



MBA Finance and Accounting Conference

HOLD OR SELL SERVICING RIGHTS

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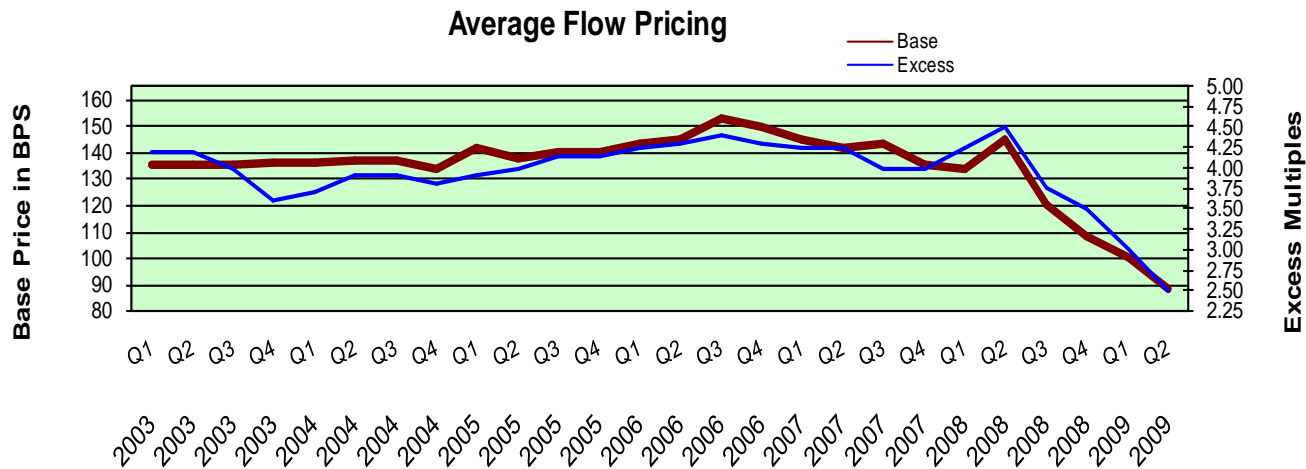
PRICE

- The ability to create an annuity income stream
- An asset that generates positive operating cash from day one
- Current market pricing which is below economic pricing in most cases
- Develop additional secondary execution options
- Ability to increase franchise value to your organization
- Servicing income, which can act as a hedge against production cycles
- Streamline your delivery process through GSE sales

NEW PRODUCTION MSR MARKET UPDATE

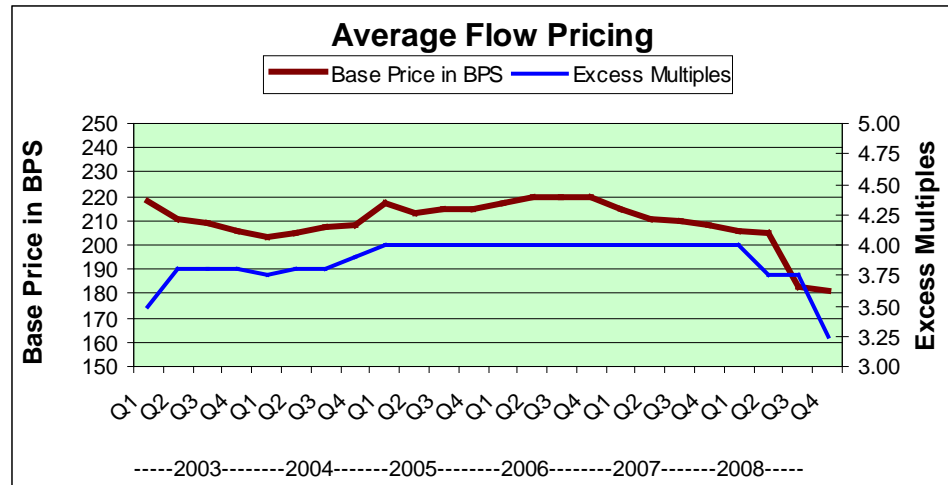
Historical Market Prices – Conventional

- Pricing for new, par-rate base co-issue servicing was relatively stable from 2003-2007 with an average price of 140bps or 5.6:1. (Prices below are approximate, based on a wide range of production profiles)
- Excess servicing multiples were more volatile during the same period, ranging from 3.6:1 to 4.4:1.
- Both base and excess multiples plunged sharply in the last year as the market has become more illiquid.
- Current base released prices are very counterparty specific with mandatory type execution implied values ranging from 2.5:1 to 3.5:1.
- At the same time mortgages rates have fallen 100 to 150 bps



Historical Market Prices – GNMA

- Pricing for new, par-rate base co-issue servicing was relatively stable from 2003-2007 with an average price of 212bps or 4.8:1. (Prices below are approximate, based on a wide range of production profiles)
- Excess servicing multiples were more volatile during the same time period, ranging from a low of 3.5x to a high of 4.0x
- Both base and excess GNMA MSR prices plunged sharply in the last 12 months.
- Unlike the limited conventional market, currently no flow market exists for GNMA product.
- Current base released prices are very counterparty specific with mandatory type execution values ranging from 2.0:1 to 3.0:1 MSR
- Over the same time frame, par interest rates have dropped 100 to 150 bpts.



RETAIN vs. RELEASE ECONOMIC FACTORS

- Released execution vs. efficient retained execution
 - Define the current all-in released execution
 - Define the most efficient retained execution — typically MBS
 - Delivery turn times
 - Ease of delivery/lack of delivery fees
 - FNMA ASAP and ASAP+ for cost of funds/warehouse management
 - Estimate the economic value of retained servicing
 - Compare execution options

Primary Considerations to Retaining are:

Things to consider are

- If a best efforts released seller needs to add pipeline hedging function
- Cash flow
- Capital Requirements
- Develop a hold strategy — must think like a portfolio lender
 - Product Type, rate ranges, credit buckets
 - Hold all or a portion of production
- What is efficient volume
- Not operationally set up to efficiently take advantage of the opportunity
- Managing the servicing asset from an accounting prospective
- Accounting treatment LOCOM vs. Fair Value
- Mark to market risk
- Servicing hedge strategy

- **Cash flow considerations**

- **Up front cash lost vs. economic value over time**

- **Break even cash flow**

- **Understand advances requirements based on type of investor remittance**

- **Seller/Servicer Approved with FNMA, FHLMC, GNMA ?**
- **Servicing platform or sub-servicer in place?**
- **Ability to monitor sub-servicer to GSE requirements?**
- **Ability to issue securities?**
- **Dedicated staff to manage change from current operations?**

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The Value of MSR

- Mortgage Servicing Right is the contractual right to receive mortgage loan payments from borrowers while remitting the components of the payments (Principal, Interest, Tax, Insurance) to the appropriate parties for a fee.
- MSR is created
 - When loans are sold with the right to service the loan retained
 - When servicing rights are purchased separately

The value of MSR is based on the present value of expected cash flows

Value of MSR

Cash Flow Components

- Service Fee Revenue
- Float Earnings
- Ancillary Income
- Servicing Cost
- Cost of Advances

Modeling Assumptions

- Prepayment Rates
- Revenue Cash Flow Assumptions
- Expense Cash Flow Assumptions
- Rate Driven Assumptions
- Risk Characteristic Portfolio Strata

The value of MSR can change significantly based on interest rate and prepayment assumptions

Market vs. Economic Value

● Market Value

- Market based assumptions used to value the firms MSR asset
 - Market Costs and revenue assumptions
 - Assumptions used in actual market trades of MSR assets
 - Broker surveys are a good source of assumptions
 - Accounting literature specifies market based assumptions for valuation of MSR's

● Economic Value

- Represents the value of the MSR's to the individual firm
 - Cost and revenue assumptions based on experience
 - Very important to know for buy/sell decisions
 - Due to lack of trades and level 3 status of the MSR asset some firms have been using Economic as a proxy for market

Retain vs. Release Decision

- ▶ **Initial Capitalization Value**
 - ▶ Produce an internal capitalization grid
 - ▶ Grid Developed based on specific products the firm is originating
 - ▶ Assumptions should be market based
 - ▶ Grid should include interest rate adjusters for discount and premium loans
- ▶ **Other factors**
 - ▶ Different Remittance Cycles
 - ▶ State (or region)
 - ▶ Escrow/non Escrow
 - ▶ Should include a matrix for Excess Servicing
- ▶ **Best Execution**
 - ▶ Secondary marketing will use the initial cap grid plus loan pricing for Best-ex
 - ▶ Secondary can review pricing to determine optimal remittance structure
 - ▶ Servicing Group should be included in remittance decisions from operational perspective

- Expenses incurred by the servicing functions
 - Customer service
 - Investor Accounting
 - Delinquency Department
 - Foreclosure Accounting and Management
 - Systems expenses

- Expense incurred when servicer is contractually obligated to advance funds to investors
 - P&I on delinquent MBS securities
 - Pool Advances on Prepayments

Float Earnings

- Income earned from maintaining borrower escrow deposits (T&I) as well as earnings on P&I receipts prior to remittance to investors
- T&I Earnings are affected by state regulations regarding collection of taxes
- P&I Earnings are dependent on remittance structure of the security

AGENCY	REMITTANCE	REMITTANCE TYPE	P&I REMITTANCE DATE	P&I FLOAT DAYS	PREPAY REMITTANCE DATE	PREPAY FLOAT DAYS	DAYS INTEREST LOST	METHOD OF PAYMENT
FHLMC	ARC - (3 day) GOLD CASH	S/A	Within 3 days of the 15th (Average =19th)	14	Within 5 business days	7	0	
	STANDARD REGULAR	S/A	FIRST TUESDAY	29	Within 5 business days	7	0	
	SWEEP	S/A	Within 3 days of the 15th (Average =19th)	14	Default to 1 day (Negotiated)	1	0	
	SUPER ARC	S/S	Default to 10th (Negotiated: 8th, 9th, 10th)	5	Within 5 business days	7	6	
FNMA	MBS MRS	S/S	18TH	13	18TH	25	6	
	MBS EXPRESS	S/S	18TH	13	4TH DAY OF FOLLOWING MONTH	10	6	
	RPM	S/S	10TH (Negotiated: 8th, 9th, 10th)	5	10TH	16	6	
	S/A Participations	S/A	18TH OF NEXT MONTH	33	18TH OF NEXT MONTH	25	6	
	A/A	A/A	DAILY (@ \$2500 balance)	1	DAILY	1	0	
GNMA	I	S/S	15TH	10	15TH	27	2	CHECK
	II	S/S	18TH	10	18TH	28	2	ELECTRONIC

ASSUMPTIONS: 1) P&I payments received on the 5th for conventional loans & on the 7th for government loans.

2) Prepayments on 25th for conventional loans & on the 20th for government loans.

Prepayment Modeling

- Predicting borrower behavior through time and interest rate cycles
- Product specific
- Rate/Term/Age/Geography/Credit
- Third party Models often Employed

Other Valuation Assumptions

- Cash Flow Expense Assumptions
- Rate Driven Assumptions
- Risk Characteristic Portfolio Stratification
- MSR Data

- FAS 140 (LOCOM)
 - Requires periodic establishment and defense of fair value
 - Using Amortization to control the net asset
 - Establishing a ceiling
 - Easy to use and understand by senior management
 - Establishment and re-establishment of accounting tranches
- FAS 157 (Fair Value)
 - Requires periodic establishment and defense of fair value
 - Allows for future appreciation of the servicing asset
 - Simplifies the accounting around the asset
 - Requires greater disclosure in financial statements
- FAS you might need to know, but most likely not
 - FAS 133/138
 - Deals with hedging
 - FAS 166/167
 - Deals with QSPE going on balance sheets

Indirect issues to consider around the servicing asset

- Issues that effect the assessment of the asset
 - Fair value/market value/economic value
 - Spectrum of conservative to aggressive
 - View the MSR asset as important customers or financial instruments

- Type of valuation — most likely static, but stochastic is becoming increasingly popular with middle market
- Speed, Speed, Speed
 - The most important issue by far
 - Servicing involves an elaborate bet on a loans expected life
 - Know what you don't know and be flexible
- Operational assumptions tend to be the easiest to get right
 - Cost
 - Ancillary
 - Late charges
- Rate environment consideration
 - Float and cost of funds assumptions
 - Implication of interest rate volatility
 - The level and shape of the yield curve
 - and what the spot and forward curve say about future interest rates
- Think critically about all assumptions
 - Ceilings or Floors
 - Reasonableness