

# WHAT IS MSR VALUATION? MORTGAGE SERVICING RIGHTS 101

A WHITE PAPER BY MCT



Your Trusted Capital Markets Partner

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### ABSTRACT

Mortgage Servicing Rights (MSRs) are essential assets in the mortgage industry, offering optionality for businesses to pivot based on market conditions. As a distinct asset class, MSRs contribute to franchise value, act as a natural cross-hedge against declining production revenue, and provide liquidity through MSR financing or a sale with GSE approval. Nevertheless, MSR ownership also brings regulatory complexities, legal risks, and potentially resource-intensive management.

This whitepaper explores the fundamentals of MSRs, their advantages and disadvantages, accounting approaches, and the importance of accurate MSR valuations for ensuring profitability and compliance in today's dynamic mortgage market.

### SUMMARY AND INTRODUCTION

Mortgage Servicing Rights (MSR) play a crucial role in the financial sector, particularly in the secondary mortgage market. These rights, often traded among financial institutions, can offer substantial revenue streams but also come with their specific challenges.

Optionality is essential for success within secondary marketing. As a lender, being approved with the Government-Sponsored Enterprises (GSEs) and retaining servicing when conditions warrant allows flexibility to pivot based on the lender's strategic objectives along with what's happening with the market.

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## WHAT ARE MORTGAGE SERVICING RIGHTS?

**Mortgage Servicing Rights are simply the right to service a mortgage and collect the underlying servicing fee, but also includes responsibilities such as collecting borrower payments, customer service, and loss mitigation.** MSR's have value (and liability) distinct from the mortgage itself, and retaining an MSR portfolio is considered a key growth step for most mortgage lenders. MSR's are created when loans are sold into the secondary market. At that point, servicing assets become a distinct asset separated from the whole loan.

Predominantly, MSR's are linked to loans sold to government-sponsored entities like Fannie Mae and Freddie Mac, or Ginnie Mae (GNMA). MSR's become a distinct asset or liability when it's contractually separated from the underlying loan through sale or securitization.

When loans are sold to an aggregator, the seller receives a servicing release premium. Those particular loans are ultimately packaged by the aggregator and sold in the secondary market, most frequently directly to the GSEs or GNMA.

While the servicing asset and associated cash-flows are technically and legally owned by the GSEs or GNMA, they still are able to benefit from the cash flows that come from servicing loans. If these entities don't have the infrastructure to service loans, they can contract out third-party approved Servicers to perform the required functions such as:

- Customer service
- Collection
- Payment processing
- Loss mitigation
- Investor reporting
- Data integrity
- Accounting and reporting

## ADVANTAGES AND DISADVANTAGES OF MSR OWNERSHIP

**Owning the MSR has become increasingly popular since early 2022 when money managers, hedge funds and others increased their demand for MSR's.** That increased demand has assisted with maintaining a stable bulk market and healthy liquidity. While all positives and negatives of retaining servicing must be considered, risks are manageable depending on the business strategy and operations.

### Advantages:

- **Immediate Cash Flow:** MSR ownership generates immediate positive cash flow from the servicing fee income.
- **Natural Cross-Hedge:** Retaining servicing hedges against declining production revenue experienced during a rising interest rate environment.
- **Increased Franchise Value:** MSR enhances the overall value of the organization with an additional annuity income stream on the balance sheet.
- **Additional Execution Alternatives:** Servicing offers various options for secondary market executions. For example, if you have received GSE approval to service, you are able to retain when market conditions warrant.

## Disadvantages:

- **Capital Intensive:** Building an MSR portfolio may require a significant upfront cash investment, depending on how the business is structured/managed (e.g. in-house, servicer, etc.)
- **Resource Intensive:** Managing MSRs demands substantial resources including staffing, compliance, and reporting. Unless a servicer is leveraged.
- **Regulatory Compliance:** Owners must navigate regulations such as Basel III, CFPB, and other tax and insurance requirements.
- **Legal and Financial Liabilities:** Company-related and borrower-related legal exposure can include cash advances and loss mitigation demands.

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## ACCOUNTING APPROACHES FOR MSR

There are two primary accounting methods for MSR: Lower of Cost or Market (LOCOM) and Fair Value.

### Lower of Cost or Market (LOCOM)

This conservative approach focuses on potential losses over recognized gains. LOCOM is less volatile on the income statement, is often easier to implement and maintain, and can require fewer resources to manage.

This method doesn't adjust the value of the MSRs upward to reflect any of the current market values, so businesses using this method can avoid any unnecessary volatility and the effects of temporary market fluctuations.

While LOCOM tends to be a more measured approach, it may not represent the actual value of the long-term asset. Once the initial capitalization rate is locked in the MSR value, it flows into the balance sheet. From that point on, that balance sheet level declines.

**Recommended for:** Businesses just starting to retain MSRs

In its analysis, LOCOM considers both amortization and impairment. Generally, when MCT's MSR clients grow, they switch from LOCOM to Fair Value.

### Fair Value

Fair Value accounting is when you receive a fair value analysis from a third party (such as MCT) and use that value to book the asset. In turn, this type of accounting practice results in a higher valuation. Because fair values can change from month to month, even when a portfolio is staying the same, market volatility alone can change the valuation of the portfolio.

Fair Value accounting is considered the more dynamic approach that provides a more accurate representation of the valuation based on current market conditions compared to LOCOM. This analysis makes it easier to compare financial statements across the industry.

With its enhanced transparency on the value of the portfolio, Fair Value accounting is considered the industry standard for growing MSR portfolios, following regulatory requirements and industry best practices.

Once adopted, per GAAP and IFRS, switching back to LOCOM is not permitted.

**Recommended for:** Businesses in the growth stages of MSR retention

## THE IMPORTANCE OF MSR VALUATIONS

**MSR valuations are critical to understanding servicing profitability, asset value, and maintaining regulatory compliance.** They provide an understanding of servicing profitability and asset value, which is crucial given that MSRs have become a major revenue source for mortgage lenders post-2020.

Valuations are required by the Financial Accounting Standards Board (FASB) and Generally Accepted Accounting Principles (GAAP) and the GSEs to ensure financial transparency, accuracy, and overall risk management.

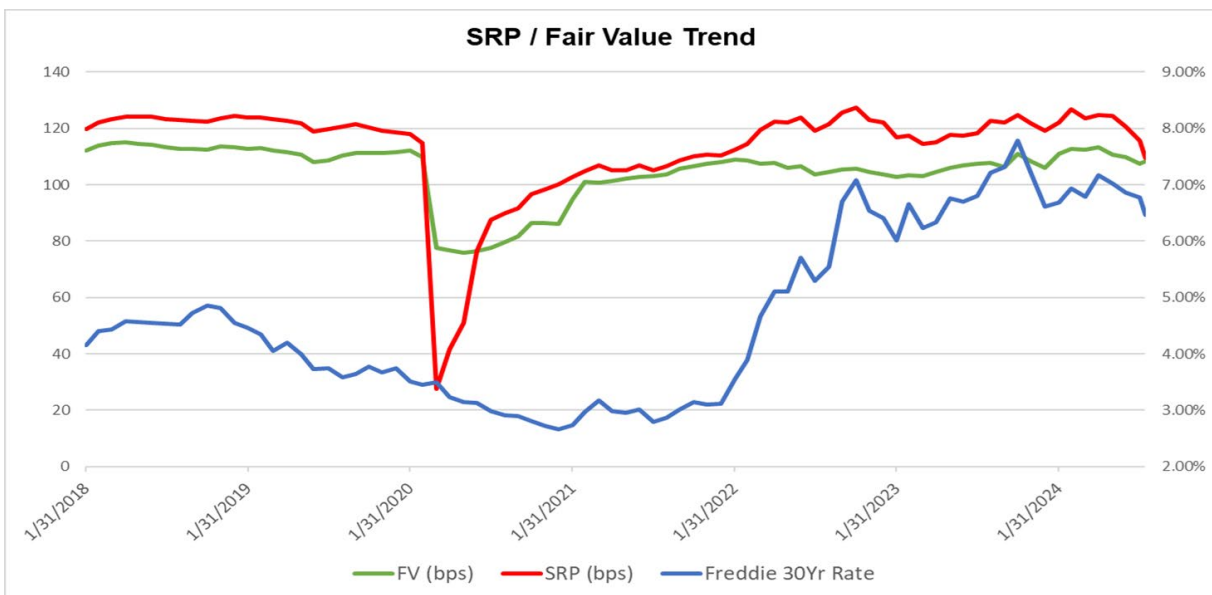
For businesses just starting their MSR journey, quarterly valuations are generally sufficient, however, valuations should take place no less than semiannually, as the value can shift dramatically over a year depending on the level of interest rate volatility. Larger and more sophisticated servicers typically leverage monthly valuations and eventually take full control of managing their MSR portfolio on a day-to-day basis through an MSR valuation platform like [MSRlive!](#)

### MSR Valuation Types

There are three primary types of MSR valuations: Market Value, Fair Value, and Economic Value.

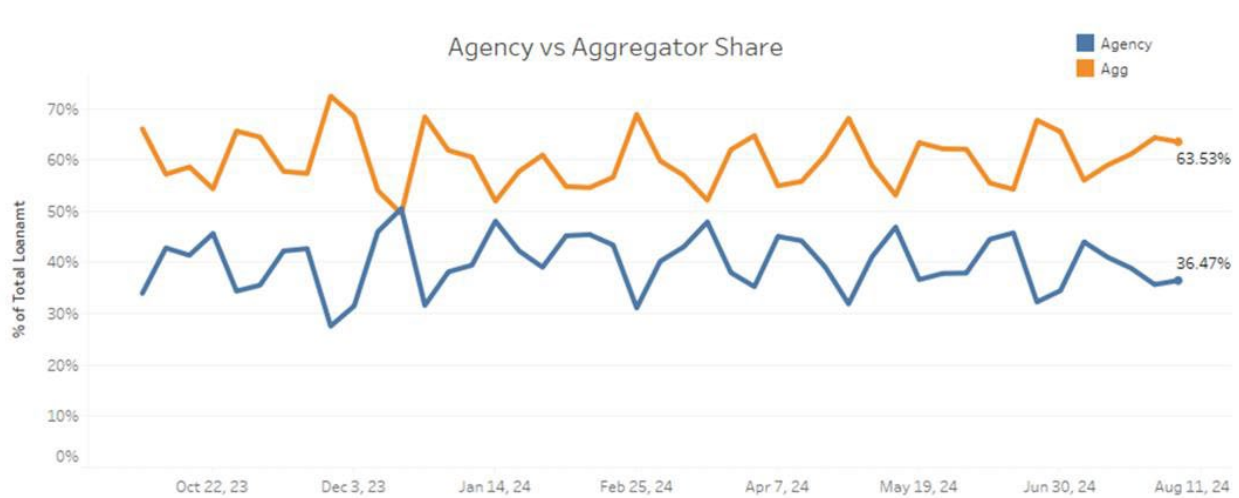
- **Market Value:** This valuation uses current market-based assumptions and actual trade activity to determine what a specific MSR portfolio would currently trade at on the open market.
- **Fair Value:** Fair value is based on third-party opinion and used for accounting purposes. When MSR bulk sales are actively trading, Fair Value tends to be in line with Market Value. However, when bulk sales are not active, approximations need to be made for Fair Value which include current Fair Value assumptions, with insights from quarterly broker surveys to help validate that those assumptions are in line with the rest of the industry.
- **Economic Value:** Economic Value is based on a company's actual valuation assumptions, such as servicing costs, earning rates on float incomes, and costs to advance. These assumptions are input into MCT's MSR model MSRlive! to generate accurately reflected cash flows for a company. This valuation is essential for companies to get a better understanding of their cash flows and the MSR asset.

The graph below illustrates the difference between the Fair Value and the Market Value (represented as Service Release Premium (SRP)):



Let's consider the Retained vs. Released Market. It's not uncommon for industry players to assume that pricing levels for the various executions are relatively stable, constant. However, values for flow MSRs since the pandemic have been relatively volatile from time to time.

As the below graph illustrates, the number of MCT clients electing to go with an aggregator and release (SRP) the MSR when selling (63.53%) has fluctuated dramatically, even over the last month. Historically, the released percentage has reached approximately 80% periodically, but the week-to-week volatility reinforces the necessity to monitor levels frequently and pivot to retention when warranted.



## KEY VALUATION DRIVERS

**Servicing fee income is the leading component of MSR values** followed by escrow earnings. There are several additional drivers behind MSR valuations including:

- Investor types
- Remittance cycles
- State/location
- Coupons
- LTV
- FICO scores
- Interest rates
- Earning rates

### Investor Types

The type of investor (e.g., Fannie Mae, Freddie Mac, Ginnie Mae) impacts the remittance cycles and float income periods. The float income period represents the number of days that the servicer is able to hold onto the principle and interest payments before remitting to the GSEs.

The discount rates of different products can also impact valuations. Since Ginnie Mae tends to include relatively more risky collateral, a 12% discount rate would be reasonable, whereas a 9.5% discount rate would be reasonable for their counterparts, Fannie Mae and Freddie Mac.

## Remittance Types

- **Actual/Actual (Fannie Mae):** For this cash window execution, the servicer remits the actual principal and interest payments received from the borrower. Actual/Actual generally has lower operational and financial exposure for the servicers.
- **Scheduled/Actual (Freddie Mac):** The servicer is required to remit the scheduled interest and actual principal payments to the GSEs. For example, if the borrower defaults on their payment, the servicer still must remit the scheduled interest payment (advances) but is not required to remit the principal amount. Scheduled/Actual introduces more risk for the servicer because of the cash advance responsibilities. Although, Servicers can increase profitability by taking advantage of float income, the number of days the interest payments are being held before being remitted to the investors (GSEs). For example, those funds can be held in an interest-bearing account creating flow income. In some cases, this predictable cash flow can also lead to a higher valuation of MSRs. When choosing the “Actual/Actual” option via Fannie Mae’s cash window, servicers don’t have to advance principal and interest when the borrower defaults. That said, the servicer will always be on the hook for the tax and insurance advances.
- **Scheduled/Scheduled (Fannie Mae and Ginnie Mae):** The servicer is remitting the scheduled principal and interest payments to the investors (GSEs) whether or not the payments are received from the borrower. Under Scheduled/Scheduled, servicers must make advances to cover the P&I for delinquent loans.

## State/Location

There are several reasons why each state can cause different MSR valuations including the economy, prepayment, foreclosure, and unpaid balances (UPBs).

- **Prepayment Speeds:** Prepayment speed expectations are a significant driver of MSR value and bulk trade multiples. Prepayment volatility is primarily driven by interest rate volatility, but also impacted by home prices, the economy, and the geographical region. MCT monitors prepayment speeds and updates its model accordingly.
- **Foreclosure Challenges:** Longer foreclosure timelines can lower valuations for MSRs.
- **UPBs:** Lower loan balances can increase the value of the MSR portfolio as prepayment risk is generally lower.
- **Economy:** Home prices can be a driver for MSR valuations.

## Note Rates

The two primary situations related to note rates that impact MSR valuations are if the current market rates are higher than the loan and if current market rates are lower than the loan.

When market rates are higher than the loan, the likelihood of a refinance is lower, and the value of the servicing is higher.

When market rates are lower than the loan, the borrower is considered “in the money”, meaning the likelihood of a refinance is higher, and the valuation is lower.



## Loan-to-Value (LTV)

When LTV is high due to a smaller down payment on the loan, it generally translates into a higher monthly payment. Higher monthly payments expose the loan to potential delinquencies, making the MSR valuation lower.

In contrast, a lower LTV from a higher down payment generally translates into lower monthly payments and less delinquency potential. That said, lower LTVs can also lead to faster prepayment speeds because those borrowers tend to have higher credit scores and are more likely to have refinance options.

## FICO Scores

FICO scores play a similar role as LTV in valuations where they impact both delinquency potential and prepayments. Higher credit scores can contribute to faster prepayments and while they do indicate a more stable borrower, higher scores tend to result in borrowers who are most sensitive to rate changes and therefore have a higher risk of refinancing more often.

Lower credit score borrowers tend to have a longer loan duration, however they can end up with higher delinquency.

## Prevailing Market Interest Rates

The 30-year prevailing mortgage interest rate can lead to lower prepayments or higher prepayments, depending on the underlying characteristics of the MSR Portfolio in question.

As mortgage rates increase, prepayment will decline, and the MSR value will increase. As rates decrease, the opposite is true with higher prepayments will lower the MSR value for existing portfolios.

## Earning Rates

Servicing fee income is the leading component of MSR values followed by escrow earnings as servicers gain interest payments annualized between 3-5%.

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## ACHIEVING PRICING AND VALUE CONTINUITY

**The importance of MSRs in the profitability of mortgage lenders has been a driver for years, but even more dramatic since COVID.**

As many new MSR Investors have entered the market over the past few years, it's essential to understand how to manage the asset effectively. Achieving pricing and value continuity can assist with increasing certainty and limiting balance sheet volatility.

Stability and continuity starts at the time of loan sale, with granular MSR pricing and the assumptions and principles behind how it's booked.

Generally, there's inconsistency around how managers Mark-to-Market the asset and how street rates are established.



Notably, aggregators price with an SRP (servicing released premium) value which is essentially Market Value-based as opposed to Fair Value. We recommend that servicers not utilize SRP grids when determining how to book their retained servicing. To limit balance sheet volatility, the most prudent approach would be to utilize Fair Value grids when booking the asset, as that would be considered the center point, middle of the road.

Establishing a consistent and granular approach to MSR pricing will assist with achieving predictability. Starting with a stable foundation by leveraging Fair Value grids to inform Mark-to-Market and Street Rate Pricing, will lead to consistency specific to the balance sheet and MSR Portfolio Valuations.

Granular pricing means that every loan has its own value from an MSR perspective. The less sophisticated approach of applying a static 4:1 multiple across all product types including different Note Rates, FICOs, geographies, etc. results in the MSR being mispriced or inaccurate in most cases.

To maintain a competitive position, and price loans in a prudent and strategic way, establishing granular MSR pricing must be a part of the strategy.

MCT's EBX tool automatically pulls loan pipeline data from [MCTlive!®](#) and portfolio characteristics from [MSRlive!®](#) to give traders and portfolio managers actionable insights for retain-release decisions. Define your typical loan characteristics to generate a pricing grid in minutes with our patented cloud-based software.

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## SUMMARY OF MORTGAGE SERVICING RIGHTS

**Managing Mortgage Servicing Rights (MSRs) is key for businesses to thrive in the changing mortgage market.** MSRs provide immediate cash flows, long-term value, and flexibility to adapt to market conditions. They help hedge against declining production revenue, enhance franchise value, and offer liquidity for financing or sale.

Strategic management, accurate valuations, and the right accounting practices are essential for leveraging MSRs to maintain profitability and a competitive edge in a volatile market.

MCT's webinar, "[MSR Risk Management, Compliance & Current Market Strategies](#)" helps build on these foundational topics to enhance your portfolio's income with regulatory best practices, tips to avoid common MSR management mistakes, and current MSR pricing trends.

[Schedule a strategy consultation](#) with our team of MSR experts today.

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## ABOUT MORTGAGE CAPITAL TRADING

For over two decades, MCT has been a leading source of innovation for the mortgage secondary market. Melding deep subject matter expertise with a passion for emerging technologies and clients, MCT is the de facto leader in innovative mortgage capital markets technology.

From architecting modern best execution loan sales to launching the most successful and advanced marketplace for mortgage-related assets, lenders, investors, and network partners all benefit from MCT's stewardship. MCT's technology and know-how continue to revolutionize how mortgage assets are priced, locked, hedged, traded, and valued – offering clients the tools to perform under any market condition.

For more information, visit <https://mct-trading.com/> or call (619) 543-5111.