

Mark To Market Valuations

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Each month, if not more often secondary marketing departments go through the exercise of valuing their loans and hedges and presenting what is commonly called a Mark to Market report. This report can have a variety of users.

People who have taken accounting classes are familiar with the Statement of Financial Condition or Balance Sheet. Certain items (typically assets) on the Balance Sheet are carried at the lower of cost or market. This is done in order to comply with Generally Accepted Accounting Principles (GAAP).

Lower of Cost or Market (LOCOM) is a concept closely related to Mark(ing) to Market. Three key accounting principles are being followed when LOCOM is employed. The first is conservatism, a company should not embellish earnings in stating their financial position.

The second is the matching of costs with revenues. Matching costs with revenues allows the economics of the business concern to more clearly understood.

The third principle is that of consistency. Consistency like the matching principle seeks to place both current and potential investors and lenders on a level playing field. If earnings are aggressively over or under valued this places someone at a large disadvantage and someone at large advantage. Accounting practices that cause huge fluctuations in earnings again tilt the landscape to someone's advantage. Thus, market value should neither reflect "a forced sale" condition nor "a theoretical ideal" that is not supported by valid market indications.

Some mortgage bankers mark their positions using the best execution value for the near month delivery for loans and mortgage trades (either whole loan or MBS). The current liquidation value for option contracts is also used in many cases. Let's see how this approach lines up with three of the principles that GAAP seeks to invoke in a statement of financial condition.

Conservatism? It is easy to make a mental link between current delivery price with conservative price. However, the fixed income markets (of which mortgages are a part) tend to price instruments at lower prices the more deferred the delivery. This fixed income market tends to be a positive carry market. In other words, someone makes money by holding onto (investing in) a mortgage-backed security. How much money depends upon the coupon rate of the security and the borrowing rate of money used to fund the investment. The amount of forward price drop experienced by a security is related to the implied cost of funds (often called the repo rate, short for repurchase agreement rate).

Thus, by pricing the loans to the forward delivery date that matches their expected delivery date a more conservative (or lower) value will often be obtained.

Best execution values for loans that are not yet ready to sale introduces a dash of hopeful optimism that these relationships will still exist when the loans are ready to be offered. Best Execution valuation is not so non-conservative for loans that are actually ready to be delivered.

It is more conservative to value options through the date they will no longer be required (the delivery

date of the loans being hedged by the options) rather than assuming an immediate liquidation. Why is this more conservative? Options are a wasting asset. They lose value with the passage of time. Therefore, an immediate liquidation (all things equal) will always tend to provide a higher value than a deferred liquidation for options that have a time value component remaining.

Matching? It is true that if loan volume equaled hedge volume both valuations would be matched. However, by matching the market price to when the loans can be liquidated and associating the hedges with those liquidation time frames a best match to the true logistics of marketing the position are achieved.

Consistency? It is true that the near bench mark approach is consistent. However, the mark will tend to be more subject to fluctuations if a best execution approach is used for valuing unclosed loans. Also, option contract value fluctuations will tend to be greater with the passage of time if an immediate liquidation price is used that includes a time value component.

In summary, users of a mark to market report are best served when the preparer matches hedges and loans to the forward delivery values that the lender is obligated to fulfill.