

# Pricing Dynamics of Using Bulk Servicing Contracts

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**A** lot of buzz exists around the topic of using a best execution approach to preparing loan rate quotes. Rightly so, using a best execution approach gives the lender the best chance at being competitive. I would suggest to you that the activity of developing and distributing rate quotes is part of the larger management activity I will call Production Risk Management.

The mortgage banking business gravitates toward being a commodity business not unlike farming, ranching, mining, etc.. To fight this attraction, participants endeavor to create new products or delivery methods that will separate them from the crowd. Sub-prime and high LTV loans are just two examples of boutique creation. In the end, if these innovations gain customer acceptance the niche is swarmed by others and the herd syndrome soon turns the product line from "value added" into a commodity.

In a commodity market if one builds too much profit into their price to the consumer, the consumer will go elsewhere and very few sales will be made – a bad outcome. On the other hand, if the price of the product is too cheap the seller will lose money with every sale (origination) – a bad outcome. These are but two of the considerations that Production Risk poses.

The rate quotes you provide shape the loan application pipeline you will manage. The market exit strategy you reference will shape the rate quotes you provide.

The value for mortgage servicing rights that you assign and pass through can significantly impact a rate quote. Many times the MSR value will mean the difference between whether or not a quote is attractive to borrowers and correspondents.

In general, servicing can either be retained (held for investment) or released (sold). The value of retained servicing is, typically developed by discounting the expected future cash flows that will accrue from servicing the mortgage. The value of released servicing, is typically developed by referencing investor valuation grids.

Bulk servicing transfer arrangements have been a popular means for marketing mortgage-servicing rights. The alternative to bulk servicing transfers is to sell the servicing rights on a loan by loan (flow) basis.

Bulk servicing is typically priced using a tiered-price grid whose tiers are based upon the weighted average servicing created for a given collection of loans. Characteristics such as the geographic location or size of a specific loan do not directly drive the price for a package. However, it is typically understood that the seller will deliver a package that on average fits general characteristics.

Bulk servicing transfer arrangements can provide a benefit to many mortgage marketing groups. However, if you use bulk servicing transfer prices to develop your pricing you risk distorting your pipeline and actually even falling out of compliance with the bulk servicing contracts pricing parameters.

Why? Well... If we look at this question from a statistician's point of view, we quickly see that the price you get from the bulk-servicing grid represents "the average value" of servicing. The rub is

that your pipeline is comprised of individual loans whose characteristics “deviate” from the average. Therefore, using an average means that for all items that equal the average, your price will be considered fair. But for the majority of the quotes you make, using this average, you will be over or under pricing to the market.

You can see where we’re going, right? Your pipeline will begin to fill up with items whose characteristics don’t justify the price you are offering. Sounds a little shaky, but what’s the harm, really??

Let’s fast forward to the delivering the loans, in bulk, against the grid. The first thing you find out is that the composition of this group of loans is significantly different than the composition upon which you based your pricing decision. Under the category of surprises that are rarely good, the new composition will almost certainly be worth less.

Secondly, the investor may decrement your pricing grid because the composition of the assets, you are now delivering, is not what you originally indicated it would be when you entered into this arrangement. This now makes you both less competitive and less profitable. The downward spiral begins.

You avoid this exercise in “tail chasing” by referencing flow-based grids for developing rate sheets. The checkpoint here is to make sure you are talking apples to apples.

Step One > Evaluate a set of loans that in aggregate are similar to the bulk servicing collections you typically deliver.

Step Two > Compute the value of each loan referencing the loan level grid.

Step Three > Aggregate the loan level MSR result.

Step Four > Price the group using the Bulk Servicing Grid.

Step Five > If the two results are identical or the variance is slight, you have identified a valid proxy.

Use the proxy for setting individual product / rate / price points. This method will be more likely to attract a pipeline that conforms to your bulk servicing targets. However, monitor the dynamics. Even with this added measure individual rate levels could be miss priced and adjustments required to bring the production set back in balance.

The production risk management effort is much easier to sustain with the right software in place. Items to look for in the software:

1. Can you perform pricing using a best execution approach?
2. Can you develop pricing using both bulk and loan level MSR Value Grids?
3. Can you compare the results of both approaches?
4. Can you monitor production growth dynamics?
5. Can you monitor production profitability?