

FAS 157 Impacts to MSR, MLHFS and IRLCs
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FAS 157 – Fair Value Measurements

- Disclosure impacts - MSR's
- Application of FAS 157 to Mortgage Loans
- Impacts to the valuation of Loan Commitments

- MSR
 - Most of the industry has classified the valuation inputs as Level 3
 - Interplay between FAS 157 and FAS 156 disclosures
 - Approach should be to make it easy for the investor to understand the activity and impacts on earnings

Disclosure Impacts - MSR's



Requirements:

FAS 157 Rollforward Disclosure Requirement –Level 3

Beginning Balance

Total gains or losses (realized and unrealized):

- Included in earnings (or change in net assets)
- Included in other comprehensive income

Purchases, issuances, and settlements (net)

Transfers in and/or out of Level 3

Ending Balance

The amount of total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

FAS 156 Rollforward Disclosure Requirement*

Beginning Balance

Additions (purchases, originations, transfers, etc)

Disposals (Sales)

Changes in fair value during the period resulting from:

- Changes in valuation inputs or Assumptions
- Other changes in fair value (with description)

Other changes that affect the balance (with description)

Ending Balance

* For each class of servicing assets or liabilities

Disclosure Impacts - MSR's



Industry approach to FAS 156 disclosures:

- “Other change in fair value” is typically used to show the amortization component of the fair value change
- “Changes in valuation inputs and assumptions” is typically the change in value due to changes in market inputs and other assumptions

Disclosure Impacts - MSR's



Approach to FAS 157 rollforward for MSR's:

- What should be included in the total gains or losses line (realized and unrealized) when FAS 156 has been adopted?
- What should be included in the purchases, sales, settlements line?
- FAS 157 was not developed with MSR's specifically in mind, like FAS 156
- Have to determine how to interpret what should be disclosed in the FAS 157 rollforward line items and how that compares to the FAS 156 rollforward so as to comply with the requirements but also present meaningful information to investors

Application of FAS 157 to Mortgage Loans



- Mortgage bankers are in the business to originate/purchase loans and then sell them into the secondary market
- Mortgage bankers typically price the loans (to borrowers and other lenders) to make a profit upon sale of the loans into the secondary market
- FAS 157 prescribes an exit price concept – so intuitively the fair value should coincide to what you would expect to receive upon sale into your principal market
 - Sounds simple – but it is not.....

Application of FAS 157 to Mortgage Loans

- Mortgage bankers, in valuing their loans held for sale, typically value the various components of the loan based on their sales execution strategy
 - valuation of the mortgage pass through coupon rate
 - valuation of the servicing component
 - valuation of any retained interests
 - valuation of any retained risk
- The inputs for a majority of the value of the loan is typically based on active market quoted prices for MBS securities (level 2 inputs)
- The inputs for the value of the servicing component of the loan and any other retained risks or interests is typically based on entity level inputs (level 3 inputs)
- Because the entity level inputs only contribute a small portion to the overall value of the loan (i.e. usually less than 3% of the total value), most industry participants will conclude that mortgage loans held for sale utilize Level 2 inputs under FAS 157

Application of FAS 157 to Mortgage Loans



- MBA members have been in discussions about the application of FAS 157 to mortgage loans held for sale
- Key topics discussed during these discussions centered around the following:
 - The use of security prices vs whole loan prices
 - The treatment of costs incurred to transform a loan into security form
 - The use of forward security prices
 - In-use versus in-exchange valuation concepts
- Based on these discussions, there was a consensus on general valuation processes for mortgage loans held for sale and the basic components to be included in the value, but there were differing views about some aspects of the valuation
 - Some of the basis for the different views was tied to different business models of the MBA members (e.g. broker/dealers vs mortgage bankers)

Application of FAS 157 to Mortgage Loans



- In summary, there were three different views that emerged from these discussions:
 - View 1 – forward security pricing, in-use valuation concept, security pricing net of cost to convert the loan into a security
 - View 2 – same as view 1, but the interest carry component was added to the forward security price to gross up the value to a “spot” price
 - View 3 – whole loan pricing

- View 1
 - Principal market is security market
 - Highest and best use of the individual loan is to pool it with other loans and convert it into a security to realize the most value from the loan – therefore, this is an in-use valuation concept
 - In order to adjust the value for the condition of the loan today, costs to convert the loan into security form should be netted from the security price to determine the value for the loan in its current condition
 - Since the principal market for the loan is the security market, the pricing should be based on what could be realized for that loan in that market today
 - Paragraph 6 of FAS 157 states the fair value measurement of the asset or liability should consider attributes specific to the asset or liability such as the “..condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset as of the measurement date”

Application of FAS 157 to Mortgage Loans



- View 2
 - Principal market is security market
 - Highest and best use of the individual loan is to pool it with other loans and convert it into a security to realize the most value from the loan – therefore, this is an in-use valuation concept
 - In order to adjust the value for the condition of the loan today, costs to convert the loan into security form should be netted from the security price to determine the value for the loan in its current condition
 - Security prices should be adjusted for implied carry component (net interest income) since if you were to sell the loan today (and deliver it today) to another party, another party would be able to realize that net carry from today forward

Application of FAS 157 to Mortgage Loans



- View 3
 - To reflect that you have a loan on your balance sheet today instead of a security, security pricing is not appropriate to use (even if you plan to convert the loan into a security for sale and the security market is your principal market)
 - There is significant value created through the securitization process and this value should not be included in the value of the loan today, since today you own a loan and not a security
 - This view was primarily supported by the broker/dealer market

Application of FAS 157 to Mortgage Loans



- Views were briefly discussed by MBA with Big 4 Accounting Firms and there was not consensus among the Big 4 firms on the views
- Ultimately, each entity needs to determine their principal market for their loans held for sale and be able to support their approach within the guidance in FAS 157
- Depending on the current yield curve environment, the difference in valuation for Views 1 and 2 are likely not materially different
- The different views may result in some geography and timing differences in P&L recognition between entities depending on their approach

Impacts to the valuation of Loan Commitments



- SAB 105 has not been modified or repealed at this point
- FAS 157 would imply that there would be some recognition of value at inception for an interest rate lock commitment
- Since there is not an active market for loan commitments, valuations would likely be a level 3 in the FAS 157 hierarchy
- Valuation approach for loan commitments should start with the value of the loan, then adjust for fallout, costs to close, and any risk premium that a third party would apply

Conclusion

- Some early adopters of FAS 157 and 159
- Valuation processes for mortgage loans held for sale will likely continue to evolve as more entities adopt
- Disclosures will continue to evolve based on investor feedback
- Conflict between SAB 105 and FAS 157 needs to be resolved by FASB and SEC

- Questions?