WILARY WINN LLC

FHFA's Guidelines for Enterprises: Risk Management and Valuation of Mortgage Servicing Rights (MSRs)

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In January 2023, the FHFA directed Fannie Mae and Freddie Mac ("the Enterprises") to establish and implement risk management policies and procedures for monitoring and valuing MSRs held by their seller/servicers. The FHFA's directive is aimed at ensuring that the Enterprises have a robust process in place to:

1. Manage risk: Create procedures to identify and address potential risks associated with MSRs, such as servicing failures or financial instability of the servicers.

2. Value MSRs accurately: Implement methodologies to determine the true value of MSRs, which can fluctuate based on interest rates and other market factors.

3. Monitor MSR performance: Continuously assess the financial and operational soundness of the entities that hold MSRs, ensuring they can meet their obligations.

When seller/servicers provide representations and warranties that the mortgages they sell to the Enterprises conform with selling guide requirements, they expose the Enterprises to counterparty credit risk. If a mortgage loan does not meet its requirements, the Enterprise can require a seller/servicer to repurchase the defective loan. If a seller/servicer is not meeting its selling commitments and servicing obligations, including required repurchases, the Enterprises could incur credit losses. The Enterprises mitigate credit risk using financial eligibility standards, ratings, limits, and ongoing evaluations of a seller/servicer's financial strength and operational performance. Entities must meet or exceed minimum financial requirements to be an approved Enterprise seller/servicer. If obligations are not being met by the seller/servicer, the Enterprise has certain rights to revoke servicing, in which case it may transfer servicing to another seller/servicer.

MSR values have a high level of uncertainty and volatility due to market conditions, interest rate changes, prepayment speeds, and Enterprise termination rights. Differing levels of sophistication between models and the assumptions used can result in a divergence of determined fair value. Proper valuation and risk management of these contractual obligations are essential to maintain the liquidity, stability, and transparency of the mortgage market. As such, the FHFA requires that Enterprises not accept MSR valuations provided by seller/servicers without **an independent evaluation** to ensure values are sound based on reasonable, defendable, and documented assumptions. In addition to an independent evaluation of MSR values, the FHFA requires that the Enterprises estimate the potential range of values under various stress scenarios to assess the effects on seller/servicer's financial condition and, in turn, the eligibility of continuing to meet eligibility requirements. Enterprises must also assess the readiness of servicers under an economically stressed environment including the impact of higher delinquencies and costs on counterparty risk and liquidity constraints.

The FHFA indicates that market research such as trade information, proxies for servicing fee multiples, or capitalized values can be used to benchmark against the value determined by the Enterprise. While the Enterprise is unlikely to have sufficient data to assess MSR values for mortgage loans it does not own or guarantee, using information provided by the seller/servicer such as general loan characteristics or independent audits and third-party valuations, the Enterprise should assess the reasonableness of the information it is able to obtain and adjust the valuations accordingly.

Conclusion

The FHFA's directive to Fannie Mae and Freddie Mac to implement risk management policies for monitoring and valuing MSRs emphasizes the importance of safeguarding the financial stability of the mortgage market. The FHFA recognizes the importance of independent third-party valuations that include market interest rate stress tests such as those provided by Wilary Winn.