FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2023 - 01: Valuation of Mortgage Servicing Rights for Managing Counterparty Credit Risk

Purpose

This Advisory Bulletin communicates FHFA's supervisory expectations for Fannie Mae and Freddie Mac (collectively, the Enterprises or individually, an Enterprise) to establish and implement risk management policies and procedures for monitoring and valuing seller/servicers' mortgage servicing rights (MSRs).[1,2] Enterprise-wide risk management policies and procedures should be commensurate with an Enterprise's risk appetite, and based on an assessment of seller/servicer financial strength and MSR risk exposure levels. Although seller/servicers assign values to their MSRs, the Enterprises should have their own processes to evaluate the reasonableness of seller/servicer MSR values.

This bulletin applies to only MSRs for single-family mortgage loans and is effective April 1, 2023.

Background

FHFA's Prudential Management and Operations Standards set forth guidance in Part 1236's Appendix A that the Enterprises should have overall risk management processes that ensure the identification, management, monitoring, and control of risk exposures. In addition, the overall risk management processes should include timely, accurate, informative risk reports, and alignment of the Enterprise's overall risk profile with its mission objectives. Collectively, the Enterprise's three lines of risk management - business unit, enterprise risk management, and internal audit - each have ownership responsibilities for identifying, monitoring, assessing, and controlling risks, including those risks attendant to counterparties and the valuation of MSRs.[3]

The Enterprise relies on seller/servicers to perform mortgage loan servicing activities, which include collecting and remitting monthly payments of principal and interest, and sometimes

[1] The term "Seller/Servicer" as used in this bulletin includes all entities that sell single-family mortgage loans to the Enterprises or perform single-family mortgage loan servicing for the Enterprises.
[2] An MSR is an expression of the value of a seller/servicer's rights to service mortgage loans on behalf of the Enterprise and does not create any legal rights of ownership for seller/servicers. These rights to service mortgage loans are contract rights terminable with or without cause by an Enterprise.
[3] 12 CFR 1236, Prudential Management and Operations Standards, Standard 8 – Overall Risk Management Processes

collecting and remitting taxes and insurance, for mortgage loans it has guaranteed or purchased. Servicing activities also include performing specific requirements for delinquent mortgage loans, including loss mitigation and management of foreclosures. The Enterprise compensates seller/servicers for their loan servicing activities. The right to receive future cash flows from servicing mortgage loans is commonly referred to as an MSR, which seller/servicers typically record as an asset for financial accounting purposes, and whose value is equal to the discounted present value of future cash flows, adjusted for expected prepayment speeds. MSRs can enhance income, capitalization, and collateral for financing of seller/servicers.

Through their contractual commitments and obligations to the Enterprise, seller/servicers expose the Enterprise to risks the Enterprise should monitor, assess, and control. The Enterprise is exposed to counterparty credit risk when seller/servicers provide representations and warranties that mortgage loans conform with its selling guide requirements. For example, if a mortgage loan does not meet selling guide requirements, the Enterprise may require a seller/servicer to repurchase the defective mortgage loan. A seller/servicer's selling commitments and servicing obligations are also a source of counterparty risk to the extent that the seller/servicer does not meet selling and servicing requirements. Failure to meet such obligations and commitments may cause the Enterprise to incur credit losses and operational costs.

The Enterprise mitigates seller/servicer credit risk through a framework of financial eligibility standards, ratings, limits, and ongoing monitoring to assess a seller/servicer's financial strength and operational practices. MSRs are an important component in the Enterprise's evaluation of a seller/servicer's financial capacity. Accordingly, the Enterprise's three lines of risk management should have an overall risk management framework that ensures MSR values are reasonable, objective, and transparent.

Guidance

A. *Objective Evaluation of MSR Values*

MSR values have a high level of uncertainty due to various factors including interest rate changes, spreads, option volatility, prepayment speeds, and Enterprise termination rights. In addition, market conditions can significantly increase or decrease MSR values as market participants acquire MSRs at varying multiples of cashflow. As such, MSR values can fluctuate greatly even during periods of low market volatility. Seller/servicers and other market participants may value MSRs based on differing model assumptions, levels of sophistication, and strategic objectives. These differences can cause volatile MSR values. For these reasons, the Enterprise should not accept MSR valuations provided by seller/servicers without an independent evaluation. The Enterprise's counterparty credit risk management policies and procedures should require the Enterprise to estimate its own MSR values based on the Enterprise's informed assumptions to ensure values are reasonable and transparent to the three lines of risk management. The Enterprise should document the rationale for the MSR valuation and ensure it is appropriate and prudent for its intended use in managing counterparty credit risk. The Enterprise's counterparty credit risk management policies and procedures should address situations where seller/servicer-provided MSR values are materially different from the

Enterprise's estimated values. The policies and procedures should specify criteria for what constitutes a material difference and how to manage the related counterparty credit risk.

B. *MSR Valuations for Mortgage Loans Owned or Guaranteed by the Enterprise and Stress Testing*

Many seller/servicers' MSR portfolios include Fannie Mae, Freddie Mac, Ginnie Mae, and private label mortgage loans. The Enterprise should establish and maintain processes to model MSR values for mortgage loans that it owns or guarantees.[4] As with any model-driven process, the Enterprise should ensure that model assumptions are reasonable, defendable, and applied in a consistent manner across mortgage loans with similar characteristics. These inputs may include information on mortgage loan characteristics such as unpaid principal balance, coupon rate, and contractual servicing fee, among other data. Assumptions may include interest rates and related forecasts, discount rates, expected prepayment speeds, cost to service, ancillary income, home price forecasts, and unemployment rates, among others.

In addition to inputs and assumptions, the Enterprise should incorporate stress scenarios to better estimate the potential range of MSR values and their effects on the seller/servicer's financial capacity. For example, stress testing may include adjusting certain macroeconomic model assumptions to reflect economic downturns. The Enterprise should also incorporate reverse stress testing where certain macroeconomic model assumptions are adjusted such that MSR values may compromise the seller/servicer's continuing eligibility to conduct business with the Enterprise.

The Enterprise should ensure that MSR valuation models use sufficient information to support its model outputs and adhere to FHFA's relevant Advisory Bulletin guidance.[5]

C. *MSR Valuations for Mortgage Loans Not Owned or Guaranteed by the Enterprise*

The Enterprise should establish and maintain processes to assess MSR values for mortgage loans it does not own or guarantee, but it is unlikely to have sufficient data to model MSR values for such loans (although the lack of sufficient data does not necessarily preclude the Enterprise from modeling MSR values). However, seller/servicers regularly provide the Enterprise with information on their MSR portfolios, such as general mortgage loan characteristics and certain MSR valuation assumptions, along with the MSR value. Some seller/servicers also commission independent audits and third-party valuations that may contain additional MSR portfolio information. Using this information or other appropriate sources, the Enterprise should assess the reasonableness of the seller/servicer's MSR valuations for mortgage loans that it does not own or guarantee and adjust the valuations accordingly.

[4] The Enterprise may use a risk-based process to evaluate MSR values for depository institutions since they are generally less reliant on MSRs than other seller/servicers. The risk-based process should involve criteria for assessing rather than modeling their MSR values based on the depository institution's financial strength or other appropriate factors.

[5] Relevant FHFA guidance includes AB 2022-02: *Artificial Intelligence/Machine Learning Risk Management* and AB 2013-07: *Model Risk Management,* and other guidance as applicable.

D. *Market Data Input*

Beyond the characteristics of the underlying mortgage loans and prevailing economic conditions, MSR values are significantly influenced by market activity. It is therefore important for the policies and procedures of the Enterprise's counterparty credit risk management to account for market factors when estimating MSR values. The Enterprise should regularly conduct market research, which may include information on recently traded MSR portfolios, and other proxies for valuation such as servicing fee multiples or capitalized values. This information can be useful in estimating MSR market values and should be used to benchmark values against the Enterprise's internally produced MSR valuation. Furthermore, during periods where values are high or volatile, the Enterprise should consider potential decreases in MSR market values.

E. *Use of Third-Party Providers*

The Enterprise may engage third-party providers for various aspects of the MSR evaluation process, which may include providing MSR valuation models and model inputs, information for benchmarking or risk management purposes, or other applicable services or products.[6] To the extent third-party providers are used to model or assess MSR values, the Enterprise should have adequate processes and controls to ensure its understanding and agreement with the third-party provider's valuation inputs, assumptions, and outputs. Such processes and controls are important for the Enterprise's independent evaluation of the seller/servicer's MSR valuation.

F. *Frequency of Evaluations*

Evaluations of seller/servicer MSRs should be risk-based and consistent with the Enterprise's risk appetite and counterparty risk management framework. In general, the Enterprise should evaluate MSRs more frequently for seller/servicers with higher volumes and exposure levels. At a minimum, the Enterprise's counterparty credit risk management policies and procedures should require an evaluation within a reasonable period after seller/servicers report MSR values to the Enterprise.

G. *Discount to MSR Values When Servicing Rights Are Terminated*

The Enterprise has certain contractual rights to revoke servicing upon a seller/servicer's failure, default of its obligations, or for other reasons, in which case it may transfer the servicing to another seller/servicer. To plan for adverse financial outcomes during the transfer of the servicing asset, the Enterprise should apply discounts to its estimated MSR values to manage counterparty risk prudently. The discount should reflect economic stress and market uncertainty, including potential price fluctuations, transaction costs, and operational costs incurred during the servicing transfer period. A discounted MSR value can provide the Enterprise a more conservative estimate of its exposure during periods of seller/servicer-specific or broader market stress and can allow the Enterprise to manage counterparty risk more effectively.

[6] When using third-party providers, the Enterprise should adhere to Advisory Bulletin 2018-08: *Oversight of Third-Party Provider Relationships.* The Enterprise should identify and mitigate any actual or potential third-party provider conflicts of interests that may be embedded in any data, model, valuations, or other products or services procured.

Related Guidance and Regulations

Model Risk Management, FHFA Advisory Bulletin 2013-07, November 20, 2013

Artificial Intelligence/Machine Learning Risk Management, FHFA Advisory Bulletin 2022-02, February 10, 2022

Oversight of Single-Family Seller/Servicer Relationships, FHFA Advisory Bulletin 2014-07, December 1, 2014

Contingency Planning for High-Risk or High-Volume Counterparties, FHFA Advisory Bulletin 2013-01, April 1, 2013

Oversight of Third-Party Provider Relationships, FHFA Advisory Bulletin 2018-08, September 8, 2018

Enterprise Risk Management Program, FHFA Advisory Bulletin 2020-06, December 11, 2020

12 CFR 1236, Prudential Management and Operations Standards, Standard 8 – Overall Risk Management Processes

12 CFR 1236, Prudential Management and Operations Standards, Standard 9 – Management of Credit and Counterparty Risk

FHFA has statutory responsibility to ensure the safe and sound operations of the regulated entities and the Office of Finance. Advisory bulletins describe FHFA supervisory expectations for safe and sound operations in particular areas and are used in FHFA examinations of the regulated entities and the Office of Finance. Questions about this advisory bulletin should be directed to: **SupervisionPolicy@fhfa.gov**.