TAX & CASH IMPLICATIONS OF CREATING EXCESS SERVICING

A WHITEPAPER BY MORTGAGE CAPITAL TRADING (MCT) AND CWDL CPA'S

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ABSTRACT

The 2020 global pandemic has created many unprecedented changes in the mortgage industry, one of these is an increase in the creation of excess servicing in the mortgage servicing rights (MSR) market. The result has been an increased MSR value and servicing cash flows in the future.

In this collaborative article, MCT teams up with CWDL to explain how excess is servicing is created. We will also discuss the cash and tax consequences of retaining the excess MSR.

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ABOUT CWDL

CWDL specializes in consulting, tax, accounting and attest for the mortgage banking industry. Mortgage lenders are subject to significant regulatory standards, and our acute focus gives us a unique advantage.

SUMMARY AND INTRODUCTION

To say that 2020 has been a year of change for the mortgage industry is an understatement as most of the changes have been pandemic related. More people working from home has led to an increase in virtual appraisals and closings. The Fed's move to drop interest rates has resulted in a refi boom with its consequent high volumes and high margins. And the Fed's efforts to support the market led to some secondary market price distortions when it was actively buying securities with only one or two pass-thru coupons, rather than all coupons.

In the mortgage servicing rights (MSR) market, these changes have created several opportunities/obligations for the small- to medium-sized originator:

- The decline in aggregator pricing at the start of the pandemic has led to originators retaining significantly more servicing.
- The secondary price distortions have led to more "down in coupon" trades, which will create less cash day one but more excess servicing. The result is increased MSR value and servicing cash flows in the future.

This whitepaper will review how excess servicing is created, then analyze the cash and tax consequences of retaining the excess MSR.

HOW IS EXCESS SERVICING CREATED AND WHAT IS A "DOWN IN COUPON" TRADE?

Excess servicing is defined as any servicing fee above 25 basis points for conventional loans and above 44 bps for government loans. In the case of Ginnie Mae, Ginnie securitization rules require no more than a 75 bps spread from the "pass thru" (security) rate and the note rate of the loan. This means, for example, that a 3.25% note rate can be delivered into a 3.0% security (25 bps between the note rate and the security pass thru rate) or a 2.5% security (75 bps between the note rate and the security pass thru rate). It could not be delivered into a 2.0% security because that would be 125 bps between the note rate and security price. Nor could it be delivered into a 3.5% security, because then there would not be enough interest in the note rate (3.25% is not high enough to cover the interest to the owners of the underlying security, let alone pay Ginnie its guarantee fee and the servicer its servicing fee).

So, for Ginnie Mae eligible loans with a note rate ending in -.25%, or -.75%, the originator has the choice to sell into a "high" coupon or a lower coupon. In the example above, selling into the high coupon security would typically generate higher price than the low security coupon. But selling into the lower security coupon would create a higher servicing fee, making the MSR more valuable as compensation. Below is an example:

FHA 3.75% loan

Ginnie 3.5% price	104.63
Ginnie 3.0 price	103.75

Decision: deliver the FHA 3.75% loan in a 3.5% security and get 104.63, and have 25bp – 6bp (Ginnie guarantee fee charged on every loan) = 19 bp MSR strip worth, say 40 bps. So, an all-in value of 104.63 + .40 = 105.03.

Or, deliver the FHA 3.75% loan into a 3.0% security and get 103.75, and have a 75 – 6 = 69 bp servicing strip, worth about 140 bps. The all-in value here is 103.75+1.40 = 105.15.

So, if the largest gain is your best ex criterion, then you would deliver into a 3.0% security and get 105.15. However, this step generates less cash (sale to Ginnie generates 103.75 rather than 104.63). Instead of cash, you have a very valuable servicing asset. But you may need cash. You may need to pay your LOs and office leases, which are normally paid from cash from gain on sale.

A similar situation has occurred with respect to Fannie cash window. Although an originator selling through the cash window does not have a direct link to the secondary market, Fannie Mae will pass thru much of the market implications through its cash window pricing. An originator has the choice between selecting a servicing fee of 25, 37.5 or 50 bps when delivering through the Fannie Mae cash window. Obviously, if you take a higher servicing fee, you are reducing the amount of interest income Fannie will have available to sell and so they will pay a lower price for the loan with the higher servicing fee strip. Once again, the originator must make the calculation between the value of the excess servicing and the price Fannie will pay for the related loan. Here is an example from October:

Note Rate: 5.125	Loan Price	MSR Val	Total
Price with 25 bp servicing:	108.44	50 bps	108.94
Price with 37.5 bp servicing:	108.24	77 bps	109.01
Price with 50 bp servicing:	108.00	99 bps	108.99

In this example, the highest all-in price is to deliver into the 37.5 servicing strip rather than the 25 or the 50 bp servicing strip.

In most normal markets, the price reduction by the secondary market far exceeds the gain in MSR, such that no excess is normally created. But the post-pandemic markets have been heavily influenced by Fed intervention, as well as expected Fed intervention in the future, so certain price distortions have been created in the secondary market and thus opportunities to create excess exist.

But don't forget about cash…

Even if the total gain is best with excess servicing, it usually means less cash up front, so that an originator must weigh the benefits of owning an MSR asset against receiving less cash.

And don't forget about taxes…

In addition to the cash/asset tradeoff, there are tax consequences to retaining MSRs. Before determining a strategy of creating excess servicing, an originator should be aware of the tax treatment of excess, how it differs from retaining normal MSRs, and how that may influence the strategy of retaining more or less excess.

TAX TREATMENT OF NORMAL ("SAFE HARBOR") AND EXCESS SERVICING RIGHTS

Until recently, it had been rare for valuations on retained mortgage servicing rights to exceed the safe harbor amounts identified under Rev. Proc. 91-50. The IRS will respect deferral of income otherwise recognized under fair value accounting to the extent that a servicing valuation does not exceed the safe harbor valuation (25 bps for conventional, fixed rate mortgages, 44 bps for FHA or VA, 37.5 bps for all other 1-4 unit residential mortgages), thus historically allowing originators to have a book to tax difference for any mortgage servicing rights capitalized during that year. Based on the events that occurred this year described above, originators may create excess servicing above the safe harbor amounts, triggering income recognition to that extent for that excess servicing strips; a separate book and tax asset should be created for this excess servicing. The excess portion would be valued at fair value (or LOCOM) for book purposes, but for tax purposes, the excess servicing is amortized over 108 months on a straight-line method pursuant to IRC §167(f)(3). Originators would continue to recognize the entire servicing fee when collected from the investor for both book and tax purposes. The amortization of the excess servicing avoids being double taxed on the excess strip.

Example:

In a normal market we have a conventional $100,000 loan that has a normal servicing fee of 25bps and a MSR value of 100bps (4x). This MSR would be recorded on day 1 as:

Debit	**MRS Asset**	**$1,000**
Credit	**MSR Revenue**	**$1,000**

The mortgage company would then collect the servicing fee every month on a cash basis and that servicing fee would be taxable. The value of the MSR would be adjusted to fair value at every reporting period.

Due the market occurrence described above, that same conventional loan of $100,000 would have a servicing fee of 37.5bps and an MSR value of 150bps (4x) (approximated, but wouldn't work out exactly this way). This MSR would be recorded on day 1 as:

Debit	**MRS Asset**	**$1,000**
Credit	**MSR Revenue**	**$1,000**

Debit	**MRS Asset**	**$500**
Credit	**MSR Revenue**	**$500**

The mortgage company would still collect the servicing fee every month on a cash basis and that servicing fee would be taxable. The value of the MSR asset would be adjusted to fair value at every reporting period and not taxable. The Excess MSR asset created would be taxable on day 1 but be amortized off over 9 years.

CONCLUSION

We see that the decision to retain or release a loan depends more on just lining up the loans from "highest to lowest" and picking the top number. Instead, cash and tax factors must be weighed as well. An individual originator's balance sheet, current obligations, and expected uses of capital come into play, both on a pretax and after-tax basis.

MCT has the tools which analysis all these factors, and includes calculation of breakeven months on an after-tax basis to optimize the retain/release decision. This optimization tool includes modeling on a loan level basis, utilizing assumptions reflecting the client's actual parameters with regard to servicing costs, tax rate, and other customized assumptions.

ABOUT MCT

MCT is a capital markets advisory firm focused on technology and service with a 15+ year track record of success.

- **Growing for Your Needs** - Since 2001 MCT has grown from a pipeline hedging services specialist into a fully- integrated provider of capital markets services & software.
- **Capital Markets Expertise** – Through a combination of unparalleled industry experience and relentless focus on data, MCT is pioneering the future of capital markets technology. From MCT*live!,* to MSRlive!, to our award-winning Bid Auction Manager (BAM) - MCT pushes the envelope to exceed client expectations.
- **Clients & Employees Agree** - MCT delivers unparalleled customer service and is proud of our outstanding client retention rate. MCT prides itself on being a regular winner of San Diego's "Best Place To Work" Award.

To schedule a meeting to discuss our software or services, contact us at mct-trading.com/contact.

MCT hedge advisory

- ✓ HALO - Traditional Full Service Hedge Advisory
- ✓ MCTlive! - Capital Markets Software Platform
- ✓ BAM - Bid Tape Management Solution
- ✓ Best Execution Analysis & Loan Sales

MCT MSR services

- ✓ MSRlive! Cloud-based Portfolio Valuation Platform
- ✓ Customized grids
- ✓ Quarterly Servicing Portfolio Valuation Reports
- ✓ One-on-one Servicing Strategy Consulting
- ✓ Enhanced Retain/Release Analyses

MCT lock central

- ✓ Outsourced Lock Desk Services
- ✓ From Initial Locks Only to Full Service
- ✓ Works with all LOS & PPE Systems
- ✓ Best Practices - Lock Desk Policy and Procedures

MCT PRODUCT & PRICING

- ✓ Proprietary Pricing & Eligibility Engine
- ✓ Real-Time Pricing for ALL Delivery Channels
- ✓ Loan Sale Best Executions
- ✓ Rate Sheet Generation Services

MCT BUSINESS intelligence

- ✓ Proprietary Loan Sale Best Execution Database
- ✓ Investor Report Cards
- ✓ Price Competitiveness
- ✓ Client Opportunity Curves
- ✓ Capital Markets Consulting

To schedule a meeting to demo our software or discuss our services, contact Phil Laren plaren@mctrade.net, Susi Schlenk, schlenk@mctrade.net, David Burruss dburruss@mctrade.net or Natalie Martinez, nmartinez@mctrade.net.