WILARY WINN LLC

ADVICE TO STRENGTHEN FINANCIAL INSTITUTIONS

MORTGAGE PARTNERSHIP FINANCE PROGRAM

FEDERAL HOME LOAN BANK OF DES MOINES

2019 Mortgage Conference

MPF Traditional –

Accounting for the MSR and Credit Enhancement

Eric Nokken, Director

Anneliese Ramin, Senior Financial Analyst

Wilary Winn LLC

April 16, 2019

TODAY'S SPEAKERS

ERIC NOKKEN

Director

Mr. Nokken has over twenty years of experience in the financial services industry and has been with Wilary Winn since 2004.

Eric leads Wilary Winn's mortgage banking activities line of business. His team provides mortgage servicing rights valuations on portfolios that range in size from $4 million to over $4 billion for more than 275 clients across the country.

Eric is an expert in the accounting and regulatory reporting related to mortgage banking activities, including interest rate lock commitment and forward loan sale commitment derivatives, as well as mortgage servicing rights.

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TODAY’S SPEAKERS

ANNELIESE RAMIN

Senior Financial Analyst

Ms. Ramin has been with Wilary Winn since 2015. Anneliese supervises analysts working on valuations of mortgage servicing rights, commercial servicing rights, SBA servicing rights, gain on sale calculations related to SBA loan sales, and valuations of trust preferred CDOs.

Anneliese also assists the firm with various fair value engagements including mergers and acquisitions, fair value advice related to footnote disclosures, post-merger re-calculation of accretive cash flows, concentration risk management, and Current Expected Credit Loss (CECL) analyses. Anneliese received her Bachelor’s Degree in Actuarial Science from the University of Wisconsin-Eau Claire.

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MORTGAGE PARTNERSHIP FINANCE PROGRAM

TOPICS COVERED

- Accounting for retained servicing

- Accounting for credit enhancement fees receivable & credit enhancement obligation liabilities

- Regulatory reporting for MPF Products

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MORTGAGE SERVICING RIGHTS

ACCOUNTING FOR LOANS SOLD UNDER THE MPF PROGRAM

The discussion which follows is based on general examples. PFIs are strongly encouraged to review the accounting for the program with their external auditors and primary regulators before implementing the accounting described in the presentation, because the facts and circumstances for a particular institution may lead to different accounting and regulatory interpretations.

We further note that for purposes of simplicity, we have omitted the accounting requirements related to the Interest Rate Lock Commitments PFIs make to their borrowers and Forward Sales Commitments a PFI enters into with the FHLB, which are both derivatives.

ACCOUNTING FOR RETAINED SERVICING

MORTGAGE SERVICING RIGHTS

ACCOUNTING IMPLICATIONS

- Accounting and reporting for MSRs is set for in FAS ASC 860-50

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EXISTENCE OF SERVICING – FAS ASC 860-50-25-1

- A servicing asset or liability arises each time an institution undertakes an obligation to service a financial asset by entering into a servicing contract in connection with –
    1. a transfer that meets the requirements for true sale or
    2. the acquisition or assumption of a servicing obligation not related to the financial assets of the servicer

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MSR ASSET OR LIABILITY – FAS ASC 860-50-30

The benefits of the servicing, including the servicing fees, ancillary income, float, etc. must exceed "adequate compensation" in order to have a servicing asset. If not, the servicer has a liability.

Adequate compensation includes a profit and is determined by the marketplace. It is based on marketplace costs, not the servicer's internal costs.

MORTGAGE SERVICING RIGHTS

INITIAL RECORDING

- Servicing assets and liabilities must be reported separately

- A servicing asset can become a servicing liability over its life and vice versa

MORTGAGE SERVICING RIGHTS

INITIAL RECORDING

- Record MSR at fair value – quoted price for exact or similar asset would be best – discounted cash flow can be used in the absence of trade information

- Industry believes MSRs are Level 2 or Level 3 assets based on a discounted cash flow model

- Value excess servicing separately - true IO
  - Creation of the IO does not violate true sale, if part of overall consideration for the 100% sale of the loan

MORTGAGE SERVICING RIGHTS

HOW TO ACCOUNT FOR THE MSR AFTER INITIAL RECORDING?

- FAS ASC paragraph 860-50-35-1 allows the asset to be measured and reported in one of two ways:
  1. Amortization Method
  2. Fair Value Method
- A servicer can select either method, but cannot switch methodologies unless it moves to the Fair Value method at the beginning of the fiscal year before interim financial statements have been released. A servicer cannot go back to the amortization method after it has elected Fair Value.

MORTGAGE SERVICING RIGHTS

AMORTIZATION METHOD

- Amortize the MSR in proportion and over the period of estimated net servicing income (level yield method) and assess servicing assets for impairment based on fair value at each reporting date.

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IMPAIRMENT

- Impairment is best measured at the loan level and is reported at the predominant risk characteristic stratum

- There is a difference between temporary impairment, which is accounted for through an allowance and permanent impairment, which requires a direct write-off

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MORTGAGE SERVICING RIGHTS

ABC BANK – $1.41 BILLION SERVICING PORTFOLIO VALUATION AS OF MARCH 31, 2019

		Principal Balance	# of Loans	WAC	WAM	Age	Avg Life	Service Fee	T&I Total	Prepayment PSA	Servicing Multiple	Fair Value %	Fair Value $	Book Value $	Fair Value - Book Value	Bal. Sheet Impact
30 & 25 year	less than 4.750%	871,192,587	3,389	3.930%	320	40	7.42	0.250%	1,019,798	155	4.3	1.083%	9,438,710	8,697,842	740,868	-
	4.750% - 6.750%	101,008,188	444	4.975%	319	42	5.31	0.250%	130,518	274	3.5	0.873%	881,360	846,127	35,234	-
	greater than 6.750%	193,490	5	7.985%	81	303	2.94	0.250%	601	254	1.5	0.381%	738	1,018	(280)	(280)
	Total 30 & 25 year	972,394,265	3,838	4.039%	320	41	7.20	0.250%	1,150,917	167	4.2	1.061%	10,320,808	9,544,987	775,822	(280)
20 year	less than 4.625%	115,973,676	550	3.763%	200	40	5.80	0.250%	159,479	144	3.7	0.932%	1,080,779	900,113	180,666	-
	4.625% - 6.625%	5,164,267	30	4.732%	201	39	4.37	0.250%	5,069	276	3.0	0.752%	38,857	32,332	6,525	-
	greater than 6.625%	-	-	0.000%	0	0	0.00	0.000%	-	0	0.0	0.000%	-	-	-	-
	Total 20 year	121,137,943	580	3.805%	200	40	5.74	0.250%	164,547	149	3.7	0.924%	1,119,636	932,446	187,191	-
15 year	less than 4.500%	288,573,047	1,894	3.313%	131	49	4.04	0.250%	390,860	164	2.8	0.708%	2,042,682	2,045,947	(3,266)	(3,266)
	4.500% - 6.500%	6,554,108	42	4.649%	164	16	3.93	0.250%	5,323	304	2.8	0.703%	46,099	43,751	2,348	-
	greater than 6.500%	-	-	0.000%	0	0	0.00	0.000%	-	0	0.0	0.000%	-	-	-	-
	Total 15 year	295,127,155	1,936	3.343%	132	48	4.03	0.250%	396,183	167	2.8	0.708%	2,088,780	2,089,698	(918)	(3,266)
10 year	less than 4.125%	4,976,068	26	3.818%	61	22	3.03	0.250%	5,334	209	2.6	0.644%	32,070	14,230	17,841	-
	4.125% - 6.125%	1,160,670	9	4.240%	102	7	3.48	0.250%	1,566	300	2.6	0.644%	7,471	1,298	6,172	-
	greater than 6.125%	-	-	0.000%	0	0	0.00	0.000%	-	0	0.0	0.000%	-	-	-	-
	Total 10 year	6,136,738	35	3.898%	69	19	3.11	0.250%	6,900	226	2.6	0.644%	39,541	15,528	24,013	-
Total excluding ARMs		1,394,796,099	6,389	3.871%	269	42	6.39	0.250%	1,718,547	166	3.9	0.973%	13,568,766	12,582,659	986,108	(3,545)
	ARMs	10,810,552	34	3.538%	351	9	3.42	0.250%	10,899	395	2.7	0.674%	72,810	44,916	27,894	-
Grand Total		1,405,606,651	6,423	3.868%	269	42	6.36	0.250%	1,729,446	168	3.9	0.971%	13,641,576	12,627,575	1,014,001	(3,545)
															Current Impairment Reserve	(1,265)
															(Additional) / Excess Impairment Reserve	(2,280)

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MORTGAGE SERVICING RIGHTS

FAIR VALUE METHOD

- The fair value is determined at each reporting period
- The asset is adjusted to equal its fair value
- The difference is taken into income or expense for that reporting period
- Institutions that hedge their servicing rights portfolios can benefit from the fair value method because the accounting is less complex than under FAS ASC Topic 815 – Derivatives and Hedging. Institutions that do not hedge their portfolios and that elect the fair value method could experience earnings volatility.

MORTGAGE SERVICING RIGHTS

FFIEC CALL REPORT REQUIREMENTS FOR MORTGAGE SERVICING RIGHTS – FORM 041

1. Total volume of loans sold - Schedule RC-S, item 11A and RC-S, Memoranda, item 2a (with recourse) or item 2b (without recourse)
2. Book value of retained servicing – RC-M, Memoranda, item 2a
3. Estimated fair value of retained servicing – RC-M, Memoranda, item 2a(1)
4. Gain or Loss on loan sales for the quarter should be reported on Schedule RI, item 5i
5. Net servicing fees for the quarter should be reported on Schedule RI, item 5f

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MORTGAGE SERVICING RIGHTS

FFIEC CALL REPORT REQUIREMENTS FOR MORTGAGE BANKING ACTIVITIES – FORM 041

Schedule RC-P – 1-4 Family Residential Mortgage needs to be completed if the following is true:

1. The Bank at which either 1-4 family residential mortgage loan originations and purchases for resale from all sources, loan sales, or quarter-end loans held for sale exceed $10 Million for two consecutive quarters.

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MORTGAGE SERVICING RIGHTS

FFIEC CALL REPORT REQUIREMENTS FOR MORTGAGE SERVICING RIGHTS – FORM 051

1. Schedule SU
    a. Item 5 – Servicing Retained with Recourse – YES
    b. Item 5 a. – Outstanding UPB of loans sold with recourse
    c. Item 6 – Servicing Retained without Recourse – YES
    d. Item 6 a. – Outstanding UPB of loans sold without recourse
2. Book value of retained servicing – RC-M, Memoranda, item 2a
3. Estimated fair value of retained servicing – RC-M, Memoranda, item 2a(1)
4. Gain or Loss on loan sales for the quarter should be reported on Schedule RI, item 5i
5. Net servicing fees for the quarter should be reported on Schedule RI, item 5f

MORTGAGE SERVICING RIGHTS

FFIEC CALL REPORT REQUIREMENTS FOR MORTGAGE SERVICING RIGHTS – FORM 051

Schedule SU – 1-4 Family Residential Mortgage Banking Activities

1. Item 2 – For 2 calendar quarters preceding the current quarter did the institution meet one or both of the following mortgage banking activity thresholds: 1. Sales of 1-4 family residential mortgage loans during the calendar quarter exceeded $10 million, or 2. 1-4 family residential mortgage loans held for sale or trading as of calendar quarter-end exceeded $10 million?
2. Item 2 a. Principal amount of 1-4 family residential mortgage loans sold during the quarter
3. Item 2 b. Quarter-end amount of 1-4 family residential mortgage loans held for sale or trading.

MORTGAGE SERVICING RIGHTS

BASEL III

- MSRs are limited to 10% of CET 1 and are part of the 15% CET 1 limitation.
- Limitation was phased in – 60% in 2016 and then 20% per year thereafter – now it is fully phased in.
- MSRs previously were risk weighted at 100% of eligible portion until 1/1/2018, now MSRs require a 250% risk weight.

MORTGAGE SERVICING RIGHTS

NCUA CALL REPORT REQUIREMENTS FOR MORTGAGE SERVICING RIGHTS

1. Servicing fees are included in Non-Interest Income – Page 5, line 12
2. Loan servicing expenses are included in Non-Interest Expense – Page 5, line 25
3. Total amount of 1st mortgage loans sold into the secondary market year-to-date is reported on Schedule A, line 18
4. Amount of real estate loans sold but serviced by the credit union (dollar amount of servicing) is reported on Schedule A, line 20
5. The MSR book value is reported on Schedule A, line 21
6. MSR book value will be risk weighted at 250% under proposed new risk-based capital rule

Accounting for Credit Enhancement Fees Receivable & Credit Enhancement Obligation Liabilities

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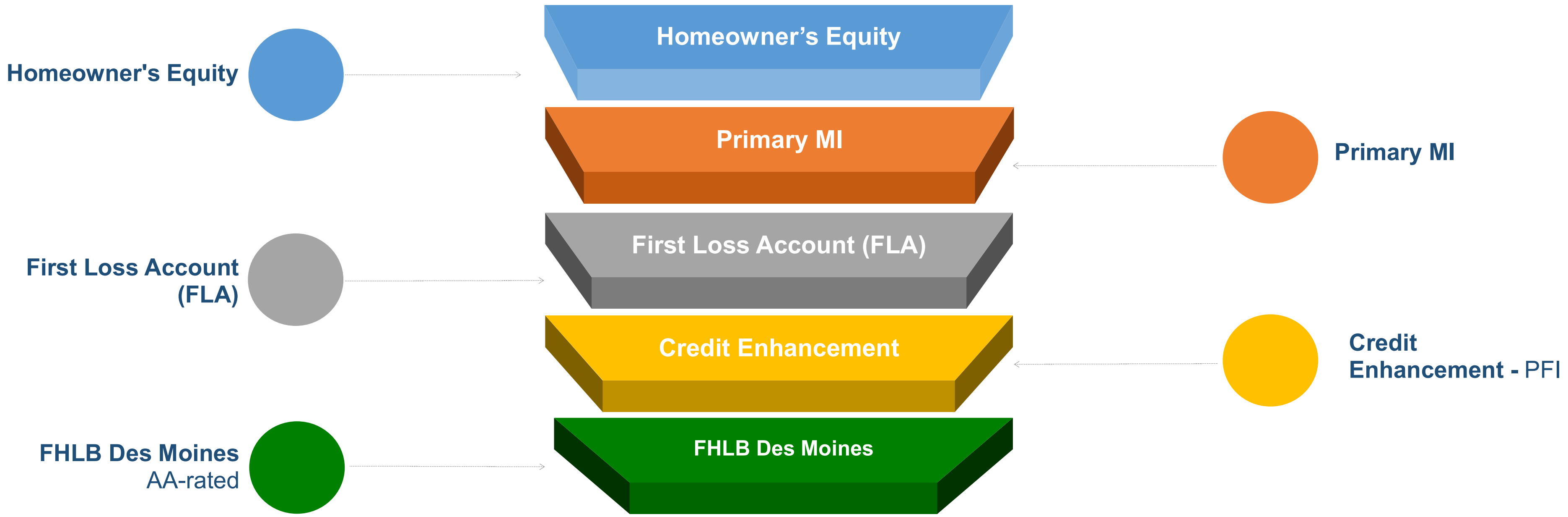
MPF PRODUCT CREDIT STRUCTURE



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MORTGAGE PARTNERSHIP FINANCE PROGRAM

CE RECOURSE LIABILITY VS. CE RECOURSE OBLIGATION AMOUNT

There is a difference between the CE Recourse Liability and the CE Recourse Obligation Amount

- The CE Recourse Liability is related to properly accounting for the loans delivered under the program per Generally Accepted Accounting Principles

- The CE Recourse Obligation amount is related to the amount of risk based capital that a PFI must hold for regulatory purposes for loans delivered under the program

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RECORDING OF THE CE OBLIGATION LIABILITY

- Record the CE Recourse Liability and the CE Fee Receivable at their fair values
- Record CE Recourse Liability equal to CE Fee Receivable – FAS ASC 460-10 Practical Expedient

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FFIEC CALL REPORT REQUIREMENTS FOR CE OBLIGATION LIABILITY

BASEL III

- "The agencies believe that these exposures that tranche credit risk meet the definition of a synthetic securitization and that the risk of such exposures would be appropriately captured under the securitization framework." (pg. 346)

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MORTGAGE PARTNERSHIP FINANCE PROGRAM

CALCULATING RISK WEIGHT ASSETS RELATED TO MPF PROGRAM

- Gross up method under general risk-based capital rules
- Simplified Supervisory Formula Approach (SSFA)
- Multiply the CE Obligation by 12.5 (dollar for dollar capital impact)
- Supervisory Formula Approach (SFA) (for largest institutions only – advanced approaches)

The SSFA and gross up method approaches are subject to a risk-weighted assets floor of 20%

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MORTGAGE PARTNERSHIP FINANCE PROGRAM

MASTER COMMITMENT DETAIL REPORT

MPF® Program
Master Commitment Detail Report

Report Date: 04/01/2019

Through March 2019

PFI: [redacted]

Credit Enhanced Master Commitments for [redacted]

Master Commitments where Originating PFI and CE Obligation Owner is [redacted]

MC#	MPF Product	Outstanding Balance of All Loans Sold	Remaining FLA	Remaining FLA as a % of Outstanding Balance	Remaining CE Obligation	Remaining CE Obligation as a % of Outstanding Balance	Outstanding Balance Excluding Loans 90+ Days Past-Due	Outstanding Balance of Loans 90+ Days Past-Due Amount (Count)	Loans 90+ Days Past-Due as a % of Outstanding Balance	Servicing Rights
11977	125	$8,093,478	$201,257	2.49 %	$114,817	1.42 %	$8,093,478	$0 (0)	0.00 %	Retained
13201	125	$28,743,684	$383,646	1.33 %	$255,390	0.89 %	$28,743,684	$0 (0)	0.00 %	Retained
14749	125	$45,459,807	$529,154	1.16 %	$245,366	0.54 %	$45,459,807	$0 (0)	0.00 %	Retained
16161	125	$42,669,125	$442,822	1.04 %	$298,693	0.70 %	$42,669,125	$0 (0)	0.00 %	Retained

Master Commitments where CE Obligation was Assumed from Others by [redacted]

No Master Commitments meet the criteria

Totals for 4 MCs:		$124,966,094	$1,556,879		$914,266		$124,966,094	$0 (0)		

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GROSS-UP METHOD – FIVE INPUTS

- Pro-rata share – for MPF CE obligation 100%
- Exposure amount – CE obligation amount
- Enhanced amount – Balance of sold loans in excess of the CE obligation amount
- Applicable risk weight – 50% for loans that are current and 100% for non-current loans
- First Loss Account – The amount of the FLA is deducted before multiplying the balance by the Applicable Risk Weight result

If a bank elects the gross-up method, it must use it for all of its securitization exposures.

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GROSS-UP METHOD – CALCULATION EXAMPLE

- Pro-rata share – 100%
- Outstanding Amount – **$42,669,125**
- Exposure amount – CE obligation amount **- $298,693**
- First Loss Account amount **- $442,842**
- Enhanced amount – Balance of sold loans in excess of the CE obligation amount – **$42,370,432**
- Delinquent loans – **$640,037 (1.50%)**
- Applicable risk weight – 50% for loans that are current and 100% for non-current loans – (1 - 1.50%)*0.5 + 1.50% = **50.75%**
- **Risk Weighted Assets = 50.75% * ($42,669,125 - $442,842) or $21,429,994**

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SSFA METHOD – CALCULATOR

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BASEL III SSFA Calculator for the FHLB MPF Program

Enable Macros before using the Calculator

Instructions | Contact Wilary Winn | Reset Calculator

MPF Program	100/125
Dollar Amount of Sold and Outstanding	42,669,125
Dollar Amount of CE Obligation	298,693
Dollar Amount of First Loss Account	442,822
Dollar Amount of Loans Greater than 90 days Past Due	640,037

Calculate

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BASEL III SSFA Calculator for the FHLB MPF Program

Instructions | Contact Wilary Winn | Calculator

Weighted Average Capital Requirement (KG) (%):	4.06%
Ratio of Delinquent Loans (90+ days) to Total Balance (%):	1.50%
Credit Enhancement Obligation (%):	0.70%
First Loss Account (%):	1.04%

View Definitions | View All Inputs

SSFA:	
Risk Weight	1250%
Total Increase to Risk-Weighted Assets $ Amt	3,733,663
Total Increase to Risk-Weighted Assets %	8.75%

Gross-Up:	
Risk Weight	50.75%
Total Increase to Risk-Weighted Assets $ Amt	21,429,849
Total Increase to Risk-Weighted Assets %	50.22%

CE times 1250%:	
Total Increase to Risk-Weighted Assets $ Amt	3,733,663
Total Increase to Risk-Weighted Assets %	8.75%

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GROSS-UP METHOD – PROS & CONS

Pros:

1. Benefits MCs with high CE balances and low DQs.
2. RWA should benefit as UPBs decrease
3. Easier calculation than the SSFA Method.

Cons:

1. Calculations should be done at the MC level.
2. PFI must use Gross-Up Method for all MCs.

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SSFA METHOD – PROS & CONS

Pros:

1. Benefits MCs with high FLA balances.
2. RWA should benefit as UPBs decrease

Cons:

1. Not "Simple"
2. Calculations should be done at the MC Level

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RISK WEIGHT CAPITAL

- For any individual Master Commitment, if multiplying the CE Obligation amount by 12.5 is a better result than either the SSFA or Gross-up method, the institution can hold dollar for dollar capital for said Master Commitment.
- An institution will report the most beneficial result to risk based assets in RC-R line 10.
- See "Guide to Reporting Under Basel III for FHLB MPF Program Participants" document on the Wilary Winn website for specifics about RC-R reporting.

MORTGAGE PARTNERSHIP FINANCE PROGRAM

COMMUNITY BANK LEVERAGE RATIO

- The newly proposed Community Bank Leverage Ratio could potentially benefit MPF participants. The rule replaces risk-based capital with a simple leverage ratio for "eligible" community banks. Eligible banks would thus not have to consider the off-balance sheet exposure arising from the CE obligations in calculating required regulatory capital. However, the proposed rule limits the amount of MSAs and off-balance sheet exposures in order to be deemed eligible to use the leverage ratio.
- The comment period for proposed rule ended April 9th. Wilary Winn has published a summary of the proposed Community Bank Leverage Ratio rule on it's website.

MORTGAGE SERVICING RIGHTS

HOW WILARY WINN CAN HELP

1. Wilary Winn can perform a valuation of a servicer's entire mortgage servicing portfolio. The valuation will include determining the **values** of the MSR at the Loan Level and assisting with any questions related to the accounting for the portfolio. Similarly, we can calculate the value of the CE Fees Receivable and CE Obligation Liability at the loan level. We can also help you calculate the amount of risk-weighted assets your bank must hold related the CE Recourse Obligation Amount.

2. For those electing the amortization method for MSRs, Wilary Winn will incorporate the MSR into a **loan level basis roll forward file**, which provides the information necessary to produce the amortization **journal entries** going forward. The file includes a section where newly sold loans can be added and the amount of the new MSR is calculated; the amortization for these loans is also calculated. We can also provide similar ongoing accounting related the CE Fees Receivable and CE Obligation Liability.

Resources

Financial accounting and regulatory reporting continue to grow increasingly complex. Find jargon-free answers to your questions here.

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MPF

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https://www.wilwinn.com/resources/

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Questions?


Thank You
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