MSR Strategy with Historically Low Interest Rates

In 2020, markets are once again experiencing historically low interest rates. As with any time interest rates have large movements, MSR strategy should be examined to ensure that your current strategy is still correct. These are a few areas of focus where MSR strategy should be examined.

MSR Fair Value vs Market (Trade) Value

Per GAAP, Mortgage Servicing Rights (MSR) are generally classified as a Level 3 asset. While at times they have some Level 2 characteristics, the vast majority of MSR holders classify them as Level 3. Relative to a Level 1 asset (e.g. stocks), where quoted market prices are readily available and transparent, the market for MSR is largely considered illiquid. While a secondary market for MSR exists, successful transactions are highly dependent upon various other factors including overall supply/demand, prevailing interest rates, portfolio characteristics and counterparty strength. The valuation of MSR also involves complex discounted cash flow modeling and reliance on assumptions and forecasts, particularly as it relates to projected prepayment and default experience.

Below are the Fair Value accounting designations:

	Level I Assets	Level II Assets	Level III Assets
Liquidity Standard	Most Liquidity	Moderate Liquidity	Least Liquidity
Valuation Method	Valued using direct market prices; based upon active trading of identical instruments	Valued using observable inputs	Valued using a financial model (e.g. discounted cash flow model)

Given the relative illiquid nature of the MSR market, auditors and regulators allow companies to carry the MSR asset at Fair Value. The Fair Value approach encompasses using industry-wide (bank-like) assumptions for valuation purposes, as opposed to company-specific (economic) performance and/or actual trade levels. Actual trade levels ("Market Value") can be utilized and incorporated into the valuation if possible, however due to the changes around price discovery and overall market conditions present, most companies have adopted a combination of independent valuations and survey data to develop their internal MSR assumptions. Ultimately, the inherent aggressiveness in using bank-like valuation assumptions drives the delta between Fair Value and Market Value.

From the perspective of the MSR market, banks are now a minority participant and are highly selective in the product they will buy and counterparty they will work with. For example, banks are not active acquirers in the GNMA space, instead focusing almost explicitly and selectively on conventional product. Private Equity/REIT ("PE/REIT") firms have been the predominant buyers of MSR (spanning all collateral types) since the financial crisis. These firms often use sub-servicers and/or have more costly specialty/legacy servicing platforms. In addition to having inferior economics compared to their bank counterparts, they also typically have higher yield requirements. At times the buy side demand for servicing is strong enough to overcome these differences and at other times the spread between Fair Value and Market Value widens. In addition to these economic differences, the expectation of future prepayment speeds (voluntary and involuntary speeds) can have a material impact on the potential spread between fair and market value. The combination of these factors further contributes to the spread between Fair Value and Market Value.

Unfortunately, when interest rates are falling and buyers perceive prepayment speeds to be volatile, the differential between Fair Value and Market Value expands further. Since Fair Value is a Level III asset as described above, valuation firms and owners of MSRs have some flexibility in valuation and capitalization strategy.

Hedging Servicing Rights

When companies experience a decline in servicing values and are unhedged, many consider implementing a servicing rights hedge strategy. A full portfolio or targeted hedge can be implemented with the existing servicing portfolio, newly capitalized servicing rights or both. Of course, one needs to consider that the hedges will be put into place at historically low interest rates, effectively "locking in" potential losses. Considerations which should be incorporated into this decision include:

- Convexity profile of MSR portfolio
- Hedge instruments to utilize and cost to implement
- Public vs Private company
- Holding MSR for short term vs long term
- Hedge Analytics

Cash Flow Modeling

With declining MSR values, it is imperative to monitor your warehouse and broker/dealer covenants closely to ensure that you will not be violating net worth and/or liquidity requirements or receiving a margin call. If you have an MSR line, this becomes even more imperative. Detailed cash flow modeling and scenario analysis are crucial to this process.

Retaining MSR

In addition to the value of existing MSR declining with declining interest rates, Aggregator and Co-issue pricing also typically declines. This can be an extremely good time to either increase your retention of servicing rights or begin to retain servicing rights. These are the considerations that should be taken before retaining:

- Cash requirements
- Short-term vs long-term hold strategy
- Tax structure
- Modeling retained value
- Retention ability
- MSR borrowing line
- Counterparty Covenants (Warehouse, Broker/Dealer)

Phoenix is ready to assist you with all of the above. Please contact your Phoenix representative or call (303) 892-7070 to discuss.