

## UPDATE ON THE MORTGAGE SERVICING RIGHTS SECONDARY MARKET

*FHN Financial Capital Assets Corp. ("Capital Assets") is preparing to render third-party Mortgage Servicing Rights ("MSRs") appraisals at quarter-end for our customers who service loans that have been sold to third-party investors. ASC 860 requires servicers to test their MSR assets for impairment by obtaining third-party appraisals such as those provided by Capital Assets. This article provides some color on MSR appraisal levels and the MSR secondary market of late, which includes the following general factors: Record-Low Mortgage Rates, Extreme Prepayments, Regulatory Issues, Loan Payment Performance, and the CARES Act of 2020.*

### ▪ **Record-Low Mortgage Rates**

The second quarter of 2020 has been filled with uncertainty and fear. The coronavirus (COVID-19) has spread worldwide, while in the US the virus has infected 2.3 million people resulting in 124,000 deaths to date.<sup>(1)</sup> Many small businesses have closed their doors permanently as their customers were forced to stay at home due to "shelter-at-home" mandates. Record numbers of employees have lost their jobs or seen their income significantly curtailed through no fault of their own, and there have been as many as 3.3 million people filing for unemployment benefits on a weekly basis.<sup>(2)</sup> The world has experienced a flight-to-quality as people have invested in US Treasuries, driving interest rates down to record levels. Mortgage interest rates are priced to the Treasury curve, and mortgage rates have declined to record rates as well. As the below table illustrates, in the last six months mortgage servicers have seen their fixed-rate servicing portfolios go from being 38% in-the-money to be refinanced to 86% in-the-money to be refinanced today.

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Typical Fixed Rate Coupon Distribution				
Coupon Range		Balance	% Of Total	Cum. % Of Total
Min	Max			
Below 3.00 %		\$27,638,742	8%	8%
3.00% - 3.24%		22,173,772	6%	14%
3.25% - 3.49%		40,142,465	11%	26%
3.50% - 3.74%		56,388,978	16%	42%
3.75% - 3.99%		70,864,824	20%	62%
4.00% - 4.24%		45,399,874	13%	75%
4.25% - 4.49%		30,030,369	9%	83%
4.50% - 4.74%		22,743,065	6%	90%
4.75% - 4.99%		16,064,844	5%	94%
5.00% - 5.24%		6,891,557	2%	96%
5.25% - 5.49%		3,981,413	1%	97%
5.50% - 5.74%		3,257,741	1%	98%
5.75% - 5.99%		2,832,436	1%	99%
6.00% - 6.24%		1,463,724	0%	99%
6.25% - 6.49%		1,047,757	0%	100%
6.50% - 6.74%		470,548	0%	100%
6.75% - 6.99%		367,190	0%	100%
7.00 % Plus		366,185	0%	100%
<b>GRAND TOTAL</b>		<b>\$352,125,486</b>	<b>100%</b>	<b>100%</b>

6.10.20  
86% In  
The Money

12.31.19  
38% In  
The Money

Source: FHN Financial Capital Assets Corp.

▪ **Extreme Prepayments**

Even as large portions of their back office staff are sheltering at home, servicers have been forced to process huge volumes of payoffs and board record amounts of current production mortgages. As the below table illustrates, projected prepayment rates on 3.00% to 4.50% mortgage gross coupons have increased 50% to 123% over the last six months. Supply of and demand for MSR assets have both diminished during this period of time. Many mortgage servicers don't have the staff to process an MSR purchase or sale right now. Traditional MSR investors' back offices are already stretched thin and can't be expected to board an MSR portfolio.

Bloomberg Seasoned FNMA 30 Year Projected Speeds				
Mortgage Gross Coupon	PSA Speeds 12.31.19	PSA Speeds 6.10.20	Change In PSA	Percent Change
2.50%	110%	134%	24%	22%
3.00%	118%	233%	115%	97%
3.50%	149%	332%	183%	123%
4.00%	192%	347%	155%	81%
4.50%	217%	326%	109%	50%
5.00%	230%	286%	56%	24%
5.50%	246%	277%	31%	13%
6.00%	230%	254%	24%	10%
6.50%	246%	247%	1%	0%
7.00%	228%	246%	18%	8%
7.50%	222%	243%	21%	9%
8.00%	230%	243%	13%	6%
8.50%	256%	267%	11%	4%
9.00%	244%	253%	9%	4%
9.50%	380%	583%	203%	53%

Source: Bloomberg, L.P.

▪ **Regulatory Issues**

Mortgage servicing has evolved over the last decade into a highly regulated industry, driving up staffing requirements and servicing costs. Depending on whether a servicer is a bank or a non-bank, the servicer is often ated by multiple entities, including the Office of the Comptroller of the Currency (“OCC”), the Federal Reserve, the National Credit Union Administration (“NCUA”), the Federal Deposit Insurance Corporation (“FDIC”), and numerous state regulatory agencies. In addition to these Regulators, the Consumer Financial Protection Bureau (“CFPB”) was formed in 2011 and has put in place numerous consumer protection regulations. In 2017, the CFPB passed a number of new servicing rules affecting eight broad areas, including:

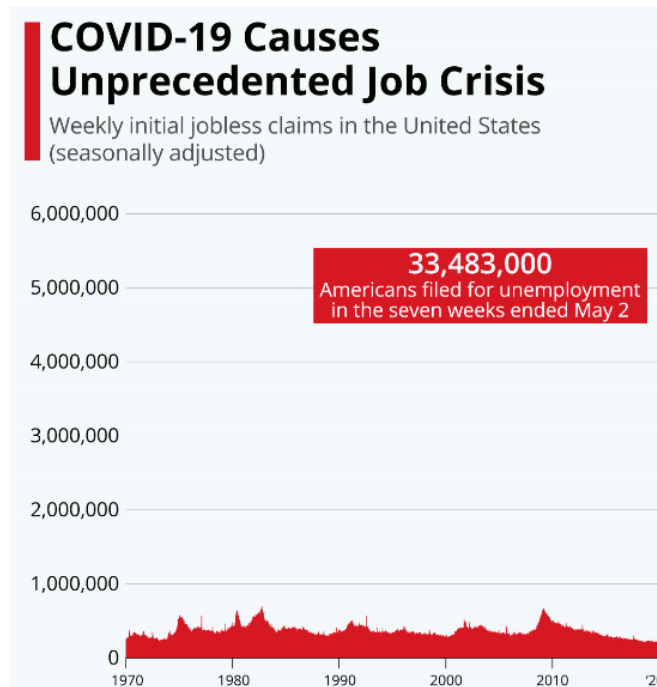
**CFPB 2017 MSR RULES**

- Periodic billing statements
- Prompt payment/payoff crediting
- Error resolution
- Continuity of contact for delinquencies
- Rate Adjustment Notices for ARMs
- Forced place insurance
- Early intervention with delinquencies
- Loss mitigation procedures

Source: CFPB, October 18, 2017. Executive Summary of the 2016 Mortgage Servicing Rule

▪ **Loan Payment Performance**

In times past, prime performing mortgage portfolios offered investors a high rate of return, increasing demand for MSR portfolios. However, COVID-19 struck in March of this year changing all of the rules. According to the US Department of Labor’s monthly report for April 2020, 33.5 million people had filed for unemployment in the previous seven weeks, and the unemployment rate jumped to 14.7%.<sup>(1)</sup> Mortgage servicers are having to process higher than normal delinquencies, bankruptcies, and foreclosures, driving up servicing costs and lowering potential rates of return to MSR investors.



Source: Statista, May 8, 2020 “COVID-19 Causes Unprecedented Job Losses” and the U.S. Department of Labor

- **The CARES Act**

President Trump signed the "Coronavirus Aid, Relief, and Economic Security Act" (the CARES Act) on March 27, 2020, in response to COVID-19 and record unemployment rates in the United States.<sup>(3)</sup> Among other things, the CARES Act provides relief to homeowners who have experienced financial hardship as the result of the virus in the form of a COVID-19 forbearance on government insured loans and loans owned by FNMA and FHLMC. The homeowner is given a 180-day delay in mortgage payments, which can be extended another 180 days. The servicer is obligated to administer the forbearance and may have to advance P&I, tax, and insurance payments for up to four months. The servicer will not receive a servicing fee as compensation for his costs incurred during this period. The amounts are recoverable when the Agencies buy the loan from the servicer. The servicer's rate of return on the MSR asset will be reduced due to the advances and non-receipt of the servicing fee during the forbearance.

### Observed Market Values

The secondary market for sold loan MSRs has been severely impacted by each of the five general factors previously discussed. Whereas the MSR secondary was vibrant and active one year ago with execution levels in the 80-90 basis point range, the market of late has seen few packages offered for sale. Execution levels of product that have been offered for sale have been around one times the servicing fee, or .25% of the principal balance of the loans being serviced. In the last month or so, levels have risen to one-and-a-half times the servicing fee, or .375% of the principal balance of the loans being serviced. Servicers don't want to sell at market lows and are not bringing MSR portfolios to market.

### Appraised Values

Capital Assets typically renders 150 to 200 MSR appraisals annually to our customers and has done so for over 20 years. These MSR appraisals have traditionally been a Type II valuation which is based upon observed secondary market activity and our in-house cash flow valuations. As the market has witnessed few MSR transactions during Q2, Capital Assets' MSR appraisals have recently been Type III valuations which utilize primarily economic values produced by an internal cash flow model. Below is an example of appraised values over the last year prepared for a typical customer:

#### EXAMPLE CUSTOMER'S MSR APPRAISED VALUES

Date	Posted Yield	PSA Speed	Average life	Appraised Value
6.30.19	3.17%	183%	6.50	0.84%
9.30.19	3.19%	188%	6.35	0.82%
12.31.19	3.29%	185%	6.40	0.84%
3.31.20	2.38%	296%	4.65	0.69%
6.20.20	2.24%	349%	4.10	0.63%

Source: FHN Financial Capital Assets Corp.

## Summary

If your institution services sold loan MSRs to third-party investors, you may need to acquire an updated valuation due to the extreme market changes during Q2. Additionally, you might want to acquire a confirmation valuation of your current MSR appraisal provider's values, as they have declined so much in the last 90 days. If so, please contact your FHN Financial account representative or Capital Assets today at 800.456.5460 for a brochure describing our MSR services and for a sample MSR appraisal.

- 1) Wikipedia, "COVID-19 Pandemic In The United States"
- 2) Statista, May 8, 2020 "COVID-19 Causes Unprecedented Job Losses"
- 3) Steptoe, March 27, 2020. "President Trump Signs CARES Act Into Law"

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