RICHEY MAY & CO

Accounting for Mortgage Servicing Rights

September 2015

In mortgage banking, companies originate and acquire mortgage servicing rights as a source of additional revenue and as a natural hedge against the production side of the business. It also enhances their ability to maintain relationships with borrowers as they perform the servicing function. The following whitepaper discusses the treatment of mortgage servicing rights for both financial statement and tax reporting purposes.

Accounting for Mortgage Servicing Rights

By: Jennifer Hannah, CPA – Audit Partner | **Josh Ratner** JD, CPA, LLM – Tax Manager

Mortgage Servicing Rights

Mortgage servicing rights (MSRs) are a significant revenue source for a growing number of independent mortgage banking companies and community banks. In changing interest rate environments, MSRs can create a natural hedge against the production side of the business. As mortgage interest rates rise, prepayment speeds typically slow down and the value of MSRs generally increases. Conversely, as mortgage interest rates fall, prepayment speeds increase and the value of MSRs generally decreases. Although retaining servicing rights requires a significant amount of cash, MSRs can be a good source of fee income and can add value to mortgage banking companies, particularly in rising interest rate environments.

FASB ASC 860-50, *Transfers and Servicing* (*ASC 860-50*), outlines the accounting and reporting requirements for MSRs. Under *ASC 860-50*, a company shall recognize a servicing asset or liability when it enters into a servicing contract and the contract creates an obligation to service a financial asset. The MSR asset can only be recognized once control over the related mortgage loan held for sale is surrendered by the company. This surrender typically occurs when the loan is sold to an investor and is outside the reach of the company's creditors.

Disclaimer

This is a highly complex area of accounting and tax that is often not understood by professionals without specialized expertise in the area.

Please feel free to contact us with any questions.

Initial Recording of Mortgage Servicing Rights

After a loan is sold servicing retained and control of the loan is surrendered, the MSR should be capitalized at fair value and subsequently accounted for using either the *amortization* or *fair value method*. When the MSR is initially capitalized, an asset is recorded to the balance sheet and income is recorded through the statement of operations for the full fair value of the asset. The initial recording of the MSR asset is not a taxable event, as there is zero basis in the asset for tax purposes.

The fair value of the MSR asset is best determined by quoted market prices, if available. However, since MSRs are not actively traded in the open market, a valuation model that calculates the present value of future cash flows is the most commonly used methodology for determining the fair value of MSRs. When using this model, the MSRs are stratified into tranches, typically based on loan term, interest rate and product type. The various models incorporate assumptions that market participants, if not necessarily the company itself, would use in estimating the future net servicing income tied to the MSRs. The key assumptions used are typically prepayment speeds, discount rates, the cost to service the loan, and delinquency rates. Other assumptions used can include such items as contractual service fees, ancillary income and late fees, float value, and the inflation rate. Given the number of assumptions used in valuation models, considerable judgment is required to estimate the fair value of MSRs, and changes in these assumptions could materially affect the estimated fair value of the servicing rights.

MSRs purchased from third parties are recorded at the purchase price, which is assumed to be the fair value.

Amortization Method

After initially capitalizing MSRs at fair value, under the a*mortization method,* the MSRs are amortized over the estimated economic life of the related mortgage and the asset is amortized in proportion to the estimated expected future net servicing revenue generated from servicing the loan. The amortization expense related to the MSR asset is not deductible for tax purposes since taxable income was not recognized when the asset was initially capitalized.

MSRs should be evaluated for impairment at least every reporting period, if not more frequently. Impairment occurs when the MSR asset, net of accumulated amortization, is carried at an amount in excess of the estimated fair value of the servicing right. If there is deemed to be an impairment of the MSR asset, a valuation allowance should be recorded to bring the asset down to fair value. If it is later determined that all or a portion of the impairment for a specific stratification of MSRs no longer exists, then the previously impaired asset can be recovered and the valuation allowance is reduced through a recovery to earnings. This recovery cannot be in excess of the previous impairment and must be applied to the same stratification on which impairment had originally been taken.

The *amortization method* typically results in less volatility in earnings than does the *fair value method*. The *amortization method* also results in a more conservative balance sheet. However, the accounting is more complex, which creates an administrative burden on accounting staff.

Fair Value Measurement Method

If the f*air value method* is chosen to account for MSRs, the MSRs are measured at fair value each reporting period and the changes in fair value are recorded to earnings in the period in which the fair value changes occur. Similar to the *amortization method*, MSRs are evaluated periodically to determine that capitalized amounts are not in excess of their estimated fair value. Impairment in fair value is recorded directly to the MSR asset under the *fair value method* and no valuation allowance is needed. Changes in fair value of MSRs are not taxable.

The *fair value method* creates additional volatility compared to the *amortization method,* as fluctuations in the value of the asset are not offset by the amortization of the MSRs, resulting in a more pronounced effect on earnings. The amounts recorded in the balance sheet more closely reflect the economic value of the asset and will always be greater than or equal to the amounts recorded using the *amortization method*. The *fair value method* is also less administratively cumbersome than the *amortization method*. Once the *fair value method* is elected, a company cannot change to the *amortization method*.

Tax Accounting for Retaining or Purchasing MSRs

The tax code requires that a determination be made as to whether any portion of the MSR should be considered *excess servicing* for tax reporting purposes. Excess servicing is defined as compensation received in excess of the *normal servicing* fee, which is the amount under the servicing contract that represents *reasonable compensation* for servicing the loans.

Reasonable compensation is considered to be the amount of mortgage interest paid by the borrower that the servicer is entitled to receive in order to perform the servicing function, up to the safe harbor rates set forth by the IRS, plus any other income the servicer receives from servicing the loans (i.e., various fees, interest, and float).

In addition to determining what portion, if any, of the MSR income received by a taxpayer is considered excess servicing, it is also important to note that Originated Mortgage Servicing Rights (OMSRs) and Purchased Mortgage Servicing Rights (PMSRs) are treated differently for tax purposes.

For OMSRs, the normal servicing income is considered a right to receive compensation from the holder of the related mortgage note for servicing the mortgage under the contract. As a result, no asset, and therefore, no tax basis, is created for the servicing contract portion of the MSR relating to reasonable compensation, and income should be recognized as it is received for performing the services.

In the case of PMSRs, the purchase price relating to the normal servicing, exclusive of any excess servicing, is deemed to be the tax basis of the PMSR. It is amortizable over a useful life of nine years unless acquired in a transaction (or series of transactions) involving the acquisition of all or a substantial portion of a trade or business, in which case a useful life of fifteen years should be used.

Notice to Reader: