Coping with Risks in the Servicing Marketplace

By Larry R. Kirschner

The technical valuation of loan servicing is in its infancy and is currently undergoing great change. Now is the time for new participants in the servicing portfolio marketplace as well as experienced traders, to become familiar with new techniques. The expanding market has also created a greater need for use of the broker and a new definition of his/her role.

Until as recently as the early 1980s, servicing was commonly traded at one percent regardless of its characteristics and imputed value. The volatility of interest rates caused buyers and sellers of loan servicing to realize the correlation of interest rates to servicing income, forcing them to reevaluate their pricing methods. The market is now moving to highly sophisticated techniques for evaluating servicing; this change has been accompanied by tremendous increases in the volume of servicing being traded. As these factors continue to expand, a window of opportunity opens for buyers and sellers in the marketplace; but along with these opportunities comes a certain element of risk for those buyers and sellers who may be uninformed or slow to react.

The activity of the past few years has caused a number of things to happen. Buyers have experienced segments of their portfolios prepaying at more rapid rates than ever before such that in some cases loans have prepaid before the purchase price could be amortized; some buyers have grossly overpaid for portfolios and have purchased packages they did not fully understand. Sellers have sold packages they should have retained or accepted prices below the true market. The marketplace is constantly changing, and both buyers and sellers need to be well informed and cautious in order to execute prudently as opportunities arise.

The continued volatility of interest rates (particularly lower rate scenarios) is becoming an increasing element of risk to the buyers of servicing. This interest rate risk can be reduced by hedging strategies that will be addressed later in this article.

Calculated Present Value

The calculated present value of loan servicing is obtained by discounting (at a given discount rate) all expected cash flows (net of expected expenses) over the life of the portfolio to establish a value in today's dollars. There is a considerable amount of data that must be collected for the valuation of loan servicing. Each corporation values a package differently and uses different priorities. Some of the most important information needed for any valuation is as follows:

- 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 and impound balances
- types of advances that must be made (if any)
- rate that must be paid to the borrowers on impound balances
- late fee provisions
- types of loans (fixed or variable, conventional or government etc.)
- P & I float (amount and time)
- geographic diversification or concentration
- amount of foreclosure exposure
- delinquency and foreclosure history.

The items listed above are known factors about a certain portfolio; the other elements used in the valuation of loan servicing are, of necessity, assumptions. Some of these assumed factors include:

- future rate of prepayments
- interest rate used to discount the cash flows
- delinquency and foreclosure projections
- future growth rate for servicing costs
- future growth rate for impound and escrow balances
- future interest rate earned on escrow and impound balances
- collection rate of late fees
- estimated cost of conversion of the portfolio.
- the method of amortization of the purchase price for tax purposes

Again, it is important to remember that because of these assumed factors, there will always be many interpretations in the value of a single package.

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Calculated Value Versus Market Price

A combination of the factors listed above can be used to determine the calculated value, which should then be related to the market price. The market price is the actual price upon which an independent buyer and seller agree to execute a trade. The relationship between the market price and the calculated value is important to both buyers and sellers. Buyers should look for lower market prices than the calculated value they assign to a portfolio. For instance, a portfolio may calculate at 3.50 percent, but the market may have a psychological barrier against paying more than 3.00 percent. Buyers should attempt to optimize the relationship of calculated value to price paid by having or working with brokers who have a good knowledge of current market levels for various types of servicing. This portfolio could be purchased at approximately a 14 percent discount from calculated value.

Sellers should also calculate their own value and relate it to the market price. If the market price is not within an acceptable range of the calculated value, then the package should not be traded. Since people calculate value differently, there will be differences of opinion. By the same token, however, it is almost always possible to arrange and rearrange packages to suit the needs and purposes of both the buyer and seller.

Future Prepayments

Of the many factors involved, future prepayments are one of the most important assumptions to be made in determining the value of loan servicing. Tremendous research on prepayments has been conducted in the mortgage-backed securities markets in recent years. The same concepts used there should be applied to the area of loan servicing. While there is no definitive answer to the question of future interest rates or future loan prepayment rates, one can take advantage of available research to assist in making educated projections.

When considering a specific portfolio offering, historical prepayments on the loans in the offering (or similar loans) compiled by interest rate and geographic breakdown, should be referenced when projecting future patterns of prepayments. Keep in mind that certain regions of the country seem to consistently prepay faster than others. Another factor to consider is that higher interest rate loans prepay faster than lower interest rate loans. However, the relationship of the increase in prepayments to the decrease in interest rates should be addressed.

For example, because a 14 percent Ginnie Mae may prepay 50 percent faster than a 12 percent Ginnie Mae, this does not imply that a 16 percent Ginnie Mae prepays fifty percent faster than a 14 percent Ginnie Mae. There is a great deal of research available on government and conventional loan rates of prepayment. All of these elements should be used when formulating an estimation of future prepayment patterns.

Hedging

As previously mentioned, a certain amount of all valuations must be based on assumptions; therefore, it is essential to build protection devices into your strategy. Hedging is a device that can be applied to help protect loan servicing acquisitions. This type of hedging is not an exact science but will aid in reducing future prepayment risk due to falling interest rates. A good hedge works because as interest rates fall prepayments increase, causing a loss of anticipated income from a purchased portfolio. This loss of income can be offset with a gain in the financial futures markets. Conversely, as interest rates rise there will be a loss in the financial futures markets, which should be offset by a greater than expected income stream from the servicing portfolio due to slower than expected prepayments and greater than expected earnings on impound and escrow balances.

There cannot be a perfect hedge, so exact earnings cannot be projected. However, if the hedge is executed and monitored properly, it will keep the earnings somewhat stable and guard against huge losses, while still allowing for higher than expected earnings.

The Role of the Broker

Now more than ever the broker plays an important part in many servicing transactions, and this role is changing as the marketplace changes. The broker plays the role of the intermediary, whose function ranges from locating appropriate bidders to being familiar enough with the secondary market to help both the buyer and seller determine economic and market value ranges. Take time to find a knowledgeable broker who is familiar with all of the aspects of a servicing sale transaction and is able to help both the buyer and seller determine a fair market value.

Communication with industry peers and affiliations is a good way to locate brokers who specialize in servicing. Ask the broker about his or her experience in trading servicing, general experience in the industry, and the types of clients he or she deals with. The broker should be able to supply all necessary prepayment statistics and to professionally package the offering. It is advisable for the seller to use only one broker to market its package. A package can become overexposed very easily. Most buyers agree that if a package is shown to them by more than one person, it will lose their interest if not its value as well. A package that is overexposed gives the appearance that the seller is desperate to sell and creates the illusion that there is more servicing on the market than there is in actuality. Since the market is dictated by supply and demand, this appearance of more servicing falsely increases the supply, causing prices to fall.

Professional, accurate, and complete packaging of the portfolio is essential so that buyers will have access to all of the data needed and not waste time requesting information that should already be included. Assume a seller is selling a package of servicing that has fifty percent fixed-rate loan servicing and fifty percent adjustable-rate loan servicing. As the package is being marketed, two buyers are interested in it. One buyer may be an aggressive bidder for fixed-rate servicing, while the other buyer may be interested only in adjustable-rate servicing. The package must be clearly presented so that it can be bid in two segments to take advantage of both buyers. Each segment of the package must be examined on its own specifications and then shown to bidders accordingly. If a bidder likes ARMs or favors a certain region of the country, he or she must be made aware that these portions of the package can be bid separately.

Sellers must remember that the highest bid is not always the best bid. Recently a bid was accepted that was 75 basis points higher than the rest of the bids, but the seller should have been leery of this huge price differential. However the bid was accepted without question. When the buyer realized the true market value several weeks later, he backed out of the contract prior to the transfer of the servicing. The seller had to remarket the package and ended up losing the competitive bids that had earlier been submitted. A knowledgeable broker could have helped the seller to see the possible risks in this bid.

Another function of a broker is to maintain client confidentiality by showing the portfolio anonymously for the seller. It is important for a broker to maintain the seller's integrity by showing the package discreetly. Conversely, buyers only want their name known to sellers and brokers that will show complete packages that are within their buying guidelines. A buyer of fixed-rate, geographically concentrated servicing should not have to waste time reviewing a package of ARMs spread throughout the country. Sellers should make sure that the broker they select does not show their package to other brokers or randomly mail packages without first contacting potential bidders.

Buyers beware of a broker who has no knowledge of what he is marketing. He or she can unknowingly misrepresent a package. Try to personally get to know your broker; the name of a reputable firm does not always insure his or her competency. Evaluate each broker on his or her own merits. With a little homework, careful consideration of the factors of valuation, and the help of a knowledgeable broker, buying and selling servicing packages can be painlessly and profitably achieved.