	0	0.00%	0.00%	0.00%
JUMBO 5 YR	0	0	0	0	0	0.00%	0.00%	0.00%
JUMBO ARMs	0	0	0	0	0	0.00%	0.00%	0.00%
OTHER	0	0	0	0	0	0.00%	0.00%	0.00%
SUBTOTAL	228,822	(82,441)	159,244	305,625	10,000,000	1.46%	1.59%	3.06%
ADJUSTMENTS:								
OPTION FEES				0				
MARK TO MKT CBT OPTIONS				0				
COMMITMENT FEES				0				
PAIROFFS				(146,382)				
DISCREPENCIES				0				
SETTLEMENT DISCREPENCIES (EOM)				0				
MISC TRADING FEES				0				
OTHER BUY UP/DOWN FEES				0				
FHLMC BUYUP/BUYDOWN FEES				0				
FNMA/FHLMC NON OWNER OCCUPIED FEES				0				
INTEREST INCOME CREDIT				0				
OTHER				0				
SUBTOTAL ADJUSTMENTS				(146,382)				
TOTAL PROFIT (LOSS)				159,243	10,000,000	0.00%	1.59%	1.59%

SOURCE: Mortgage Capital Management

FIGURE 3: SETTLEMENT METHOD SPREADS IT OUT

Using the example in **Figures 1 and 2**, the settlement method of accounting doesn't allow matching up the gain on sale with the transaction month. Here's what happens:

	Transaction Month	Next Month	2nd Month	Total P&L
Gain on Sale	\$-146,381	0	\$146,381	0
Servicing	0	0	\$159,243	\$159,243
Total	\$-146,381	0	\$305,625	

according to a best execution and best delivery model.

Further, if the loans were hedged during the processing cycle with a combination of FNMA 8's and a FHLMC 7.5 put option that produced a pair-off loss of \$146,381 due to a rising market, the month's gains and losses could only be balanced by using a designation based accounting method.

FIGURE 2 indicates the gain on sale P&L from a designation point of view. As shown here, the gain from the transaction of \$305,625 is booked along with the pair-off loss of \$146,381, leaving a net \$159,243 gain

loss that is wired the next day), leaving the revenue from the loan sale to be recognized as the investor settles the transaction, usually 1 to 3 months later.

This method has arbitrarily increased the volatility of the company's gain on sale P&L. Assuming no other transactions, the net zero gain on sale P&L and a \$160,811 servicing sale gain is spread over two to three months as shown in **FIGURE 3**.

By using the settlement accounting method, the variance between months for the firm's gain on sale has increased significantly, due to the fact that the activity and the

on the servicing sale for the month, and a zero gain on sale P&L on the loans.

Alternatively, if the transaction was booked using the settlement based accounting approach, the gain on sale loss would be booked in the current month (the pair-off loss is a cash

booking of P&L does not match up.

Mismatches add up

In just this one transaction, a zero gain on sale P&L is transformed into a \$146,381 loss one month, then to a \$146,381 gain two months later. When combined with the many other transactions executed over a month's time - i.e. dollar rolls, pair offs for best execution and delivery purposes, cross hedging transactions, and so on - the combined effect is to completely shade the secondary manager's vision from the actual P&L activity when booked according to the "preferred" settlement method.

Hence, as this example demonstrates, the settlement approach can significantly distort your hedging performance reporting if looked at from only the settlement based accounting method.

If for practical reasons you cannot change your accounting method to the designation based method, you should at least track your transactions using the method.

Thus, when faced with explaining the loss to the management team, you will have solid facts and data to support your performance and maintain your "position." **SME**