Volatile Rates Cause Servicing Repricing

HOUSTON.—The volatile interest rates of the past two years have caused buyers and sellers of loan servicing to reevaluate their pricing methods, according to a broker here.

Larry Kirshner, first vice president, Westcap Corp., which specializes in brokering servicing, said that the rule of thumb used to be that a servicing portfolio traded at 1% of the note amount, regardless of its characteristics and value.

Volatile interest rates have put an end to that, he said.

"The combination of sophistication and volume opens windows of opportunity for buyers and sellers in the servicing marketplace," Mr. Kirschner wrote in a recent issue of the Federal Home Loan Mortgage Corp.'s *Secondary Mortgage Markets.*

The most common reason for selling servicing, he noted, is to recognize income. Once an institution sells the servicing, it books the revenue as immediate income, rather than as income over the life of the servicing.

Selling servicing, wrote Mr. Kirschner, also allows an institution to raise cash quickly, due to the servicing's extreme liquidity.

He also noted that an institution may decide to sell only a portion of its servicing—a portion that it may not have the expertise to handle.

For instance, he wrote, a seller with neither the staff nor the system to service Federal Housing Administration or Veterans Administration loans may sell its Government National Mortgage Association servicing and concentrate on the kind of servicing it can handle more efficiently.

On the other hand, buyers purchase servicing in the secondary market in order to take advantage of its high yield.

Mr. Kirschner pointed out that the yield is not risk free and the "risk/reward" factor should be considered.

He emphasized that for whatever reason an institution buys or sells servicing, it must investigate and evaluate the portfolio thoroughly before closing the deal.

Some of the factors to be considered are: the weighted average servicing fee, weighted average loan interest rate, weighted average original maturity, weighted average loan age, weighted average loan size, number of loans, number of investors, average escrow or impound balances, late fee provisions, types of loans, float from principal and interest, geographic diversification or concentration, amount of foreclosure exposure, and delinquency and foreclosure history.

One of the most important objectives that both buyers and sellers use to value servicing is the desired yield, he wrote.

The seller, Mr. Kirschner pointed out, should always calculate the value of a given portfolio before deciding to sell it. He should compare the yield of the servicing to the potential yield of the proceeds from the sale.

The Westcap executive noted that two important assumptions that analysts make to determine the value of loan servicing are future prepayments and future interest rates.

However, the relationship between prepayments and interest rates is "nonlinear."

Since volatile interest rates are increasing the risk for buyers of servicing, the risk should be reduced through hedging.

"A good hedge works," he wrote, "because the value of the hedge moves inversely to servicing income."

As interest rates fall, prepayments increase. The loss of anticipated income from a purchased portfolio can be offset with a gain in financial futures markets, according to Mr. Kirschner.

As interest rates rise, the financial futures markets decline and the loss can be offset by the servicing portfolio, which, he wrote, will produce a greater-than-expected income stream because prepayments will be slower and earnings will be greater than anticipated on impound and escrow balances.

Mr. Kirschner advised investors to be aware of the dangers involved in hedging.

If interest rates rise slowly and prepayments increase on the packages being hedged, the investor will lose both servicing and hedging income.