WILARY WINN LLC

Advice to Strengthen Financial Institutions

Mortgage Servicing Marketplace in the Face of COVID-19

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INTRODUCTION

COVID presented two challenges to mortgage servicing rights valuation experts in the early months of 2020. First, how to properly incorporate the potential credit and prepayment risks into the valuation. Second, how to properly account for the servicing rights as the servicing released marketplace collapsed.

Valuations had to incorporate the default risks arising from the virus and the federal government's massive stimulus efforts.

The accounting required a thorough understanding of FAS ASC 820 and why a discounted cash flow technique was preferred in the absence of an "orderly market."

KEY TAKEAWAY

This white paper is an example of where we excel. We combined the use of sophisticated financial techniques with a deep understanding of the required financial accounting to value mortgage servicing rights for our clients during a very challenging time.

HOW CAN WE HELP YOU?

Founded in 2003, Wilary Winn LLC and its sister company, Wilary Winn Risk Management LLC, provide independent, objective, fee-based advice to nearly 600 financial institutions located across the country.

We provide the following services:

CECL & ALM
Holistic solutions to measure, monitor and mitigate interest rate, liquidity, and credit risk on an integrated basis.

MERGERS & ACQUISITIONS
Independent, fee-based determinations of fair value for mergers and acquisitions.

VALUATION OF LOAN SERVICING
Comprehensive and cost-effective valuations of servicing arising from the sale of residential mortgage, SBA 7(a), auto, home equity and commercial loans.

ADDITIONAL SERVICES
Services to support our CECL, ALM, Fair Value and Loan Servicing product offerings.

Mortgage Servicing Marketplace in the Face of COVID-19

Overall

We are currently witnessing a global economic slowdown due to the COVID-19 outbreak and most economists are projecting a pandemic-driven severe recession. In response to the outbreak, the Federal Government has undertaken countermeasures, including massive fiscal and monetary stimulus, making the economic effect difficult to predict. The recently enacted Coronavirus Aid, Relief, and Economic Security ("CARES") Act provided an estimated $2.2 trillion in relief. The Federal Reserve has lowered interest rates to near zero.

At the same time, under the CARES Act, FNMA, FHLMC, the FHA and the VA began offering COVID-19 forbearance programs. These programs provide six months of forbearance to borrowers adversely affected by the virus and include the option for the borrower to request an additional six months at a later date. While the CARES act does not directly affect the FHLBanks' MPF® Traditional Conventional loan products, it does apply to government loans and loans owned by Fannie Mae.

In addition, PFIs and Servicers originating, delivering or servicing:

- MPF Government loans and Government MBS must adhere to relief policies and guidance provided by the applicable Government Agencies;
- MFP Xtra® loans must adhere to the relief policies and guidance provided by FNMA; and
- MPF Direct loans must follow the relief polices and guidance provided by Redwood Trust, the product's investor.

We further note that the FHLBanks' are offering forbearance to borrowers in the MPF Traditional (conventional) products under the FHLBanks' terms.

Mortgage Marketplace

The mortgage marketplace began to show signs of significant stress in the third week of March. Major mortgage loan aggregators announced they would suspend purchases of loans insured by the FHA and guaranteed by the VA. The servicing released premiums ("SRPs") for these Government loans fell to zero, or in some instances went negative. Similarly, SRPs for loans guaranteed by FNMA, FHLMC and the FHLBanks dropped dramatically. Wilary Winn believes the effect on Government loans was much more severe for two reasons.

First, Government loans are generally pooled and sold in the form of GNMA securities. GNMA requires servicers to advance all scheduled principal and interest to the mortgage-backed security investors even when the borrower does not make their required payment. This scheduled/scheduled loan servicing requirement caused great anxiety among servicers because they feared significant numbers of borrowers would seek forbearance – for periods up to a year – leaving the servicers with advancing obligations for principal and interest over the forbearance time period. In addition to principal and interest payment advances, servicers would also have to advance for payments of taxes and insurance and other escrow items. The advance obligations require significant levels of liquidity which not all servicers possess.

Second, and much more significantly, the economics associated with Government servicing depend on whether or not the borrower ultimately defaults on the loan. If the borrower does not default, the detriment to the servicer related to the advances made on behalf of the borrower is the present value difference between the time period of the advance and its repayment. On the other hand, a borrower default on a Government loan generally leads to significant losses for the servicer. In our experience, the FHA does not fully reimburse the servicer for all advance costs. In addition, the servicer advances interest at the interest rate on the mortgage-backed security and is reimbursed by the FHA at a rate equal to the FHA debenture rate (which is lower). For loans guaranteed by the VA, servicers face the risk that the VA will not bid at the foreclosure auction, which happens when housing prices deteriorate, leaving the servicer with the loss. Wilary Winn believes investors are rightfully concerned about the default risk because loans backed by the FHA and VA have lower FICO scores and lower downpayment requirements when compared to Conventional loans.

In addition to more favorable loan attributes, Conventional loan servicing allows for an actual/actual remittance to investors. The servicer remits only the principal and interest it receives from the borrower, thus mitigating the advancing risks arising from forbearance. However, the servicer still must advance payments for property taxes and insurance. From an economic perspective, we believe the present value diminution in value from the advance is offset by the expected drop in prepayments.

Given current market conditions, Wilary Winn believes the best execution for mortgage loan transfers is to sell the loan servicing retained. In this case, instead of selling the servicing and receiving an SRP, the seller records the estimated present value of the expected net cash flows from servicing the loan – the mortgage servicing right ("MSR").

MSR Valuation Considerations

Recognizing not all PFIs have retained and recorded MSRs, following is a very brief summary of the valuation components. MSRs are a modified interest-only strip. The key valuation components are:

- The loan amount
- The servicing fee, which is paid monthly based on the outstanding principal balance of the loan
- The loan's expected loan life – dependent on the rate at which the borrower curtails interest or prepays
- Expected ancillary income – late fees, credit life insurance commissions, etc.
- Current and future servicing costs, which should be expressed in dollars per loan
- Current and expected delinquency rate and related incremental servicing costs
- The risk the loan will default and whether it has been sold with recourse, no recourse, or has a limited form of credit exposure
- The method the servicer has elected to remit to the mortgage loan investor – actual/actual; scheduled/scheduled or a combination of the two.
- The yield used to discount the future cash flows to present value

Accounting Considerations

Many are concerned about the effects the recent collapse in the mortgage loan servicing marketplace will have on their accounting for MSRs. Wilary Winn believes that retained MSRs are a level 3 asset in the fair value hierarchy and should be recorded at the amount primarily derived from valuation as of March 31 quarter-end and not on fire sale prices derived from a panicked market.

Fair value determinations are based on transactions between willing participants in an orderly market. GAAP provides specific fair value guidelines when the volume or level of activity for an asset or a liability has significantly decreased – "The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). To determine whether, on the basis of the evidence available, there has been a significant decrease in the volume or level of activity for the asset or liability, a reporting entity shall evaluate the significance and relevance of factors such as the following:

a. There are few recent transactions.
b. Price quotations are not developed using current information.
c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).
d. Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, taking into account all available market data about credit and other nonperformance risk for the asset or liability.
f. There is a wide bid-ask spread or significant increase in the bid-ask spread.
g. There is a significant decline in the activity of, or there is an absence of, a market for new issues (that is, a primary market) for the asset or liability or similar assets or liabilities.
h. Little information is publicly available (for example, for transactions that take place in a principal-to-principal market)."1

Wilary Winn believes the mortgage servicing marketplace at March 31 exhibited many of these characteristics. GAAP provides clarification about what to do in this situation. "If there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, a reporting entity shall consider the reasonableness of the range of fair value measurements. The objective is to determine the point within the range that is most representative of fair value under current market conditions".[2]

Wilary Winn recommends that PFIs weight the March 31 present value results much higher than the trade results seen that day. We note that if SRP prices do not recover during the second quarter, then servicers should place significant weight on them when estimating fair value.

Near Future

We believe the federal government will continue to provide fiscal and monetary relief. Congress is discussing providing an additional $2.3 trillion. Perhaps more importantly, the Fed has acted aggressively to intervene in the capital markets and expressed its intent to continue to do so. Housing agencies are taking specific actions to relieve servicers. For example, GNMA recently announced it will implement a pass-through

[1] FAS ASC 820-10-35-54C
[2] FAS ASC 820-10-35-54F

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assistance program ("PTAP") to provide liquidity to servicers faced with significant principal and interest advances.

Conditions continue to change rapidly, and we encourage PFIs to continue to vigilantly monitor the situation and take action accordingly. Please let us know if we can be of help with your valuation and/or MSR accounting needs.