

PENNYMAC FINANCIAL SERVICES, INC.

Form 10-Q

May 08, 2015

[Table of Contents](#)

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2015

Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number: 001-35916

PennyMac Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Delaware	80-0882793
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6101 Condor Drive, Moorpark, California 93021
(Address of principal executive offices) (Zip Code)

(818) 224-7442

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting

company” in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes
No

Indicate the number of shares outstanding of each of the registrant’s classes of common stock, as of the latest practicable date.

Class	Outstanding at May 7, 2015
Class A Common Stock, \$0.0001 par value	21,657,405
Class B Common Stock, \$0.0001 par value	53

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

FORM 10-Q

March 31, 2015

TABLE OF CONTENTS

	Page
<u>Special Note Regarding Forward-Looking Statements</u>	3
<u>PART I. FINANCIAL INFORMATION</u>	5
<u>Item 1. Financial Statements (Unaudited):</u>	5
<u>Consolidated Balance Sheets</u>	5
<u>Consolidated Statements of Income</u>	6
<u>Consolidated Statements of Changes in Stockholders' Equity</u>	7
<u>Consolidated Statements of Cash Flows</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	44
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	65
<u>Item 4. Controls and Procedures</u>	65
<u>PART II. OTHER INFORMATION</u>	66
<u>Item 1. Legal Proceedings</u>	66
<u>Item 1A. Risk Factors</u>	66
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	66
<u>Item 3. Defaults Upon Senior Securities</u>	66
<u>Item 4. Mine Safety Disclosures</u>	66
<u>Item 5. Other Information</u>	66
<u>Item 6. Exhibits</u>	67

Table of Contents

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (“Report”) contains certain forward looking statements that are subject to various risks and uncertainties. Forward looking statements are generally identifiable by use of forward looking terminology such as “may,” “will,” “should,” “potential,” “intend,” “expect,” “seek,” “anticipate,” “estimate,” “approximately,” “believe,” “predict,” “continue,” “plan” or other similar words or expressions.

Forward looking statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain financial and operating projections or state other forward looking information. Examples of forward looking statements include the following:

- projections of our revenues, income, earnings per share, capital structure or other financial items;
- descriptions of our plans or objectives for future operations, products or services;
- forecasts of our future economic performance, interest rates, profit margins and our share of future markets; and
- descriptions of assumptions underlying or relating to any of the foregoing expectations regarding the timing of generating any revenues.

Our ability to predict results or the actual effect of future events, actions, plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward looking statements. There are a number of factors, many of which are beyond our control that could cause actual results to differ significantly from management’s expectations. Some of these factors are discussed below.

You should not place undue reliance on any forward looking statement and should consider the following uncertainties and risks, as well as the risks and uncertainties discussed elsewhere in this Report and the section entitled “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2014, filed with the SEC on March 13, 2015.

Factors that could cause actual results to differ materially from historical results or those anticipated include, but are not limited to:

- the continually changing federal, state and local laws and regulations applicable to the highly regulated industry in which we operate;
- lawsuits or governmental actions if we do not comply with the laws and regulations applicable to our businesses;
- the creation of the Consumer Financial Protection Bureau (“CFPB”), its rules and the enforcement thereof by the CFPB;
- our dependence on U.S. government sponsored entities and changes in their current roles or their guarantees or guidelines;
- changes to government mortgage modification programs;

- the licensing and operational requirements of states and other jurisdictions applicable to our businesses, to which our bank competitors are not subject;
- foreclosure delays and changes in foreclosure practices;
- certain banking regulations that may limit our business activities;
- our dependence on the multi-family and commercial real estate sectors for future originations and investments in commercial mortgage loans and other commercial real estate related loans;
- changes in macroeconomic and U.S. real estate market conditions;
- difficulties inherent in growing loan production volume;
- difficulties inherent in adjusting the size of our operations to reflect changes in business levels;
- purchase opportunities for mortgage servicing rights (“MSRs”) and our success in winning bids;
- changes in prevailing interest rates;

Table of Contents

- increases in loan delinquencies and defaults;
- our reliance on PennyMac Mortgage Investment Trust (“PMT”) as a significant source of financing for, and revenue related to, our mortgage banking business;
- any required additional capital and liquidity to support business growth that may not be available on acceptable terms, if at all;
- our obligation to indemnify third party purchasers or repurchase loans if loans that we originate, acquire, service or assist in the fulfillment of, fail to meet certain criteria or characteristics or under other circumstances;
- our obligation to indemnify PMT and certain investment funds if our services fail to meet certain criteria or characteristics or under other circumstances;
- decreases in the historical returns on the assets that we select and manage for our clients, and our resulting management and incentive fees;
- the extensive amount of regulation applicable to our investment management segment;
- conflicts of interest in allocating our services and investment opportunities among ourselves and certain advised entities;
- the effect of public opinion on our reputation;
- our recent growth;
- our ability to effectively identify, manage, monitor and mitigate financial risks;
- our initiation of new business activities or expansion of existing business activities;
 - our ability to detect misconduct and fraud; and
- our ability to mitigate cybersecurity risks and cyber incidents.

Other factors that could also cause results to differ from our expectations may not be described in this Report or any other document. Each of these factors could by itself, or together with one or more other factors, adversely affect our business, results of operations and/or financial condition.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	March 31, 2015	December 31, 2014
	(in thousands, except share data)	
ASSETS		
Cash	\$ 82,032	\$ 76,256
Short-term investments at fair value	30,275	21,687
Mortgage loans held for sale at fair value (includes \$1,132,568 and \$976,772 pledged to secure mortgage loans sold under agreements to repurchase; and \$196,716 and \$148,133 pledged to secure mortgage loan participation and sale agreement)	1,353,944	1,147,884
Derivative assets	61,064	38,457
Servicing advances, net (includes \$20,197 and \$18,686 valuation allowance)	242,397	228,630
Carried Interest due from Investment Funds	68,531	67,298
Investment in PennyMac Mortgage Investment Trust at fair value	1,597	1,582
Mortgage servicing rights (includes \$361,413 and \$325,383 mortgage servicing rights at fair value; \$413,582 and \$392,254 pledged to secure note payable; and \$222,309 and \$191,166 subject to excess servicing spread financing)	790,411	730,828
Furniture, fixtures, equipment and building improvements, net	11,118	11,339
Capitalized software, net	559	567
Receivable from Investment Funds	2,488	2,291
Receivable from PennyMac Mortgage Investment Trust	18,719	23,871
Deferred tax asset	42,141	46,038
Loans eligible for repurchase	112,201	72,539
Other	40,524	37,858
Total assets	\$ 2,858,001	\$ 2,507,125
LIABILITIES		
Mortgage loans sold under agreements to repurchase	\$ 992,187	\$ 822,621
Mortgage loan participation and sale agreement	190,762	143,638
Note payable	134,665	146,855
Excess servicing spread financing at fair value payable to PennyMac Mortgage Investment Trust	222,309	191,166
Derivative liabilities	10,903	6,513
Accounts payable and accrued expenses	86,945	62,715
Mortgage servicing liabilities at fair value	6,529	6,306
Payable to Investment Funds	32,011	35,908

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Payable to PennyMac Mortgage Investment Trust	130,870	123,315
Payable to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement	71,094	75,024
Liability for loans eligible for repurchase	112,201	72,539
Liability for losses under representations and warranties	14,689	13,259
Total liabilities	2,005,165	1,699,859

Commitments and contingencies

STOCKHOLDERS' EQUITY

Class A common stock—authorized 200,000,000 shares of \$0.0001 par value; issued and outstanding, 21,657,017 and 21,577,686 shares, respectively	2	2
Class B common stock—authorized 1,000 shares of \$0.0001 par value; issued and outstanding, 54 shares	—	—
Additional paid-in capital	164,656	162,720
Retained earnings	60,270	51,242
Total stockholders' equity attributable to PennyMac Financial Services, Inc. common stockholders	224,928	213,964
Noncontrolling interest in Private National Mortgage Acceptance Company, LLC	627,908	593,302
Total stockholders' equity	852,836	807,266
Total liabilities and stockholders' equity	\$ 2,858,001	\$ 2,507,125

The accompanying notes are an integral part of these financial statements.

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Quarter ended March 31,	
	2015	2014
	(in thousands, except per share data)	
Revenues		
Net gains on mortgage loans held for sale at fair value:		
From non-affiliates	\$ 76,667	\$ 36,436
Recapture payable to PennyMac Mortgage Investment Trust	(1,289)	(1,898)
	75,378	34,538
Loan origination fees	16,682	6,880
Fulfillment fees from PennyMac Mortgage Investment Trust	12,866	8,902
Net loan servicing fees:		
Loan servicing fees		
From non-affiliates	50,101	36,100
From PennyMac Mortgage Investment Trust	10,670	14,591
From Investment Funds	968	1,477
Ancillary and other fees	11,185	5,151
	72,924	57,319
Amortization, impairment and change in fair value of mortgage servicing rights:		
Related to servicing for non-affiliates	(53,684)	(18,347)
Change in fair value of excess servicing spread payable to PennyMac Mortgage Investment Trust	7,536	4,792
	(46,148)	(13,555)
Net loan servicing fees	26,776	43,764
Management fees:		
From PennyMac Mortgage Investment Trust	7,003	8,074
From Investment Funds	1,486	2,035
	8,489	10,109
Carried Interest from Investment Funds	1,233	2,157
Net interest expense:		
Interest income	8,933	4,110
Interest expense:		
To non-affiliates	8,077	3,524
To PennyMac Mortgage Investment Trust	3,752	2,862
	11,829	6,386
Net interest expense	(2,896)	(2,276)
Change in fair value of investment in and dividends received from PennyMac Mortgage Investment Trust	107	115
Other	1,679	1,303
Total net revenue	140,314	105,492
Expenses		
Compensation	58,144	42,886

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Servicing	9,735	3,090
Technology	4,938	2,823
Professional services	2,833	2,199
Loan origination	4,351	1,417
Other	7,075	4,016
Total expenses	87,076	56,431
Income before provision for income taxes	53,238	49,061
Provision for income taxes	6,114	5,523
Net income	47,124	43,538
Less: Net income attributable to noncontrolling interest	38,096	35,566
Net income attributable to PennyMac Financial Services, Inc. common stockholders	\$ 9,028	\$ 7,972
Earnings per share		
Basic	\$ 0.42	\$ 0.38
Diluted	\$ 0.42	\$ 0.38
Weighted average common shares outstanding		
Basic	21,593	20,866
Diluted	76,050	75,952

The accompanying notes are an integral part of these financial statements.

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

PennyMac Financial Services, Inc. Stockholders

Number of Shares		Common stock		Additional paid-in capital	Retained earnings	Nonc inter Natio Acc Comp
Class A (in thousands)	Class B	Class A	Class B			
20,813	—	\$ 2	\$ —	\$ 153,000	\$ 14,400	\$ 46
—	—	—	—	—	7,972	35
—	—	—	—	555	—	1,7
—	—	—	—	—	—	(6)
66	—	—	—	563	—	(56
—	—	—	—	(6)	—	—
20,879	—	\$ 2	\$ —	\$ 154,112	\$ 22,372	\$ 49
21,578	—	2	—	162,720	51,242	59
—	—	—	—	—	9,028	38
31	—	—	—	1,124	—	2,8
—	—	—	—	—	—	(5,
4	—	—	—	74	—	—
44	—	—	—	792	—	(79
—	—	—	—	(54)	—	—

21,657 — \$ 2 \$ — \$ 164,656 \$ 60,270 \$ 62

The accompanying notes are an integral part of these financial statements.

7

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Quarter ended March 31,	
	2015	2014
	(in thousands)	
Cash flow from operating activities		
Net income	\$ 47,124	\$ 43,538
Adjustments to reconcile net income to net cash used in operating activities:		
Net gains on mortgage loans held for sale at fair value	(75,378)	(34,538)
Accrual of servicing rebate to Investment Funds	104	152
Amortization, impairment and change in fair value of mortgage servicing rights	46,148	13,555
Carried Interest from Investment Funds	(1,233)	(2,157)
Accrual of interest on excess servicing spread financing	3,752	2,862
Amortization of debt issuance costs and commitment fees relating to financing facilities	1,708	1,213
Change in fair value of investment in common shares of PennyMac Mortgage Investment Trust	(15)	(71)
Stock and unit-based compensation expense	3,948	2,473
Provision for servicing advance losses	1,510	—
Depreciation and amortization	394	286
Purchase of mortgage loans held for sale from PennyMac Mortgage Investment Trust	(4,989,838)	(3,130,530)
Originations of mortgage loans held for sale, net	(904,213)	(317,915)
Purchase of mortgage loans from Ginnie Mae securities for modification and subsequent sale	(84,488)	(26,827)
Capitalization of interest on mortgage loans held for sale at fair value	(1,154)	—
Sale and principal payments of mortgage loans held for sale	5,763,272	3,292,398
Sale of mortgage loans held for sale to PennyMac Mortgage Investment Trust	8,405	—
Repurchase of loans subject to representations and warranties	(1,294)	(1,970)
Increase in servicing advances	(15,277)	(17,067)
Increase in receivable from Investment Funds	(301)	(299)
Decrease (increase) in receivable from PennyMac Mortgage Investment Trust	5,878	(1,493)
Decrease in deferred tax asset	4,212	5,520
Decrease in payable to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement	(4,299)	—
Increase in other assets	(5,315)	(6,664)
Increase in accounts payable and accrued expenses	24,307	3,263
(Decrease) increase in payable to Investment Funds	(3,897)	169

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Increase in payable to PennyMac Mortgage Investment Trust	7,446	3,747
Net cash used in operating activities	(168,494)	(170,355)
Cash flow from investing activities		
(Increase) decrease in short-term investments	(8,588)	101,625
Purchase of mortgage servicing rights	(63,137)	(25,866)
Settlements of derivative financial instruments used for hedging	15,404	—
Purchase of furniture, fixtures, equipment and building improvements	(660)	(2,084)
Acquisition of capitalized software	(77)	(35)
Increase in margin deposits and restricted cash	(1,328)	(2,462)
Net cash provided by (used in) investing activities	(58,386)	71,178
Cash flow from financing activities		
Sale of loans under agreements to repurchase	5,431,114	3,161,215
Repurchase of loans sold under agreements to repurchase	(5,261,548)	(3,065,070)
Issuance of mortgage loan participation certificates	3,387,582	—
Repayment of mortgage loan participation certificates	(3,340,458)	—
Repayment of note payable	(12,190)	(3,335)
Issuance of excess servicing spread financing	46,412	20,526
Repayment of excess servicing spread financing	(12,731)	(7,413)
Distributions to Private National Mortgage Acceptance Company, LLC partners	(5,522)	(6)
Decrease in leases payable	(3)	(3)
Net cash provided by financing activities	232,656	105,914
Net increase in cash	5,776	6,737
Cash at beginning of period	76,256	30,639
Cash at end of period	\$ 82,032	\$ 37,376

The accompanying notes are an integral part of these financial statements.

Table of Contents

PENNYMAC FINANCIAL SERVICES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1—Organization and Basis of Presentation

PennyMac Financial Services, Inc. (“PFSI” or the “Company”) was formed as a Delaware corporation on December 31, 2012. Pursuant to a reorganization, the Company became a holding corporation and its primary asset is an equity interest in Private National Mortgage Acceptance Company, LLC (“PennyMac”). The Company is the managing member of PennyMac and operates and controls all of the businesses and affairs of PennyMac subject to the consent rights of other members under certain circumstances, and consolidates the financial results of PennyMac and its subsidiaries.

PennyMac is a Delaware limited liability company which, through its subsidiaries, engages in mortgage banking and investment management activities. PennyMac’s mortgage banking activities consist of residential mortgage loan production (including correspondent production and consumer direct lending) and mortgage loan servicing. PennyMac’s investment management activities and a portion of its loan servicing activities are conducted on behalf of investment vehicles that invest in residential mortgage loans and related assets. PennyMac’s primary wholly owned subsidiaries are:

- PNMAC Capital Management, LLC (“PCM”)—a Delaware limited liability company registered with the Securities and Exchange Commission (“SEC”) as an investment adviser under the Investment Advisers Act of 1940, as amended. PCM enters into investment management agreements with entities that invest in residential mortgage loans and related assets.

Presently, PCM has management agreements with PennyMac Mortgage Investment Trust (“PMT”), a publicly held real estate investment trust, PNMAC Mortgage Opportunity Fund, LLC and PNMAC Mortgage Opportunity Fund, L.P., (the “Master Fund”), both registered under the Investment Company Act of 1940, as amended, an affiliate of these funds, and PNMAC Mortgage Opportunity Fund Investors, LLC (collectively, “Investment Funds”). Together, the Investment Funds and PMT are referred to as the “Advised Entities.”

- PennyMac Loan Services, LLC (“PLS”)—a Delaware limited liability company that services portfolios of residential mortgage loans on behalf of non-affiliates or the Advised Entities, originates new prime credit quality residential mortgage loans, and engages in other mortgage banking activities for its own account and the account of PMT. PLS is approved as a seller/servicer of mortgage loans by the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and as an issuer of securities guaranteed by the Government National Mortgage Association (“Ginnie Mae”). PLS is a licensed Federal Housing Administration (“FHA”) Nonsupervised Title II Lender with the U.S. Department of Housing and Urban Development (“HUD”) and a lender/servicer with the Veterans Administration (“VA”) and U.S. Department of Agriculture (“USDA”). We refer to each of Fannie Mae, Freddie Mac, Ginnie Mae, FHA, VA and USDA as an “Agency” and collectively the “Agencies”.
- PNMAC Opportunity Fund Associates, LLC (“PMOFA”)—a Delaware limited liability company and the general partner of the Master Fund. PMOFA is entitled to incentive fees representing allocations of profits (“Carried Interest”) from the Master Fund.

The accompanying consolidated financial statements have been prepared in compliance with generally accepted accounting principles (“GAAP”) in the United States as codified in the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“Codification”) for interim financial information and with the SEC’s instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, these financial statements and notes do not include all of the information required by GAAP for complete financial statements. The interim consolidated information should be read together with the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

The accompanying unaudited consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial position, income, and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year ending December 31, 2015. Intercompany accounts and transactions have been eliminated.

Table of Contents

Preparation of financial statements in compliance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results will likely differ from those estimates.

Note 2—Concentration of Risk

A substantial portion of the Company's activities relate to the Advised Entities. Fees charged to these entities (generally comprised of management fees, loan servicing fees, Carried Interest and fulfillment fees) totaled 26% and 35% of total net revenues for the quarters ended March 31, 2015 and 2014, respectively.

Note 3—Transactions with Affiliates

Transactions with PMT

Following is a summary of mortgage lending and sourcing activity between the Company and PMT:

	Quarter ended March 31,	
	2015	2014
	(in thousands)	
Fulfillment fee revenue	\$ 12,866	\$ 8,902
Unpaid principal balance of loans fulfilled for PennyMac Mortgage Investment Trust	\$ 2,890,132	\$ 1,919,578
Sourcing fees paid	\$ 1,421	\$ 892
Unpaid principal balance of loans purchased from PennyMac Mortgage Investment Trust	\$ 4,735,374	\$ 2,974,077
Sale of mortgage loans held for sale to PennyMac Mortgage Investment Trust	\$ 8,405	\$ —
Mortgage servicing rights recapture recognized	\$ —	\$ 8

Following is a summary of mortgage loan servicing fees earned from PMT:

	Quarter ended March 31,	
	2015	2014
	(in thousands)	
Loan servicing fees relating to PennyMac Mortgage Investment Trust:		
Mortgage loans acquired for sale at fair value:		
Base and supplemental	\$ 26	\$ 17
Activity-based	31	26
	57	43
Mortgage loans at fair value:		
Base and supplemental	4,032	4,966
Activity-based	2,894	6,386
	6,926	11,352
Mortgage servicing rights:		
Base and supplemental	3,656	3,148
Activity-based	31	48
	3,687	3,196
	\$ 10,670	\$ 14,591

Table of Contents

Following is a summary of the management fees earned from PMT:

	Quarter ended March 31,	
	2015	2014
	(in thousands)	
Management fees:		
Base	\$ 5,730	\$ 5,521
Performance incentive	1,273	2,553
	\$ 7,003	\$ 8,074

In the event of termination by PMT, the Company may be entitled to a termination fee in certain circumstances. The termination fee is equal to three times the sum of (a) the average annual base management fee, and (b) the average annual performance incentive fee earned by the Company, in each case during the 24-month period before termination.

Following is a summary of financing activity between the Company and PMT:

	Quarter ended March 31,	
	2015	2014
	(in thousands)	
Issuance of excess servicing spread	\$ 46,412	\$ 20,526
Repayment of excess servicing spread	\$ (12,731)	\$ (7,413)
Change in fair value of excess servicing spread	\$ (7,536)	\$