

Fair Value Accounting For MSR's: The Good, The Bad And The Ugly

Allowing fair value accounting for mortgage servicing rights will increase confusion about analyzing financial statements.

By Sachit R. Kumar

Readers of financial statements under Generally Accepted Accounting Principals (GAAP) are confused by the inconsistent, complex and incomplete disclosures of mortgage banks' implementations of mortgage servicing rights (MSRs) Financial Accounting Standards (FAS) 133 accounting procedures. The Mortgage Bankers Association and the Financial Accounting Standards Board (FASB) response to this financial transparency problem is to allow mortgage bankers to elect fair value, or mark-to-market, accounting for their MSR's.

This step will do some good, do some bad, and ultimately do little to improve the situation for readers of financial statements and simply obfuscate the real problem.

On Aug. 11, FASB issued an exposure draft of a proposed statement of financial accounting standard that will amend the current FAS 140. Under the proposed FASB

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amendment, a mortgage bank can elect to maintain all separately recognized mortgage servicing rights at fair value.

Once a mortgage bank has capitalized its servicing rights, the company would be permitted to elect either the current lower of cost or market (LOCOM) accounting or the proposed fair value accounting for each class of separately recognized servicing asset. This election would be permanent: Once a company decides that it will use fair value accounting, it cannot go back to LOCOM.

Industry participants have had differing views from the beginning of the FASB fair value initiative. The proposed statement accommodates all participants by allowing them to switch to fair value accounting on an elective basis. Most mortgage banks that elect not to hedge their MSR's will continue to use the less volatile LOCOM accounting for MSR's. Only the active MSR hedgers are likely to elect to switch to fair value.

Fair value accounting, while eliminating hedge accounting, could significantly increase the volatility of the income statement if the serv-

ing asset is not hedged effectively. Mortgage banks that are not hedging their servicing asset would prefer to keep their LOCOM accounting for their servicing asset.

The good

Proponents of the movement to fair value assert that by having both sides of the equation - MSR assets and derivative hedges marked-to-market - the financial statements of the institutions will become easier to understand. Furthermore, the principle motivation for moving to fair value accounting is to eliminate the complex hedge effectiveness testing and implementation requirements for FAS 133 and MSR's.

Mortgage banks that had wished to hedge their MSR's but were intimidated by the complexity of implementing FAS 133 will certainly be more inclined to initiate MSR hedging programs. This will reduce earnings volatility and risk management practices.

Of the large mortgage banks that hedge their MSR's, nearly all have business procedures in place to hedge the economic risk at the MSR portfolio level or at a very aggregated product-level basis, such as all fixed-rate conventional MSR's.

However, FAS 133 requires that measurement of hedge effectiveness be done at a similar-asset level, although procedures for creating simi-



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lar assets and the statistical methods for measuring price sensitivity and hedge effectiveness are certainly highly complex and very difficult for non-MSR hedgers to understand. By electing to use fair value accounting of the MSRs, the hedging at the highly-aggregated level will be accurately

fair value accounting, the whole market value change on its entire servicing portfolio will go into the income statement. This will likely force mortgage banks to hedge 100% of their servicing portfolio market value risk. As a result, mortgage banks will likely incur higher hedging costs.

the initially booked embedded value of the MSR will have to be written down to fair value.

Because the mortgage-backed securities portion of the loan is effectively hedged while in the pipeline, the change in the fair value of the MSR during this period will impact earnings and increase its volatility. Unless the fair value electors begin to hedge their MSRs while they are in the pipeline, they will increase their earnings volatility.

Motivated To Hedge

Institutions electing to use fair value, or mark-to-market, accounting will be motivated to hedge their mortgage servicing rights while they are still in their pipelines because the loans are subject to lower-of-costs-or-market accounting rules. An example illustrates the situation.

At Close	At Settlement (Rates Fall)	Basis Change At Settlement
Loan MTM: 100	Loan MTM: 100.75	
Loan LOCOM: 100	Loan LOCOM: 100	
MBS Component: 99	MBS Component: 100	MBS and Hedge Change: 0
MSR Component: 1	MSR Component: 0.75	MSR Change: -0.25
Hedge Position: -99	Hedge Position: -100	

SOURCE: Mortgage Industry Advisory Co.

reflected in accounting statements.

With fair value accounting, mortgage banks could start hedging their risk exposure at the enterprise level, where they could look at the mortgage pipeline and the MSR portfolio together and hedge their net risk exposure. Effectively integrating these symmetrical risk profiles doesn't work currently because the MSR cannot be written up beyond the amortized book basis. Mortgage banks could take advantage of the fair value accounting and could use analytics that facilitate hedging their net risk exposure of the mortgage pipeline and the MSR portfolio.

The bad

Under the current MSR hedging practice, mortgage banks focus primarily on hedging their impairment risk. Accounting risk strata that has a higher market value than the amortized book basis of mortgage servicing asset will have no affect on the income statement. And, as a result mortgage banks don't hedge the market value change above the amortized book basis.

If a mortgage bank switches to

Over the last few years, under current accounting, mortgage banks have built in huge impairment reserves that they still plan to recover. If interest rates start rising, mortgage banks will recover these reserves and start building a book cushion at the accounting risk strata level. With a cushion established, they will hedge only to the extent that they have the impairment risk exposure at the accounting risk strata level and therefore incur lower MSR hedging costs than hedging 100% of fair value change.

Institutions electing to move to fair value will be increasingly motivated to hedge their MSRs while they are still in the pipeline. Loans in the pipeline that have closed and not yet settled are subject to LOCOM accounting. This means that if rates fall during the closed-to-settlement period, the value of the loans will appreciate; however, LOCOM will not permit upward adjustment in their book basis. Nevertheless, the value of the MSRs will decline during this period.

As a result, the embedded value of the MSR booked at close will have declined at settlement. At settlement,

The ugly

Heretofore, auditors, regulators and equity analysts have faced some serious issues on how to accurately measure the fair value of MSRs. The procedures for GAAP fair value accounting are well established; however, readers of financial statements usually believe that fair value is a close proxy for estimated market value. For illiquid and complex assets such as MSRs, this is often not the case.

Previously, this issue has been most pronounced in periods of declining interest rates when the MSR values are impaired. However, in a world of fair value of MSRs, the fair value of the MSRs on the market value will become apparent in all rate environments.

The issue isn't whether the company properly implements fair value accounting procedures, but whether the fair value properly reflects a value of the MSRs that the readers of the financial statements believe it is telling them.

The current lack of transparency or understanding of the financial statements is not the result of the complex FAS 133 procedures and their particular implementations. The lack of transparency in the financial statements is the result of highly complex and difficult-to-validate methods for determining the fair value of MSRs, not complex hedge effectiveness measurement techniques.

Ticking time bomb

The most difficult and obfuscated issue for readers of MSR balance sheets is the methodology and accu-

racy of the MSRs' fair values. GAAP fair value methods allow considerable latitude in the methodologies for price discovery of illiquid assets. Without a liquid marketplace, which valuation method permissible under GAAP fair value accounting can be used to most accurately replicate market values? This ongoing debate within the industry is often characterized and simplified as the "option adjusted spread vs. static" debate.

Another contributing factor to the confusion surrounding reading MSR balance sheets is the widely divergent set of equity analysts that cover mortgage banking that read the GAAP financial statements. Currently, mortgage banking companies are covered by analysts in the auto, lodging industry, thrift, money center bank, European bank and mortgage banking sectors.

Can this diverse set of analysts acquire the expertise needed to understand this complex financial asset? Surely this widespread confusion represents an opportunity for some equity analysts to do their homework

and fully understand these MSR valuation issues.

Ultimately, if a company's GAAP fair value differs greatly from a reasonable market value, someone is going to be held accountable. Most likely, eliminating the analyst's focus on understanding the complexities of FAS 133 implementations will make his job slightly easier, but it won't address the fundamental problem with GAAP statements.

Are the recorded book values on these balance sheets approximately equal to the estimated market value of these assets, which is the objective of fair value reporting? This is a very serious question and will emerge as the most significant debate in the mortgage banking industry in coming years.

The proposed amendment to initially measure all separately recognized servicing rights at fair value will be effective for transactions occurring in the earlier of the first fiscal year that begins after Dec. 15 or fiscal years beginning during the fiscal quarter in which the final statement is issued.

The amendment would require the subsequent measurement at fair value, if elected, to be applied to existing classes of servicing rights as of the beginning of a fiscal year or to initial recognition for new classes of servicing rights. The statement would enable entities to make a permanent election to subsequently measure a class of separately recognized servicing rights at fair value after the earlier of fiscal years beginning after Dec. 15 or the fiscal year that begins during the quarter in which the final statement is issued.

The subsequent measurement of a class of separately recognized servicing rights at fair value would be applied prospectively to all new and existing separately recognized servicing rights within that class. The adjustment to reflect the carrying amount of separately recognized servicing rights existing at the date of initial application of fair value measurement would be reported as a cumulative effect adjustment to beginning retained earnings. Early or retrospective application of this proposed statement would not be permitted. **SME**