



Mortgage Industry Trends and Key Implications For CFOs

**MBA's Accounting, Tax and Financial Analysis Conference
November 15, 2006**

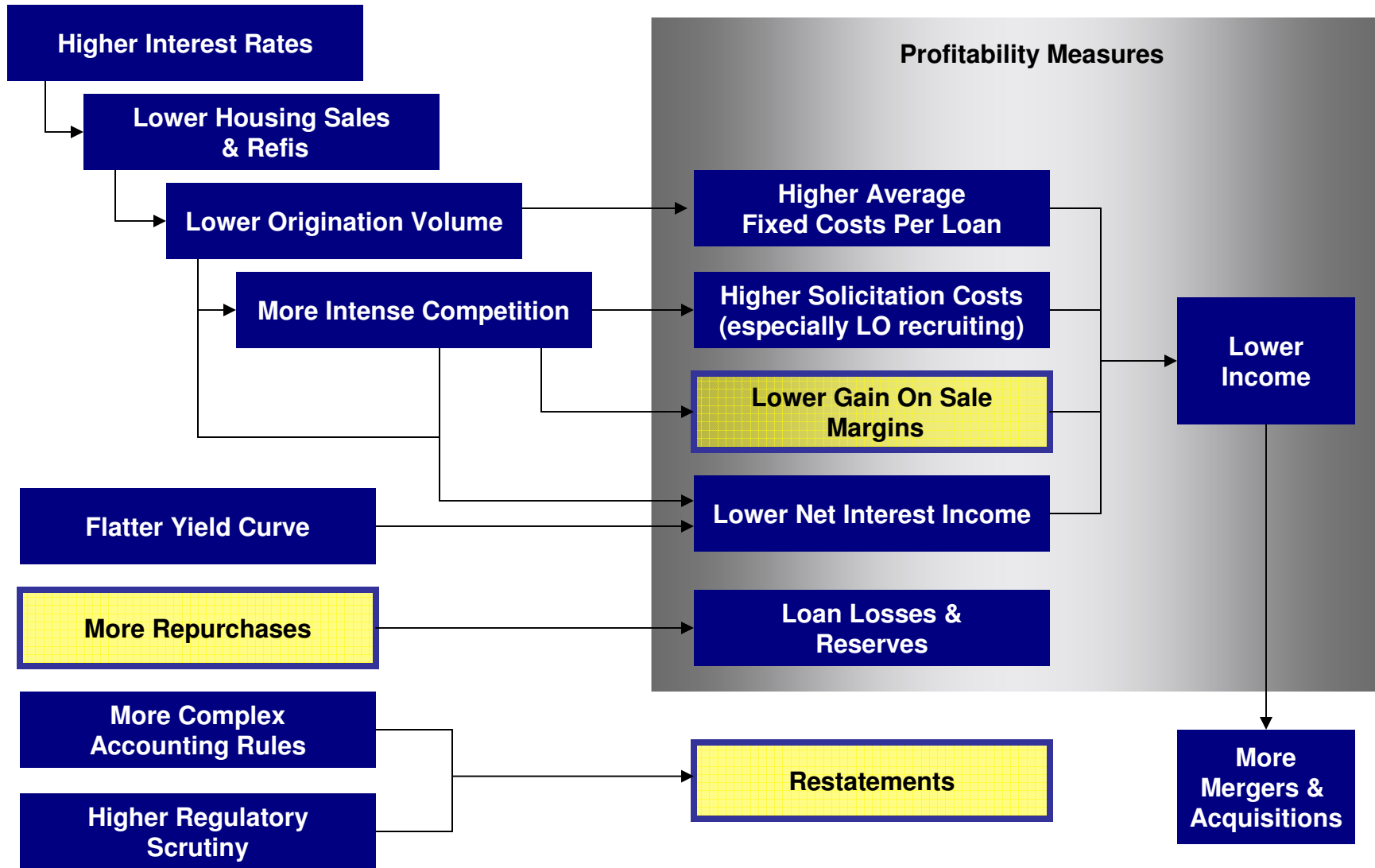
**Terry Couto
Partner, Newbold Advisors LLC
tcouto@newboldadvisors.com
727-492-7417**

- **Briefly discuss industry trends**
- **Drill down into 3 areas**
 - **Gain On Sale Margins/Secondary Marketing Oversight**
 - **Restatements**
 - **Repurchase Management**
- **Provide recommendations for CFOs and other financial managers**

Recommendations are not just focused on accounting – they include ways to improve the economics and the operational effectiveness of the business.

Mortgage Industry Trends

Mortgage Industry Trends



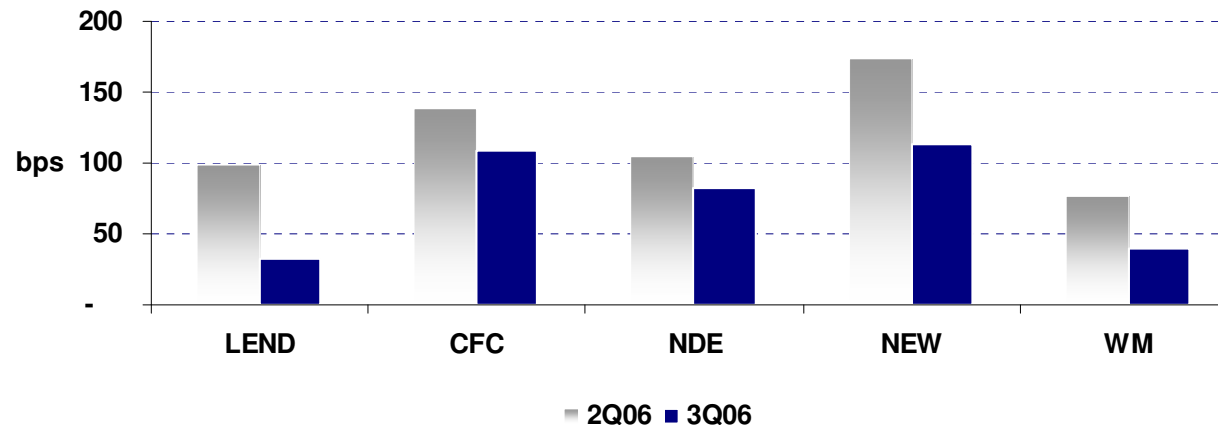
Gain On Sale Margins/ Secondary Marketing Oversight

Will explain the key drivers of margins, discuss pricing engines, provide examples of secondary execution, and make recommendations for CFO oversight/monitoring of Secondary Marketing activities

Margins – Recent Results

- Most Companies Experienced Sharp Margin Declines Across All Product Lines In 3Q06
- Trend Is Expected To Continue Into 4Q06 and 2007

Gain On Sale Margins

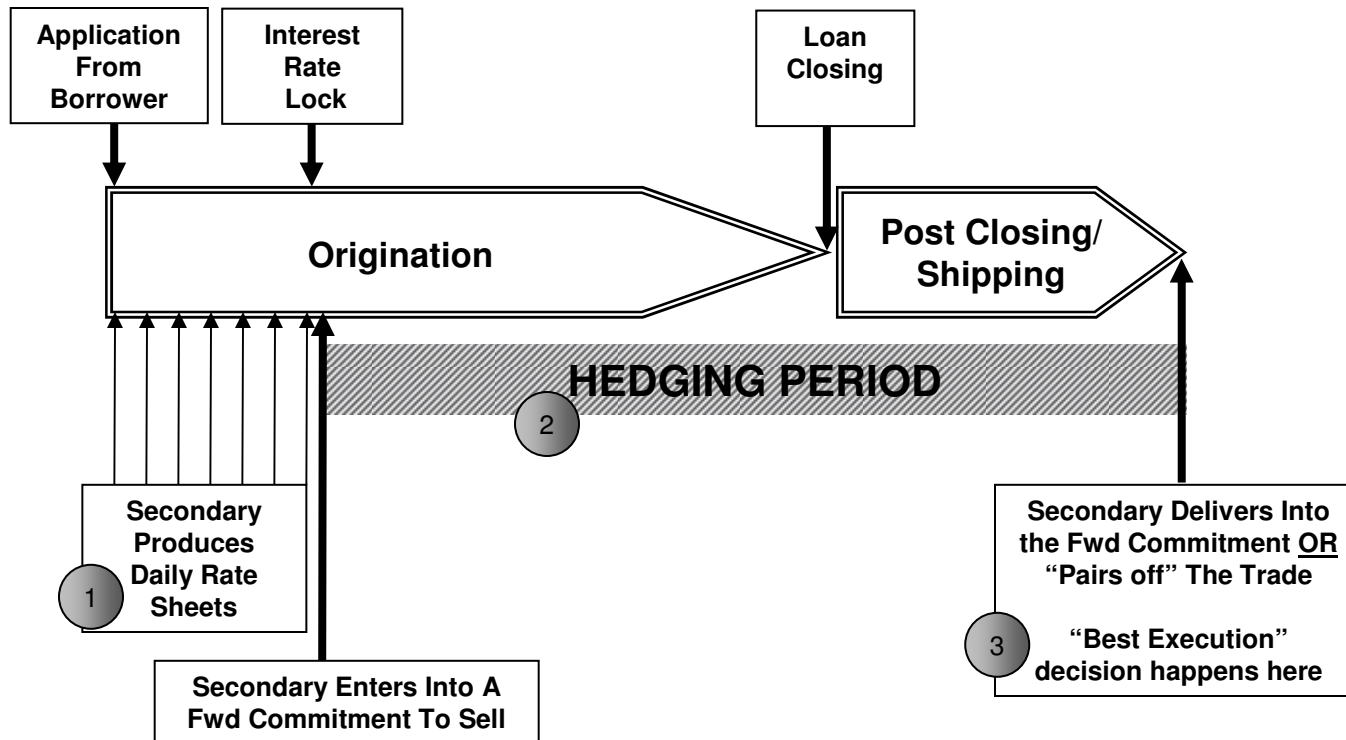


		Margins (in bps)			%	Product Focus
		2Q06	3Q06	Change	Change	
Accredited	LEND	99	33	(66)	-67%	Subprime
Countrywide	CFC	138	109	(29)	-21%	Prime, Subprime
IndyMac	NDE	104	82	(22)	-21%	Alt-A
New Century	NEW	174	113	(61)	-35%	Subprime
WaMu	WM	77	39	(38)	-49%	Prime, Subprime

Margins – Secondary Marketing Overview

Margins are primarily a function of:

- 1 Pricing,
- 2 Hedging, and
- 3 Best Execution Decisions



Margins – Example

Assumptions		Income	
Price for 5.50% security	98.50	Cash:	
Loan amount	\$100,000	Sale of security	\$98,500
Discount points collected	(500)	Loan Basis	(98,750)
FAS 91 deferrals	(750)	Risk based fees paid	(500)
Net loan basis	<u>\$ 98,750</u>	Cash gain/(loss) on sale	<u>(750)</u>
Risk based fees	(.50)%	Non-cash:	
Note rate	6.00%	Mortgage Servicing Rights (MSRs)	1,200 (A)
Normal servicing fee	(.25)%	Excess servicing	<u>480 (B)</u>
Guarantee fee	(.13)%	Non-cash adjustments	1,680
Excess servicing fee spread	(.12)%	Gain on sale	\$ 930
Security pass through	<u>5.50%</u>	Margin	93 bps
MSR value	4.8 multiple		
Excess servicing value	4.0 multiple		

(A) 25 bp normal svcg fee x 4.8 multiple = 1.20%, or \$1,200

(B) 12 bp excess spread x 4.0 multiple = .48%, or \$480

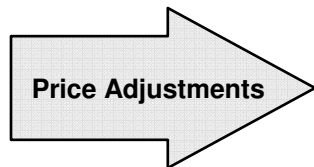
Note: a very small relative fair value adjustment is required by FAS 140 but is not shown in this example

Margins – Market Price Adjustments

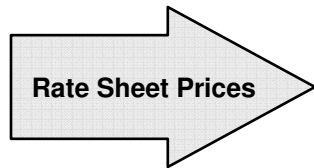
Each day, Secondary adjusts market prices to produce rate sheets . . .



+



=



30 Year Fixed Conforming Conventional					
Pass thru Rate	Prices From Bloomberg - "Sell Price"				
	Nov	Dec	Jan	Feb	
6.000%	100.50	100.00	99.50	99.25	
5.875%	100.25	99.75	99.25	99.00	
5.750%	100.00	99.50	99.00	98.75	
5.625%	99.75	99.25	98.75	98.50	
5.500%	99.50	99.00	98.50	98.25	
5.375%	99.25	98.75	98.25	98.00	
5.250%	99.00	98.50	98.00	97.75	
5.125%	98.75	98.25	97.75	97.50	
Note Rate	Management Price Adjustment/Subsidy				
	10days	30days	60 days	90 days	
6.500%	1.00	1.00	1.00	1.00	
6.375%	1.00	1.00	1.00	1.00	
6.250%	1.00	1.00	1.00	1.00	
6.125%	1.00	1.00	1.00	1.00	
6.000%	1.00	1.00	1.00	1.00	
5.875%	1.00	1.00	1.00	1.00	
5.750%	1.00	1.00	1.00	1.00	
5.625%	1.00	1.00	1.00	1.00	
Note Rate	"Buy" Price For Rate Sheet				
	10days	30days	60 days	90 days	
6.500%	101.50	101.00	100.50	100.25	
6.375%	101.25	100.75	100.25	100.00	
6.250%	101.00	100.50	100.00	99.75	
6.125%	100.75	100.25	99.75	99.50	
6.000%	100.50	100.00	99.50	99.25	
5.875%	100.25	99.75	99.25	99.00	
5.750%	100.00	99.50	99.00	98.75	
5.625%	99.75	99.25	98.75	98.50	
		(Premium)/Discount For Rate Sheet			
		10days	30days	60 days	90 days
		(1.50)	(1.00)	(0.50)	(0.25)
		(1.25)	(0.75)	(0.25)	-
		(1.00)	(0.50)	-	0.25
		(0.75)	(0.25)	0.25	0.50
		(0.50)	-	0.50	0.75
		(0.25)	0.25	0.75	1.00
		-	0.50	1.00	1.25
		0.25	0.75	1.25	1.50

Price adjustments should be determined using a product level "pricing engine"

- **The purpose of a pricing engine is to ensure that daily pricing adjustments are made in a disciplined manner as opposed to being simply market driven**
- **Should be driven by assumptions for each product type, including:**
 - Servicing values (e.g., difference in a 30 year conventional @ 4.8 multiple vs. a 5 yr balloon @ 3.0 multiple is almost 50 bps in price)
 - Net interest spread (e.g., ARMs often have negative warehouse spread)
 - Guaranty fees – they are different for 30 year, 15 year, 7 year, etc.
 - Fixed and variable origination cost per loan
 - Many costs are the same regardless of loan size, so convert to basis points
 - The cost to originate a government and sub-prime loans is greater than conventional loans – hard to compute but at least get it directionally correct
 - Fixed costs per loan are markedly higher in lower origination environments, so assumptions should be changed periodically

- **Pricing engines allow management to understand the profitability of each product . . . best practice is to review a product level summary with senior management weekly**
 - Increases income by not origination certain loans at a loss
 - Provides a basis for decision making around “one-off” subsidy requests from loan officers and branch managers
- **The CFO should regularly review the assumptions and the functionality of the model**

- **Some accountants think of “best execution” as a trade-off between whole loan sales and securitization . . . but it’s far more complex.**
- **There are literally hundreds of possible ways to structure the sale and/or securitization of loans and the related servicing rights. Therefore, a sophisticated “best execution” model should be used to optimize all of the trade-offs and interdependencies.**
- **A simplified “best execution” example is provided on the next page. It shows only a couple of moving parts.**
- **The page after the example lists other variables to consider in the development of a “best execution” model.**

Simplified Best Execution Example

	Excess Servicing (same as other example)	Buyup Guarantee Fee	Buydown Guarantee Fee	
Assumptions	Note rate	6.00%	6.00%	6.00%
	Normal servicing fee (Servicer)	(.25)%	(.25)%	(.25)%
	Guarantee fee (FNMA)	(.13)%	(.13)%	(.13)%
	Excess servicing fee spread (Servicer)	(.12)%	-	-
	Guarantee fee buyup spread (FNMA)	-	(.12)%	-
	Guarantee fee buydown spread (FNMA)	-	-	.13%
	Security pass through	<u>5.50%</u>	<u>5.50%</u>	<u>5.75%</u>
Security price	98.50	98.50	99.00	
Income	Cash: Sale of security	\$98,500	\$98,500	\$99,000
	Cash: Buyup (.12% x 4.0 multiple)	-	480	
	Cash: Buydown (-.13% x 5.8 multiple)			(750)
	Non-cash: Excess servicing (.12%x4.0)	480		
	Non-cash: MSR (.25% x 4.8 multiple)	<u>1,200</u>	<u>1,200</u>	<u>1,200</u>
	Income recognized	\$100,180	\$100,180	\$ 99,450
			<i>difference (730)</i>	

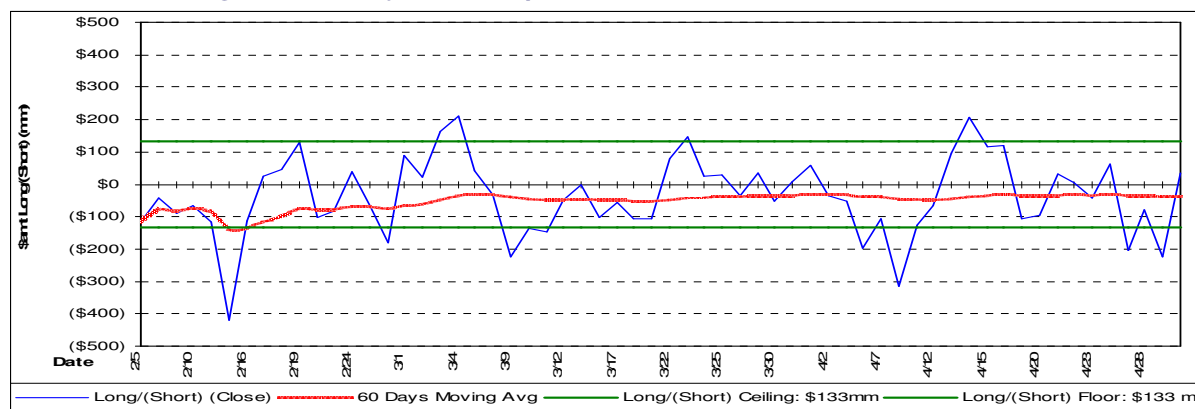
NOTE: There are negative tax consequences from keeping excess servicing, so the first column would be preferred over the second. CFO's should force Secondary Marketing to minimize the creation of excess servicing.

Best Execution Variables To Consider

- **“Best Ex” models should consider the following variables when deciding to sell whole loan or securitize, and when deciding how to allocate loans to securities/trades**
 - As shown in the example, - MBS coupon prices in relation to agency buyup/buydown multiples
 - Timing of sale and the impact on net interest income (days in warehouse x the net interest spread)
 - Guarantee fees
 - Excess servicing valuation
 - Normal/base servicing valuations in flow servicing contracts (based on MBS coupon or wtd avg interest rate of loans in the pool)
 - Restrictions in flow servicing contracts (e.g., maximum note rates, tiered pricing for excess servicing, maximum excess servicing levels, maximum prices/multiples) and whether they are measured monthly or quarterly
 - Prepayment protection in flow servicing contracts
 - Loan level investor fees and adjustments
 - Reps & warranties
- **CFO should periodically review the model & assumptions**

▪ Secondary Marketing's Daily Position Report

- Review the report and make sure you understand it
- Reconcile closed loans on the position report to loans held for sale on the accounting system and warehouse loans on the servicing system (3-way reconciliation is an important control to ensure everything is being hedged)
- Track the Daily Long/Short Position
 - Locks on new applications are allowed after the markets close
 - Impose limits for maximum long/short position
 - MBA Committee/Commission recently predicted that a shock in bond market will occur again – is your exposure limited?



- **If month-end report is used for accounting entries (e.g., LOCOM, mark-to-market, derivative valuations, and hedge ineffectiveness), it is absolutely imperative to ensure that the report is accurate**
 - Make sure market prices are accurate -- some large companies have created Independent price verification (IPV) groups in accounting
 - Understand timing/cut-off issues and make manual adjustments if necessary
- **Monitor aged inventory**
 - Bad loans only get worse – they need to be closely monitored
 - Aged inventory should be reviewed by CFO and other senior managers on a monthly basis
 - Fix defects so the loans can be sold (or refinance the loans)
 - If loans cannot be sold, move the from “loans held for sale” to “loans held for investment”

Secondary Marketing Related Accruals

- **Pair-off Fees**

- A pair-off occurs when a company chooses to settle a forward commitment (i.e., a “Trade”) in cash instead of delivering mortgages into the trade.
- Pair-offs can result in cash payable or receivable depending on the move in the market since the Trade date.
- The cash will be transferred on the original Trade settlement date.
- Paired off Trades should be removed from Secondary’s mark-to-market/position report even if cash has not yet been transferred.
- Pair-off income/receivable or expense/payable should be accrued at month-end.

- **Post-Settlement Fees**

- Fannie Mae and Freddie Mac usually draft “post-settlement” fees out of a company’s custodial account on about the 4th day of each month. The fees include buyup fees receivable, buydown fees payable, and risk based pricing fees (e.g., non-owner occupied and cash out refi fees).
- The drafted fees relate to the prior month’s pool settlements. Therefore they should be accrued at each month-end.
- If early funding programs are used, the post-settlement fees will be drafted in the second month after settlement, so they should be accrued for an extra month.

Restatements

Will provide a list of questions to be considered to help reduce the risk of restatement.

Mortgage related restatements have included the following:

- **FAS 91**

- *Fannie Mae*
- *Freddie Mac*
- *Many smaller companies that had incorrectly used straight-line amortization*

- **FAS 140**

- *Fannie Mae*
- *Freddie Mac*
- *Countrywide*

- **FAS 133**

- *Fannie Mae*
- *Freddie Mac*
- *Saxon*
- *Bank of America*
- *Flagstar*
- *Eight Federal Home Loan Banks*

Questions You Should Ask

• FAS 91

- Are you properly deferring direct revenues and expenses on loans held for sale?
 - Most companies track revenue deferrals at the loan level and used an average cost for expenses
 - These deferred fees should not be amortized
 - These deferred fees are part of the basis in the loan, so they should be considered in LOCOM calculations
- Are you properly deferring direct revenues and expenses on loans held for investment?
 - Are you using a “level yield” or “contractual” amortization method? Straight-line is not allowed
 - Are you making “catch up” adjustments under your level yield amortization method?

• Loans Held For Sale (HFS)

- Are you performing a lower-of-cost or market (LOCOM) calculation and recording an adjustment if cost exceeds market?
- Is your aggregation method documented? You may choose to segregate prime & subprime, firsts & seconds, residential & commercial, etc.
- Are your market prices accurate and supportable? Do you use whole loan prices or security prices? If you use security prices, are you factoring in adjustments for normal servicing fees, guarantee fees, and excess servicing fees?
- Are you including deferred FAS 91 fees as an adjustment to the basis in the loans?

Questions You Should Ask (continued)

- **Loans held for investment (HFI)**

- For loans transferred from held for sale to held for investment, are they being transferred at market value with a related gain or loss in the income statement?
- Are you including deferred FAS 91 fees as an adjustment to the basis in the loans?

- **Mortgage securities**

- Are you distinguishing between the following?
 - Held to maturity (HTM) – should be carried at historical cost
 - Available for sale (AFS) – should be carried at fair value with mark-to-market (MTM) adjustments through OCI on the balance sheet
 - Held For Sale(HFS) or Trading – should be carried at fair value with MTM adjustments through income
- Are you selling any HTM securities? If so, the HFI designation might be tainted which could require MTM adjustments.
- Are you performing impairment tests?
- If you own a significant piece of the security, have you determined whether the security should be consolidated either because you have “control” or because you are the primary beneficiary under FIN 46?

Questions You Should Ask

• Derivatives

- Does your documentation comply with the GAAP requirements to achieve hedge accounting?
 - Documentation must be complete, detailed, and contemporaneous
 - Must designate between fair value or cash flow hedges
 - Must explicitly identify the hedged item
- Are you recording the fair value of interest rate lock commitments (IRLCs)
- Does your IRLC methodology effectively record income upon the creation of the IRLC (or does it properly factor in the impact of “pricing adjustments”)?
- Are you recording forward commitments and other hedges as derivatives?
- If you are using the “short cut” method, is it allowed?
- Are you measuring and recording hedge ineffectiveness?
- Are there any embedded derivatives in company contracts/agreements?
- Are accounting and secondary marketing personnel properly trained on the nuances of derivative accounting?

• Other

- Do you have proper controls (including documentation and testing) around spreadsheets and access databases that are used to create journal entries
- Have you invested enough in people and systems to ensure accurate accounting?

Repurchase Management

Will make recommendations to improve the management of repurchases.

- **Originate quality loans**
 - Strong front-end controls, including services to detect fraud
 - Perform background checks on new loan officers
 - Perform thorough due diligence on new brokers and correspondents
- **Implement a rigorous quality control program**
 - Perform 100% QC on first months production from new loan officers, branches & correspondents
 - Monitor delinquencies and early payment defaults by origination source (e.g., by branch, broker, correspondent)
 - Identify root causes and address them decisively

Repurchase Management (continued)

- **Vigorously defend all repurchase requests**
 - Assign a person or people with underwriting background to investigate the facts and write 'defense' letters where appropriate
 - Try to indemnify the loan in lieu of repurchase when possible
 - All repurchases and indemnifications should be approved by a committee comprised of secondary marketing, underwriting, quality control, and post closing managers
 - Maintain a database of all pending repurchase requests and related metrics (e.g., delinquency rates, BPOs, MI coverage, etc) and incorporate into loan loss reserve methodology
 - Maintain a database of all indemnifications to facilitate handling of future "make whole" invoices
- **Expedite loan set-up for repurchased loans**
 - Immediately initiate collection procedures or foreclosure proceedings