FAS 156 Adoption & Fair Value Option Concerns

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FAS 156 -- Early Adoption

- More than 70% of the large servicers early-adopted FAS 156
- Under 10% of medium and small servicers early-adopted (based on UCM's anecdotal experience)
- 100% of early-adopters use some sort of financial hedge to manage a major portion of their MSR valuation risk

Types of Servicing Elected

- Included:
  - Residential MSRs
  - Small amounts of Commercial MSRs
- Excluded:
  - Large Commercial Portfolios
  - Auto servicing
  - Credit Card Servicing
- Anecdotal only, based on review of a few 10Qs

FAS 156 Avoids FAS 133 Morass

- Easier to explain to board
- Eliminates operational exposure to FAS 133 application errors
- Eliminates burdensome “similar asset” grouping
- Eliminates arbitrary rules against net written options
- Eliminates complicated effectiveness proof & ineffectiveness accounting

Other Positive Decision Factors

- Accounting is more transparent
- Eliminates misleading single-tranche impairments
- Allows realization of previously unrecognized MSR value, increasing equity for some
- Those already impaired under FAS 140 viewed election of FAS 156 as a small change

Negative Decision Factors

- Eliminates the “accounting hedge”. (UCM observes that over 80% of the smaller companies use this “hedging” method).
- Accounting is more “transparent”, diminishing “wiggle room”.
- Not enough time to early-adopt.
- Want to see what happens with early-adopters.

Surprise Implications – New Transparency

- Apples-to-apples MSR comparisons are much easier with the enhanced disclosures
- Freed of FAS 133, hedgers open up MSR hedges to cover additional risks, such as the SRP value risk embedded in the pipeline
- Many (most?) managements have linked their hedging results disclosures to their MSR asset changes, easing third-party analysis of hedging

Sample Roll Forward

	Quarter End 3/31/2006
Balance at beginning of period	**$1,094,490**
Cumulative-effect adjustment due to change in accounting for MSRs	17,561
Additions	230,057
Change in fair value due to runoff	(68,158)
Change in fair value due to market changes	84,054
Change in fair value due to application of external benchmarking policies	(3,571)
Balance at end of period	**$1,354,433**
MSRs as basis points of unpaid principal balance	140

Current Status – Second Wave Breaking

- FAS 156 requires initial booking of MSRs at fair value, starting the erosion of accounting "hedge" cushions
- Larger public servicers feel pressure to elect FAS 156 to come in alignment with prevailing industry practice
- Smaller servicers feel pressure to decide, either hedge and adopt 156, sell, or do something else

Fair Value Option – MSR Issue

- If SAB No. 105 applies, then the MSR component of loan fair value will be excluded
- Fair value recognition of closed mortgages will move MSR and most profit recognition up from loan sale to loan closing (this troubles some)
- FAS 157 says, "Fair value is the price that would be received to sell an asset…in an orderly transaction between participants at the measurement date"
- MBA's position is that excluding the servicing strip from fair value is inconsistent with FAS 157

Fair Value Option – More Issues

- The IRLC still presents problems because it excludes the MSR risk component (SAB 105)
- SRP/MSR component changes in value inversely to the value of the loan corpus, so excluding it distorts the risk analysis
- Those that use off-balance-sheet warehouse financing will still have hedge accounting issues

UNITED CAPITAL MARKETS

- Denver-based hedging advisor to Banks, Thrifts & Mortgage Companies with mortgage servicing assets since 1996
- Experienced management team has provided hedges for MSRs since 1987
- Web site: www.ucm-inc.com

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- **37 years financial services**
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