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Mortgage series on management estimates

Many of the most subjective and judgmental valuations recorded by institutions engaged in mortgage origination and servicing have been increasing in balance in the years since the economic downturn began. This is due to not only the potential subjectivity of assumptions made, but also the complexity of the methods used to calculate and record the assets or liabilities. In addition, the assumptions and methods used generally require a high degree of competency and involve significant amounts of data. These management estimates should be considered critical to properly reflect the assets and liabilities disclosed in the institution's financial statements. This includes the recording and valuation of a mortgage servicing right ("MSR"); the recording of a servicing advance receivable (including estimating a reserve for non-recoverability); estimating and recording a compensatory fee liability assessed by a government sponsored entity ("GSE"); and estimating the repurchase reserve resulting from a putback and related activity.

Following five turbulent years for housing, recent evidence indicates the worst is likely over and healing is underway. However, the road to full recovery will likely neither be a smooth nor short journey, making an on-going understanding of the housing and mortgage markets important to your outlook and strategy.[1] Certain factors to consider moving forward include the accounting principles for these significant assets and liabilities, and the assumptions used to create management estimates.

MSR and servicing advance receivables consider prepayment speeds and delinquency trends, which may fluctuate based on interest rates, trends in home prices and other macroeconomic conditions. In addition, there is often a lack of transparency and unique characteristics of the market transactions with respect to MSR trades and recoverability of servicing advances, which can contribute to increased subjectivity of recorded values.

Repurchase reserves and compensatory fees liabilities consider an institution's origination and servicing practices, but also consider potential actions by GSEs and parties to private label securitizations. Activity by these third parties continues to evolve and recorded estimates for repurchase reserves and compensatory fee liabilities may be frequently revised to incorporate this ever-evolving behavior.

In this paper we will discuss the background and nature of these assets and liabilities and expand on the current accounting under U.S. Generally Accepted Accounting Principles for each.

Background

Mortgage servicing assets and liabilities

An originated mortgage loan inherently includes both the value of the coupon lent to the borrower as well as the servicing fee component to compensate the servicer for their servicing activities. If a loan is originated and held by the originator as held for investment ("HFI") there is

[1] Deloitte Center for Financial Services — U.S. Residential Mortgage Market Update, October 2012.

generally no contractual separation of the loan from the servicing. However, if the originator decides to sell the loan to another party, that sale can be structured with the servicing either retained or released. If the servicing is released then the originator will receive a price to compensate them for the market based value of the coupon and the servicing. The servicing could be released to the purchaser of the mortgage loan or could be separately sold to a third party servicer. Conversely, if the loan is sold and the servicing is retained, a contractual separation of the servicing occurs from the underlying mortgage loan. This results in the recognition of an MSR asset or liability.

Servicing advances

The originator, now turned servicer, receives a servicing fee (recorded in the value of the MSR) that compensates them for the costs associated with servicing along with a reasonable profit margin. These costs and the associated profit margin are contemplated for an average loan when servicing fees are calculated. However, for certain loans, the borrowers may stop making their monthly contractual principal and interest ("P&I") payments, resulting in an increased level of services required by the servicer to manage the default servicing process. Most often, servicers are required by the governing servicing agreements to continue to advance P&I payments to the investors as well as make any required payments to taxing authorities and insurance companies ("T&I payments") to keep the property in good standing. In addition, servicers are required to incur the costs associated with following up with the borrower, sending them notices, beginning legal proceedings for foreclosure, maintaining security and property preservation for certain properties, obtaining required appraisals, and in some cases even the activities involved with marketing and selling a foreclosed real estate owned ("REO") property. All of these expenses (i.e., P&I, T&I, and other fees) incurred by the servicer on behalf of the borrower and advanced to third parties create a receivable, which may be repaid through borrower or investor reimbursement or liquidation proceeds from the loan. Recoverability by the servicer is dependent on alignment of servicing practices with the relevant servicing agreements and may differ among different investors. These receivables are called servicing advances.

Compensatory fees

The activity of foreclosure related to defaulted mortgage loans can add an additional needed management estimate specific to loans purchased by the GSEs. Each of the GSEs assesses foreclosed loans to determine if the timeline to foreclosure is in line with their expectations on a state by state basis. To the extent there is a perceived delay in the time to foreclosure, the GSE may assess a compensatory fee to the servicer to account for interest penalties for the delay, which results in a liability.

Representation and warranty ("R&W") liabilities (or repurchase reserves)

Upon sale of a mortgage loan, a separate non-contingent obligation is likely to exist as a result of representations and warranties provided within the contract of sale. At the date of sale, this non-contingent obligation is recorded at the market based value it added to the sales contract. Subsequently, this obligation is assessed to determine the likelihood of repurchase risk and a repurchase reserve liability is recorded. This repurchase reserve liability captures the probable future liability that could result if the purchaser exercises their right to put back a purchased mortgage loan that they believe has violated any of the original representations and warranties made by the seller.

Accounting primer

Mortgage servicing assets and liabilities

An entity must recognize a servicing asset or liability upon execution of a contract to service financial assets. A servicing contract is either undertaken in conjunction with selling or securitizing the financial assets being serviced or it is purchased or assumed separately (please note that this does not apply to loan originators who own the loan while also performing the servicing). Typically, the benefits of servicing are expected to be more than adequate to compensate the servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. Adequate compensation is a market based factor and does not necessarily consider the servicer's internal costs to service.

Balance sheet classification	Asset, Liability
Relevant accounting guidance	ASC 860-50, Transfers and Servicing — Servicing Assets and Liabilities
Recording and valuation of a servicing asset or liability	**Initial recording** — Current accounting requirements dictate that an MSR should be initially recorded at fair value. Subsequent measurement can either be at fair value or at amortized cost with an assessment for impairment. The election to subsequently measure each class of MSR at fair value is irrevocable and is made at the time of initial recognition. Classes of servicing must be defined by considering (1) market inputs available to determine fair value (2) methodology involved in managing the risks associated with servicing or (3) a combination of (1) and (2). **Subsequent measurement (amortization)** — MSR accounted for under the amortization method is amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). The resulting amortized cost basis of the MSR is periodically assessed for impairment or increased obligation based on fair value at each reporting date. To assess for impairment, the MSR portfolio is stratified within separate tranches based on one or more predominant risk characteristics of the underlying financial assets (characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location). The amount of impairment recognized is the amount by which the amortized cost basis of an individual MSR tranche exceeds its fair value. A valuation allowance is adjusted to reflect changes in the measurement of impairment. Note that the fair value in excess of the carrying amount of servicing assets for that tranche, however, shall not be recognized. **Subsequent measurement (fair value)** — Under the fair value method, an MSR is recorded at fair value at each reporting date and changes in the fair value are recorded in earnings in the period in which the changes occur. Note: The mortgage servicer must disclose information that enables users to assess the valuation techniques and inputs used to develop the fair value of the MSR (for both impairment evaluation in the amortization method and for fair value) as well as the effect of the measurements on earnings for the period.
Accounting for de-recognition of servicing assets/liabilities	Mortgage servicing rights can be sold and all administrative obligations would be passed to the buyer. However, certain criteria should be considered when evaluating whether a transfer of servicing rights qualifies as a sale. Such considerations include whether the transferor has received written approval from the investor, if required under the contractual agreements, whether the transferee is currently an approved servicer, and whether all risks and rewards of ownership have been passed to the buyer. A sale of mortgage servicing rights with a subservicing contract will be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage servicing rights have been effectively transferred to the transferee.

Servicing advances

Servicing advances occur when mortgage servicers advance certain funds to the investors, taxing authorities, and/or service providers of defaulted loans during default servicing activities. Obligations of and recovery by the servicer are governed by servicing agreements. This obligation to advance funds (which may include P&I, T&I or other reasonable out of pocket expenses) creates a receivable, which may be reimbursed through cash collected from the borrower, the investor and/or through sale of the foreclosed property.

Balance sheet classification	Asset, Contra-Asset
Relevant accounting guidance	ASC 310-10, Receivables
Recording a servicing advance receivables (including estimating reserve for non-recoverability)	Servicing advances are receivables recorded based on amount of cash advanced on behalf of the borrower or investor. Receivables are recorded initially only to the extent they are considered recoverable. The receivable decreases as amounts are recovered. Subsequent to initial recording of the receivable, recoverability should be reassessed. If recoverability is not expected, a reserve, or contra-asset is recorded to reduce the balance of the servicing advance receivable. A related charge to expense would also be incurred on the income statement. The reserve should be recorded for the difference between the expected recovery amount and the carrying amount of the receivable.

Compensatory fees

GSEs have specific rights that may be exercised in the event a given servicer is not servicing loans in line with the contracted servicing agreements and/or is otherwise determined to not be fulfilling applicable contractual obligations. The GSE may levy compensatory fees on the mortgage servicer related to such claims. Certain compensatory fees may also be levied when mortgage loans delivered to the GSE fail to meet certain loan quality metrics.

Balance sheet classification	Liability
Relevant accounting guidance	ASC 405-10, Liabilities
Estimating and recording compensatory fee liabilities	Compensatory fees are recorded as a liability when the fees become estimable and probable of payment. The liability is estimated based on the historical and current information about the behavior of the GSEs and the entity's foreclosure practices and timelines. This estimate would be revised at each reporting period, resulting in an increase or decrease to the liability. Additionally, as payments are made to the GSEs, this liability would be extinguished.

Representation and warranty ("R&W") liabilities (or repurchase reserves)

A seller may make contractual representations and warranties within a loan sale regarding whether the loans comply with established underwriting criteria or meet certain characteristics. Upon discovery of a breach in those representation & warranties, investors, insurers, or government guarantors have the right to demand the institution to provide a remedy such as repurchasing the defective loan or indemnifying (or make-whole) the investor, GSE, or monoline.[2]

Balance sheet classification	Liability
Relevant accounting guidance	ASC 450-20, Loss Contingencies ASC 460-10, Guarantees ASC 860-20, Sale of financial assets ASC 820-10, Fair Value Measurement
Estimating liabilities for repurchases resulting from violations of selling representations and warranties	A liability for repurchase reserves are recorded on the balance sheet at the time loans are sold. The estimate of the reserve is based on the market value attributed to this obligation within the sale agreement. This fair value component of the repurchase reserve liability is subsequently released as the seller is released from its obligation to perform. On a recurring basis, an estimate of probable repurchase demand activity is determined and if an amount is reasonably estimable there will be an increase or decrease in the repurchase reserve liability. This estimate incorporates GSE, investor and other third party behavior (e.g., monolines), as well as the potential defects or breaches with the mortgage loans. As payments are made to settle any demands or repurchase loans, the liability is extinguished by a corresponding amount.

Increased balances of MSRs, servicing advances, compensatory fees, and repurchase reserves have heightened the importance of mortgage originators and servicers to create management estimates that properly reflect fair value and recoverability of servicing assets and their potential exposure to contingent liabilities. The processes and policies for developing management estimates and the assumptions used in those estimates are critical components that institutions should evaluate in order to properly reflect the associated assets and liabilities for financial statement users.

[2] A monoline refers to a business that focuses its operations in a specific area to deliver one particular good or service (i.e., mortgage insurance).

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