

FHN Financial Capital Assets Corp.'s MSR Valuation Service: Satisfying Your MSR Impairment Testing Requirements

FHN Financial Capital Assets Corp. (Capital Assets) established a third-party Mortgage Servicing Rights (MSR) appraisal service over a decade ago. Our MSR appraisal service is available to help customers comply with accounting and regulatory requirements of MSR ownership. As your institution closes out its year-end and you evaluate the need for a third-party MSR appraisal, we wanted to remind you that we offer this service. In addition, if you are dissatisfied with the turnaround time or customer support from your existing MSR valuation service provider, be sure to investigate the prompt, full service support offered by Capital Assets.

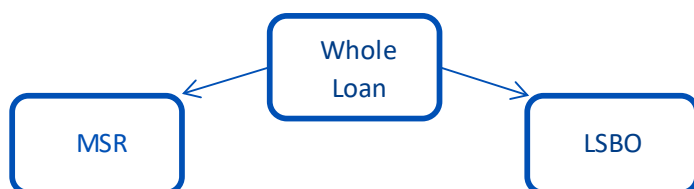
Mortgage Servicing Rights

Mortgage servicing rights (MSRs) are created when a lender makes loans to homeowners that are collateralized by mortgages on the borrower's real estate properties. The MSRs represent the right and the obligation to:

- Collect monthly principal and interest payments on loans made to a pool of mortgaged homeowners,
- Collect and administer monthly tax and insurance escrow payments from the pool of homeowners, and
- Monitor the payment status on the mortgages, referring seriously delinquent loans for more aggressive collection and potential foreclosure.

Bifurcation of the Whole Loan

After originating the pool of mortgages, the servicer may later decide to liquidate its investment in the mortgages but retain the right to service the mortgages for a monthly fee. At the time of sale, the lender legally bifurcates the whole loan it originated into two assets: an MSR asset and a net loan asset serviced by others (LSBO). The lender then retains the MSR asset and sells the LSBO to an end loan investor. After the sale, the servicer continues to collect monthly payments from the mortgagors, deducts a monthly servicing fee, and remits the net loan payments to the loan investor.



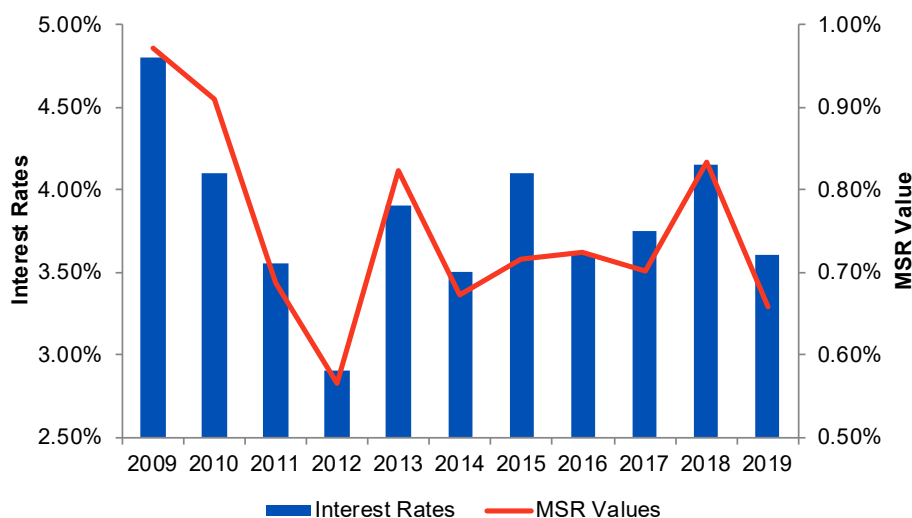
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Liquid Market for MSRs

MSRs retained by mortgage lenders or purchased by other mortgage servicers are a liquid asset tradeable in an active, well-developed secondary market. The primary source of economic value of MSR assets is the present value of the monthly servicing fee, typically calculated as a small percentage of the outstanding loan balance. Because MSR assets are essentially an interest-only strip, the MSR's market value can be volatile and is positively correlated with the level of interest rates. When interest rates rise, the rate of prepayments decreases, the stream of servicing fees lengthens, and the market value of the MSR increases. The reverse occurs when interest rates decline, which results in a decrease in the market value of the MSR. The direct correlation between interest rates and MSR values is evidenced by historical market activity in recent years, as the below graph depicts.



Source: FHN Financial Capital Assets Corp.

Accounting Treatment

The accounting treatment of MSRs is governed by Accounting Standards Codification (ASC) 860 – Transfers and Servicing (formerly FAS 140) [ASC 860]. ASC 860 dictates that this MSR be recorded at market value at the time of sale and then periodically adjusted to the lower of cost or market as it is amortized against income from the servicing. ASC 860 requires that the MSR must periodically be evaluated for impairment against its carrying value. The frequency with which this impairment testing is conducted varies, depending primarily on whether an institution is publicly traded or privately held. Publicly traded institutions generally perform testing on a quarterly basis, while it is more common for non-publicly traded institutions to perform annual tests of impairment. It is generally required by auditors that this testing be conducted by an unbiased third party.

Capital Assets' ASC 860 MSR Appraisal Program

Capital Assets established an ASC 860 third-party MSR appraisal service several decades ago. Our ASC 860 service is available to assist our customers in complying with the accounting and regulatory requirements of MSR ownership. Additionally, our in-house CPAs and MBAs are available as a source of further guidance and information in understanding ASC 860 specifically and the loan servicing portfolio's investment risk in general.

Determining Current Market Value

The goal of an ASC 860 analysis is to estimate the amount at which your portfolio could be bought or sold between willing parties in today's market, other than in a forced or liquidation sale. Your portfolio will be assessed using our proprietary cash flow model to determine that amount.

First, the underlying loans are amortized to the remaining term, incorporating Bloomberg consensus prepayment speeds. We then project sources of servicing revenue and expense to arrive at a net cash flow stream that a servicing investor would expect to earn over time if they bought your particular portfolio. This cash flow stream is then present-valued, at current secondary market yields to arrive at an estimated current market value.

Interest Rate Stress Testing

MSRs are highly volatile financial assets which are subject to changes in interest rates and mortgagor refinancing activity. As a result, ASC 860 dictates that you not only monitor the current market value of your servicing, but that you also stress-test the effect of interest rate changes to that value. To assist our customers in complying with this requirement, the portfolio is re-valued assuming an instantaneous, across-the-board change in interest rates, using a total of seven interest rate environments: up and down 300 basis points in 100 basis point increments. For each rate environment, the portfolio's forecasted prepayment speed, forecasted average life, and estimated market value are provided.

Assessing Impairment of Book Value

ASC 860 requires that institutions evaluate and measure their servicing for impairment of book value. As part of our ASC 860 Service, a valuation report is generated that quantifies fair market value of the capitalized servicing. By comparing the values generated in this report to recorded book value, the institution can determine whether it has an impairment problem.

The amount of impairment recognized is the amount by which the book value of the servicing assets exceeds its fair market value.

Capital Assets' ASC 860 Service Highlights

- Initial request for services includes an example opinion letter and reports which illustrate our approach;
- Customer portfolio is assessed using Capital Assets' proprietary cash flow model;
- Customized, easy to understand reports;
- Quick turnaround time;
- Internet delivery available, using PDF format;
- Access to our in-house CPAs and MBAs for additional guidance and information in understanding ASC 860;
- Report includes required stress tests that illustrate forecasted prepayment speed, forecasted average life, and estimated market value for seven different interest rate environments;
- Utilizes Bloomberg consensus speeds;
- Capital Assets utilizes reasonable and conservative assumptions that have consistently withstood bank audit and regulatory scrutiny.

Obtaining Your Third-Party MSR Appraisal

As your institution closes out its fiscal year-end, be sure to be aware of the need to obtain a third-party opinion of value of your servicing assets. In addition, if you are displeased with the turnaround time or customer support from your existing ASC 860 service, be sure to investigate the prompt, full service support offered by Capital Assets. For more information, contact your FHN Financial sales representative or Capital Assets at 1.800.456.5460 today.

RELATED LINKS

[ASC 860 Servicing Valuation Brochure](#)

[Example \\$250MM Servicing Appraisal](#)

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