INTRODUCTION

This Section discusses profitability; the components of mortgage servicing; the general valuation of mortgage servicing; the valuation of PMSR for regulatory capital purposes; dealings with new, unknown, or unregulated servicers; and the issues of most concern to regulators.

Servicing Profitability

For most thrifts, mortgage servicing is viewed as an expense that reduces the total return on the portfolio. For a mortgage banker, however, servicing is an asset that is the single most important component of profitability, and that must be actively managed to be profitable and to retain its value. Servicing provides relatively stable earnings and servicing rights may be sold at a profit. To achieve long-term servicing profitability, however, thrifts must treat servicing like the mortgage banker by achieving the economies of scale that reduce servicing costs per mortgage and by maintaining that scale by replenishing the portfolio with new servicing as servicing pays off.

Today the largest servicers tend to be most profitable since they have the lowest servicing costs per mortgage. This has led to a great deal of consolidation among servicers, with many small- and medium-size servicers being bought out by the industry giants. For the thrift entering mortgage servicing for others, it is important to carefully plan for the types and volumes of mortgages needed from each new investor to earn an adequate profit. Without such planning, new mortgage servicing activities can produce a portfolio that is unprofitable. It is usually better to sell servicing for release fees than to retain small amounts of servicing types.

Mortgage bankers have come to rely increasingly on automation as the one tool that can stabilize servicing costs in the face of rising investor demands. For the larger and more profitable mortgage bankers, automation no longer is confined to computerized accounting but is used in every aspect of servicing; from the payment of taxes and insurance to collections and investor reporting. These computer systems are very expensive to design and to implement and are even more expensive to maintain in the face of ever-changing investor demands. Computer systems that meet the requirements of today’s investors are usually operated by only the larger servicers and specialized service bureaus. Servicing for investors is usually unprofitable without these sophisticated computer systems; however, thrifts servicing their own portfolios can usually get by with very basic systems. The challenge for thrifts entering servicing for others is to pick the most cost efficient computer and other systems for the types of mortgages and investors that will be serviced.

Main Areas of Mortgage Servicing

Mortgage servicing includes the functions of cash management, investor accounting and reporting, escrow administration, collections and foreclosure, real estate owned (REO), and customer service. The precise servicing functions required by the owner of each group of mortgages as well as the servicer’s compensation are spelled out in the individual investor servicing agreements, which vary widely. These agreements specify the servicing policies that are to be used for that investor’s mortgages, such as collections, assumptions, and instructions for investor accounting and reporting.

<u>Cash Management</u>. Cash management is the collection of customer payments and the deposit of those funds into custodial accounts at financial institutions that meet investor’s requirements for safety and soundness; usually the thrift’s accounts are adequate. The principal and interest (P&I) portion of the payment is segregated from escrow and remitted to the investor as required under the servicing agreement. The escrow portion is placed into a separate account that also meets investor requirements and this money is retained in that account until needed to pay property taxes or insurance. Principal curtailments and payoffs are

usually remitted to the investor on an expedited basis.

Monthly payments of P&I are generally due on the first of the month and contain provisions for late charges of 5% of the P&I amount for payments not received by the fifteenth of the month, in accordance with FNMA, FHLMC, and GNMA requirements. The escrow portion of monthly payments is generally excluded from late charge requirements. Monthly mortgage payments may be returned by the thrift to the borrower for the payment of late charges.

Investor Accounting and Reporting. Investor reporting covers all of the investor's requirements for various reports and for remitting cash. Since FNMA, FHLMC, and GNMA all require servicers to advance mortgage payments for their mortgage securities on certain dates, whether or not the payments have been made, those dates are the critical ones for most investor reporting. In private sales, however, the nature and timing of the reports are specified by the servicing agreements, which vary widely.

With GNMA I servicing, the servicer remits P&I directly to individual MBS holders. With GNMA IL FNMA, and FHLMC servicing, the servicer sends remittances to a central processing center which remits to the security holders. For other types of servicing, the types of investor reports and their timing are usually specified in the servicing agreements. Most investors are paid once a month and receive reports of collections, delinquencies, and a trial balance. Reports of foreclosures, property inspections, and REO are usually sent as needed.

Document Custodian. Although many investors retain the original note and mortgage assignment or use third-party custodians, the remaining mortgage documents are usually safeguarded by the servicer. These documents should be stored in a secured and protected area that is fireproof, but accessible. Controls should exist for files that are removed. Some servicers only use microfilmed copies to work with so that original file documents are better protected.

Escrow Administration. Escrow account administration includes: (1) the maintenance of the escrow funds in a safe account meeting investor requirements; (2) tracking the city, county, state, and other property taxes and paying them by the due dates to avoid penalties; (3) making sure that property insurance is maintained at all times and obtaining temporary coverage when necessary; (4) maintaining adequate insurance records to maintain the loss payable clause in favor of the servicer which usually means holding the original property insurance policies and paying the renewal premiums on those policies as they come due; (5) annually analyzing the escrow account balance in relation to anticipated expenses and adjusting escrow payments, if necessary; and (6) annually reporting the escrow account activity and its analysis to the borrower.

Escrow funds can only be collected and held up to the limits established by the Real Estate Settlement and Procedures Act § 12 U.S.C. 2609 (RESPA). RESPA limits funds held in escrow to the amount required to make anticipated payments over the next twelve months plus an additional one-sixth of that amount (two months). State laws, and the mortgage itself, may also establish limits and roughly 30 percent of the states require servicers to pay interest on escrow accounts; usually one or two percent annually.

Vendors and subservicers are often used to assist in paying taxes and insurance, to conduct property inspections, to perform the legal work on foreclosures, and to perform document custody functions. Servicing management should regularly assess the quality of vendors' work and annually evaluate their adequacy and financial strength.

Collections. One of the major tasks of the servicer is collecting overdue payments on mortgages. The servicer must closely follow investor requirements on the timing, type, and manner of collection activities. Collection efforts usually include sending late notices every 15 days, making telephone calls, setting up face-to-face contacts for serious delinquencies, conducting property inspections, and executing foreclosures according to investor's requirements and state law. Collection procedures must also be performed in compliance with the Fair Debt Collections Act. (See the Compliance Handbook.)

FNMA, GNMA, and FHLMC require servicers for their MBSs to advance their own funds to pay the investor monthly for both principal and interest when individual mortgage payments from borrowers are not received on schedule. This is true no matter how long the delinquency exists, and even if the mortgages are in bankruptcy or foreclosure for several years. The secondary market organizations only become involved in this payment process if the servicer fails to make scheduled payments or otherwise defaults. GNMA also requires their servicers to absorb all foreclosure costs in excess of the amounts paid by FHA, FMHA, and VA.

In order to reduce the cost of advancing delinquent payments on bankruptcy, foreclosure, and other extended delinquencies, many servicers now buy seriously delinquent mortgages from the pools. This is possible because the servicer's cost of funds is usually less than the pass-through rate on the MBS. This technique can also reduce foreclosure costs on GNMA MBSS, however, its use in all cases should be carefully monitored to prevent inappropriate use and abuse. *The repurchase of each seriously delinquent mortgage should be supported by written policies, a detailed cost/benefit analysis, and approved by the appropriate officer. A repurchase monitoring report should also be utilized by management to continuously monitor the total amount of repurchases, the mortgages involved, and the causes for the repurchases.*

<u>Real Estate Owned</u>. Depending on the provisions of the servicing agreement the servicer may be required to take title to foreclosed property as real estate owned (REO). In some cases the servicer is also required to perform property inspections, make essential repairs, market, and sell REO on behalf of investors. In other cases, the servicer has only administrative responsibilities as agent for the investor or may be bypassed entirely.

A Department of Veterans Affairs (VA) no-bid occurs on foreclosures of VA mortgages in GNMA pools when the VA exercises its no-bid option at a foreclosure. The VA/GNMA no-bid option permits the VA to pay the servicer its maximum percentage claim for a VA mortgage foreclosure rather than buying the property at the foreclosure sale. The servicer is then required to buy the property and dispose of it under GNMA regulations. Because GNMA servicers are required to absorb all losses, any costs or losses on the sale of a property securing a VA/ GNMA mortgage that are in excess of the amount paid by VA must be paid by the servicer. These losses can be very large. In cases where the VA mortgage is not in a GNMA pool, the servicing agreement controls whether the owner of the mortgage or the servicer pays no-bid losses, but usually such losses are the mortgage owner's responsibility.

<u>Data Processing</u>. Since servicers are so dependent on data processing services, adequate systems are vital to meet marketing and investor needs, management controls, audit coverage, and to keep costs low. Data systems for thrifts servicing their own portfolios and a few private investors are often not capable of producing the reports and cash management services required by FNMA, FHLMC, GNMA and other participants in the secondary mortgage market. Service bureaus are generally the lowest cost data processing source for new and small mortgage bankers because they spread development and maintenance costs over a large number of clients.

The more complex the data system, the more effort that is required by the servicing department to maintain it. Servicing must update the information in the data processing system as often as needed to ensure accurate reports and must maintain controls over those changes to limit the number of errors and the possibilities for fraud or embezzlement.

<u>Other Servicing Functions</u>. Customer service encompasses the remainder of mortgage servicing functions and generally includes payoffs, assumptions, new mortgage set-up, purchases and sales, questions, problems, and other miscellaneous items. In handling all servicing functions the servicer should always be careful to follow the investor's requirements. Employees should have access to and be encouraged to use the servicing manuals of all of the investors that they deal with; especially FNMA, FHLMC, and GNMA. A failure to follow an investor's policies or procedures can be very expensive.

Multifamily Servicing. The servicing of multifamily mortgages under one of the FNMA, FHLMC, or GNMA programs usually requires special expedited payment and payoff remittances, special accounting procedures, aggressive delinquency collections, occasional use of the assignment of rents clause in the mortgage, detailed property inspection reports, and sometimes REO management, renovation, and sale (see the multifamily servicing sections of those organization's Guides). Because of these requirements, multifamily servicing can be very expensive to service and, thus, has much less value than one- to four-family servicing. The failure of the multifamily servicer to follow investor servicing requirements can leave the servicer liable for damages.

Due to the high servicing costs, FNMA and FHLMC multifamily servicing is rapidly being consolidated into organizations with large FNMA and FHLMC multifamily servicing portfolios. Thrifts with a small amount of this type of servicing should consider selling that servicing since it can be unprofitable in small quantities.

Commercial Servicing. Generally these mortgages will be more carefully monitored than one- to four-family or even multifamily mortgages. Their servicing should carefully follow the servicing instructions of the investors, which vary widely. Generally, collection efforts should begin earlier and be more intensive; however, finding and curing the cause of commercial mortgage delinquencies is of primary importance. Also, the liabilities for errors or failure to follow investor instructions can be a major potential liability for smaller thrift servicers.

The servicing of commercial mortgages for investors is also consolidating into firms that specialize in these mortgages. The efficiencies achieved through volume and the ability to afford the experts needed to handle these mortgages are critical factors in profitability.

General Valuation Factors

The number of servicing sales and the dollar volume of servicing rights purchased and sold have become a significant part of the mortgage banking business. Among the factors driving servicing transfers are the: (1) economies of scale; (2) servicing sales to produce current earnings; (3) accounting profits through servicing swaps; (4) desires to increase the servicing portfolio; and (5) general asset and income growth of the mortgage banking operation.

The book values of originated mortgage servicing rights (OMSR) or retained normal servicing, excess servicing fee receivables (ESFR), and purchased mortgage servicing rights (PMSR) are determined by GAAP and are discussed with a chart in Section 573, Accounting. Only accounting treats mortgage servicing rights differently based on the method of acquisition (i.e., purchased versus originated) and only GAAP values the normal and excess portions of servicing fees separately. Thus, in the servicing marketplace ESFR generally cannot be traded separately from the remainder of the servicing cash flows. The separate market values for only a portion of the servicing rights are further restricted by FNMA and FHLMC which prohibit splitting the servicing ownership for servicers of their mortgages.

For accounting purposes, the theoretical market value of the OMSR and ESFR are calculated by using different parts of the same cash flows. The normal portion usually equals the present value of 25bp, 37.5bp, or 44bp depending on the type of servicing. The excess portion equals the remainder of servicing fee after deducting the mortgage pass-through rate, guarantee fee, and normal servicing fees. For example, if a fixed-rate conventional mortgage in a FNMA/FHLMC security with a 10% coupon rate has a pass-through rate of 9% and a guarantee fee of 25bp, then the normal servicing fee is 25bp, which leaves 50bp as the remaining excess portion of the servicing fee (10%-9%-.25%-.25%=.50% or 50bp). (See Section 573, Accounting.)

The real market value for whole servicing rights are estimated by determining the present value, discounted at a market rate, of: (1) the cash flows generated by servicing fees; (2) plus ancillary fee income; (3) plus the float income from escrow balances and payments; (4) minus the operating costs of servicing. The valuation process utilizes historical data, current income and expense figures, and assumptions regarding future economic and portfolio performance. It is in the future category that major divergences in value tend to occur.

Servicing purchases are an investment opportunity and need to be evaluated for their risks and earnings potential in comparison to the risks and benefits of alternative investments. The market value of servicing is most appropriately calculated using a required pretax rate of return or discount rate without debt leveraging which is called the return on investment (ROI). This is because the value of debt leveraging and taxes varies from buyer to buyer.

The present value of the estimated future cash flows from the servicing portfolio in the hands of a specific servicer is known as its economic value. The economic value or return on equity (ROE) is unique to each servicer because of the inherent differences in each servicer's ability to optimize servicing revenues and costs. ROE is calculated by using the fully allocated costs of servicing and includes both income taxes and debt leveraging. ROE is more appropriate for a thrift's internal planning purposes than ROI.

The factors that ultimately determine the value of servicing rights fall into several major categories:

- Servicing portfolio characteristics:
  - Mortgage type;
  - Program type and investor;
  - Geographic location;
  - Interest rate;
  - Average mortgage balance;
  - Remaining term;
  - Servicing fee;
  - Average escrow balances;
  - Ancillary income; and
  - Delinquency/ foreclosure experience.

- Internal operating characteristics:
  - Cost structure;
  - Servicing capacity; and
  - Cash management efficiency.

- Assumptions and forecasts about the future:
  - Future prepayment rates;
  - Interest-rate scenarios;
  - Delinquency/foreclosure rates and related
  - costs;
  - Growth in escrow balances and future earnings rates; and
  - Servicing costs.

- The required rate of return or discount rate.

Valuation of PMSR for Regulatory Capital

The following guidelines for the Valuation of PMSR for regulatory capital are from Thrift Bulletin 60. Significant clarifications, additions, and emphasized items are shown in italics.

FIRREA, FDICIA, and the OTS' implementing regulations limit the amount of PMSR that thrifts may include in regulatory capital to the lower of: (1) 90% of current fair market value determined at least quarterly; or (2) 100% of the remaining unamortized book value.

In addition to the foregoing restrictions, PMSR equal to no more than 50% of a thrift's core capital may be included in calculating core and tangible capital. PMSR purchased, or under contract to be purchased, on before February 9, 1990, however, are not subject to these concentration limitations and are thus grandfathered. All PMSR, regardless of purchase date, are subject to the two-part test described in the preceding paragraphs and, thus, are subject to these valuation guidelines.

Independent Fair Market Valuation

An independent (i.e., third party) fair market valuation must be obtained at least annually if the unamortized book value of PMSR exceeds 25% of a thrift's core capital. The OTS may also require independent PMSR valuations for troubled thrifts, even if the level of PMSR is less than 25% of core capital.

Valuation and Appraisal Guidelines

Thrifts must follow the guidelines below for both quarterly and annual PMSR market valuations. *Departures from these guidelines may result in the exclusion of PMSR from a thrift's regulatory capital.*

A fair market valuation of PMSR is required at least quarterly by F IRREA and FDICIA. *The estimated fair market value of* PMSR *should be based on the prices currently paid for servicing rights that are similar to those being valued. Other values of PMSR, such as the economic value to the thrift owning the rights (where it differs from fair market value), are impermissible values for PMSR that are included in regulatory capital.*

The estimated fair market value of a portfolio of PMSR is defined as the single net price that the portfolio would reasonably be expected to sell for in the current market between an informed buyer and a willing seller. The estimated fair market value of PMSR should be based on the assumption that the PMSR would be marketed in portfolios of a size and composition that will bring the highest price, with the seller providing the customary representations and warranties.

Since no two PMSR portfolios are exactly the same, perfectly comparable PMSR trade data are not available. Moreover, PMSR sales data are not generally available to the public. Therefore, estimates of the fair market value of PMSR should be determined through a present value, or discounted cash flow analysis that is similar to current industry practice. Under this methodology, fair market value is determined by estimating the amount and timing of future cash flows associated with the servicing rights and discounting those cash flows using market discount rates.

The fair market value of PMSR is the present value of the expected income from the portfolio less the present value of the projected expenses. The income stream includes servicing fees, float income from payments and escrow accounts, and ancillary income. The expenses include general servicing costs, foreclosure costs, and interest expenses for funds advanced.

Where there is a range between the high and low points for each guideline below, the average or midrange of *active PMSR buyers* should normally be used rather than the high or low end of the range.

<u>Servicing Costs</u>. General servicing costs include expenses for data processing, personnel, occupancy, foreclosure and REO servicing, escrow expenses for the payment of taxes and insurance, and any interest expenses. The costs of amortizing the purchase price of the PMSR should be *a separate expense item* and excluded from servicing costs.

Long-term servicing cost projections used in valuations should be comparable to those currently used by most market participants to value similar types of PMSR. Neither the servicing costs of the thrift owning the PMSR nor marginal cost estimates are appropriate for determining the market values required under FIRREA and FDICIA unless those costs are consistent with the marketplace. The costs of servicing for FHA and VA mortgages in GNMA pools should be shown separately in the valuation report since these costs are generally higher than for conventional mortgages.

<u>Prepayment Estimates</u>. The prepayment assumptions used to estimate market value should be based on long-term consensus or average prepayment estimates for mortgages with characteristics similar to those being serviced. In general, the prepayment estimates should represent the average prepayment estimates for pools of geographically dispersed mortgages made by the major mortgage market dealers (i.e., national prepayment estimates). National prepayment estimates for 15-year, 30-year, and balloon payment FNMA/FHLMC and GNMA, fixed-rate mortgages can be obtained from various reporting services *such as Bloomberg, Knight-Ridder, and Telerate.*

Historical rates of prepayment may be used as a basis to modify national prepayment estimates or as the basis to estimate future prepayments instead of the national prepayment estimates: (1) if national prepayment estimates are not available for a particular type of mortgage; (2) if the portfolio being valued is highly concentrated in certain geographical areas; or (3) if the appraiser can demonstrate that historical rates better indicate future prepayments for that portfolio than national prepayment estimates. Such historical data should come from recognized mortgage dealers, the federally sponsored secondary market organizations, the FHA Mortality Tables, generally accepted private reporting services, or the thrift's own documented long-term experience.

Historical prepayment experience used to base estimates of future prepayments should be for similar types of mortgages, should at a minimum cover twelve months (preferably thirty-six months), and should be documented or clearly referenced. Merely projecting that future prepayments will be the same as in the past is generally not acceptable without consideration of whether those prepayment rates are likely to continue. In all cases, the thrift will be responsible for justifying any prepayment estimates that deviate from the national prepayment estimates.

Prepayment rates should be expressed in terms of a CPR (constant percentage or prepayment rate) or PSA, a standard prepayment measure developed by the Public Securities Association. The use of the average life method or any measure other than CPR or PSA is not acceptable. Exceptions to this rule may be made for nonstandard mortgages such as multifamily and balloon payment mortgages. All prepayment estimates used in valuations should be supported with documentation.

Computer models that use static or fixed estimates of future prepayments are normally preferred because they are the predominant method currently used in the PMSR secondary market. Models that use option adjusted spread (OAS) or vector prepayment projection methodology are generally acceptable provided that those models produce values that are consistent with the PMSR secondary market *and are supported by adequate documentation.*

Discount Rates. The discount rates used to value each segment of a portfolio should correspond to the *pre-tax rates* currently demanded by investors for similar types of PMSR. In selecting comparable discount rates for PMSR valuations, the discount rates for the most similar type of PMSR should be chosen considering such factors as mortgage type, agency program, original amortization period, geographic location, and other market factors. The discount rates used by the thrift when the PMSR were purchased, the interest rate of the underlying mortgages, and the yield on interest only strips should not be used to estimate current fair market value unless they correspond to the PMSR marketplace.

Projected Interest Rates. The interest rates used to project interest income from escrow, principal and interest (P&I), and prepayment float and to project expenses for escrow and investor advances should be realistic, shown in the valuation, based on the average duration of each type of float or advance, and consistent with the Treasury yield curve.

Escrow and Other Float. The assumptions made as to the average yearly balance of escrow accounts per mortgage, the number of days of P&I float, and the *net* number of days of prepayment float should all be shown separately in the valuation report. They should be based on the past experience of the portfolio of PMSR being valued, the remittance requirements of the investors, *and should be consistent with the prepayment assumptions. Also, any interest costs on escrows should conform to state law and be included in the calculations of market value as a separate expense item.*

Delinquency and Foreclosure Rates. Projected delinquency and foreclosure rates should be based on the actual experience of the portfolio of PMSR. When mortgages are less than 12 months old, the valuation should be based on the national or state averages of delinquency and foreclosure rates published by the Mortgage Bankers Association (MBA) for similar mortgages. *PMSR in excess of 60 days delinquent, in bankruptcy, or in foreclosure, must be excluded from the valuation and regulatory capital.*

Foreclosure Costs. Foreclosure costs should be shown separately in the valuation report. They should be the anticipated costs and should reflect the differences in costs among the types of mortgages (FHA, VA, conventional, multifamily, and commercial) and, if material, their state location, since states have different foreclosure laws.

Growth of Escrows/Servicing Costs. The rates used to estimate the growth of escrow accounts and servicing costs should be based on realistic long-term projections and not short-term experience. The rates of growth should be shown in the valuation and supported by market practice and historical trends.

Portfolio Segregation/Stratification. To determine market value, portfolios of PMSR should usually be segregated by mortgage type (conventional, FHA, VA, etc.), property type (one- to four-family, multifamily, and commercial), repayment terms (15- and 30-year fixed, ARMS, and balloon payments), investor (FNMA, GNMA, FHLMC, private, etc.), recourse and non-recourse, and coupon interest-rate ranges. The stratification of pools by interest-rate ranges should generally encompass no more than a 50bp range except for small percentages of the portfolio. Small segments of the portfolio may be combined with similar servicing for valuations when the differences are not material. *(See Section 573, Accounting, for the requirements for the calculation of book value.)*

Ancillary Income. Ancillary income is generated by such items as late charges, insurance premiums, and assumption and payoff fees. The yearly ancillary income per mortgage should be shown separately in the valuation report and should be based on the actual performance of the portfolio without an allowance for inflation, but less any anticipated runoff as a result of sale and transfer. For PMSR portfolios less than 12 months old, industry averages of ancillary income as reported by the MBA should be used. *Fees related to refinances and other non-servicing asset related activities may not be included in the valuation of PMSR.*

Transfer Costs. Transfer costs are the buyer's expenses of conducting due diligence on servicing portfolios prior to purchase and transfer. These costs are included in the market bids of buyers and, therefore, must be included in the determination of fair market value even if no sale of the PMSR is ever intended. The costs used should reflect the current market estimates as reported by PMSR brokers. Sales expenses, including brokers' commissions, should not be included in transfer costs or in the PMSR valuation because they are not included in marketplace prices.

Debt Leveraging. Borrowing to finance the purchase of PMSR, or debt leveraging, increases the internal rate of return for PMSR buyers by lowering the investment needed to produce the same PMSR earnings. Debt leveraging, however, is not relevant to the calculation of the market value of PMSR.

ARMS, GPARMS, Recourse, etc. Relative to fixed-rate one- to four-family residential mortgages, the servicing and foreclosure costs as well as discount rates and prepayment estimates are generally higher for ARMS, Graduated Payment ARMs (GPARMs), negative amortization mortgages, second mortgages, multifamily mortgages, mortgages not conforming to agency guidelines, wrap-around mortgages, and recourse servicing. Some types of PMSR, such as nonconforming GPARMS, are not readily marketable and, therefore, may have little fair market value. Each type of PMSR should be valued based on its unique costs, discount rates, prepayment estimates, and other factors.

Book Value Limits. Pools or packages of PMSR are sometimes obtained at below market prices or for other reasons have minimal or no accounting cost basis. These pools may be included in valuations in excess of their individual book value, however, *the total amount of PMSR included in regulatory capital may not exceed the lower of 90% of market value or 100% of the total remaining unamortized book value.* (The value of retained servicing (OMSR) and ESFR on the thrift's originated portfolio are not includable with PMSR for regulatory capital purposes.)

Market Value of Hedging. The value of any financial instruments that are used to hedge PMSR should not be included in the market value of PMSR. They have their own separate market values and are traded separately.

Market Value of Insurance. FNMA and FHLMC recourse servicing that includes recourse loss insurance or prepayment insurance for PMSR may be included in the determination of market value. The OTS permits the value of such policies (i.e., conversion of recourse PMSR to nonrecourse) to be included in the value of PMSR, provided the cost of the insurance policy is deducted from servicing income or added to the per mortgage servicing cost of the PMSR portfolio. The OTS reserves the right to disregard this type of insurance if concerns exist about the insurance firm's ability to meet its financial obligations.

<u>Split PMSR</u>. PMSR whose ownership is shared by two or more parties in violation of servicing contracts should not be included in the appraised value or regulatory capital of either the buyer or the seller. (FNMA and FHLMC servicing contracts contain prohibitions against splitting the ownership of servicing.) If allowed under the servicing contract, split ownership servicing must always leave the servicer a minimum spread of no less than the GAAP normal servicing fee for the OTS to allow its inclusion in regulatory capital. Servicing owned by two or more affiliated companies should have formal servicing agreements in place that specifically allow the split ownership of servicing and that provide for at least a normal servicing fee in order to be counted in regulatory capital.

<u>PMSR Not Included in Capital or Grandfathered.</u> PMSR that is not included in regulatory capital does not have to be valued either annually or quarterly. However, all PMSR that is included in regulatory capital should be valued each quarter to comply with FIRREA and FDICIA.

<u>OTS NPV Model</u>. The servicing values from the OTS Net Portfolio Value (NPV) model should not be used as the fair market value of PMSR.

<u>Contents of PMSR Valuation Reports</u>. Valuation reports should be self-contained products that identify the portfolio being valued and provide all the data used in the calculation of each segment's fair market value. Valuations should explain the methodology used and state that its purpose is to estimate the current fair market value in compliance with these guidelines. Valuations should be supported with adequate documentation and should be signed and dated by the appraiser. Independent valuations should also contain a statement of conformance with *Principals of Appraisal Practice and Code of Ethics authorized June 30, 1968, revised June 1990 by the American Society of Appraisers (ASA), 535 Herndon Parkway, Herndon, Virginia 22070.*

<u>Appraiser Due Diligence</u>. Appraisers are not required to perform on-site verifications of the thrift's PMSR computer tapes that are sent for valuation. Appraisers should, however, investigate any significant discrepancies or inconsistencies where there is a reasonable basis to doubt the accuracy of the information supplied by the thrift.

<u>Appraiser Qualifications</u>. PMSR appraisers should be experts in valuing mortgage servicing rights. The qualifications and experience of the appraiser should be described in each valuation report.

<u>Independence of Appraisers</u>. In addition to the independence definition already given, independent PMSR appraisers should comply with the ASA's *Principals of Appraisal Practice and Code of Ethics.* Among other things, these principles preclude appraisers from basing their appraisal fees on the amount of the appraisal value or related business, such as brokerage services performed for the thrift. Free appraisals or substantially reduced price appraisals offered by firms because they provide other services for the thrift are also not acceptable.

Separate valuation divisions and affiliated corporations of PMSR brokers *generally will be considered independent appraisers if there is a clear separation and independence from the PMSR brokerage area. Consultants who are not brokers and brokers acting only as appraisers generally will be considered independent appraisers as long as they did not advise or assist the thrift on the purchase of more than 25% of the current dollar amount of PMSR being appraised. Past appraisals of PMSR will not be considered by OTS as disqualifying brokers from future brokerage services with that thrift, as long as the brokerage business was not planned at the time of the appraisals.*

<u>Amortization</u>. *The costs of purchasing the PMSR portfolio and its transfer costs should be amortized proportionately to the positive cash flows over the expected life of the mortgages under FAAP. To determine PMSR market value the*

level yield or interest method of amortization should be utilized because it confirms *to GAAP and is the dominant market practice. (See Section 573, Accounting.)*

Safeguards for Outside Servicers

Some thrifts have suffered losses and had other serious problems with mortgage servicers; especially with servicers that are new, unregulated, or unknown. Most of these problems are the result of negligence, incompetent servicing staffs, or simply sloppy servicing. Occasionally, however, fraud or diversion of the mortgage P&I payments, payoffs, or escrow funds is discovered. The following are some of the problems that thrifts have encountered with servicers:

- Excessive delay in the servicer's remitting mortgage payments or prepayments so the servicer can earn additional float income;
- Diversion of escrow payments, that should have been paid for taxes or insurance, to the servicer's use;
- Keeping the funds received on full prepayments and representing to the thrift that the mortgage continues to make monthly payments;
- Missing, lost, damaged, or out-of-date records;
- Sending NSF checks to the thrift;
- Canceling insurance or bond coverage to save money;
- Falsely representing the level of delinquencies and foreclosures; and
- Sloppy handling or no attention to delinquencies, tax or insurance payments, PMI claims, or ARM adjustments.

Thrifts should be aware that some state laws view the servicer as an agent of the owner of the mortgages and, thereby, hold the owner liable for the actions of the servicer. While some states regulate servicers, the regulations are usually geared toward consumer protection, as opposed to safety and soundness. The following are the basic steps thrifts should utilize with any new, unregulated, or unknown servicers to lessen the risk of problems and losses.

New Servicers. Before using any servicer that is new or unknown to the thrift, especially unregulated servicers, the thrift should:

- Obtain financial and historical background information;
- Obtain and check references from several other financial institutions;
- Confirm the servicer's approval and check for any recent adverse audit findings or suspensions by HLTD, FNMA, FHLMC, GNMA, and all PMI companies involved in the prospective servicing;
- Perform an on-site due diligence visit;
- Determine the adequacy of the servicer's external auditor and obtain a copy of the last audit; and
- Check the adequacy of the servicer's directors and officers (F5&0) liability insurance, errors and omissions (E&O) insurance, and surety bond.

Servicing Agreement. If the servicer is acceptable to the thrift, a written servicing agreement should be drawn up that:

- Clearly specifies the servicing policies and procedures to be used by the servicer for all common or anticipated servicing situations;
- Permits on-site audits of the servicer at any normal business time by the thrift, its agents, or OTS;
- Requires the use of separate deposit accounts at financial institutions acceptable to the thrift for both P&I and for escrows with the statements going directly to the thrift;
- Requests that the PMI companies make all claim check payable to the thrift or notify the thrift o payments to the servicer;

- Gives the thrift direct access to the MIS service bureau or servicer's MIS department for audit purposes;
- Specifies the dates and frequencies that the P& and payoff funds are to be remitted to the thrift;
- States the servicing fees and the manner of payment to the servicer and who is to receive the ancillary income and float revenue;
- Permits termination of the servicing agreement, for cause, and transfer of the mortgage servicing files, records, insurance policies, computer records, and other related documents to the designee of the thrift. "For cause" should be clearly defined to include fraud, embezzlement, diversion of mortgage payments or payoffs, failure to follow any provision of the servicing agreement, or for continued sloppy servicing after the thrift has sent a formal written warning to the servicer;
- Permits the transfer of the same servicing records at any time without cause by payment of a stipulated termination fee to the servicer; and
- Requires direct notification to the thrift of E&O insurance, D&O liability insurance, and surety bond of cancellation or nonrenewal.

Past failures to take these basic precautions have led to significant losses for some thrifts.

<u>Servicer Performance and Audit</u>. The following procedures should be utilized to minimize the risk of loss from servicers:

- Monthly review remittance reports and other computer reports from the servicer to detect discrepancies and errors;
- Monthly review and reconcile bank statements with borrower's monthly payments, remittances from the servicer, and escrows held by the servicer;
- Quarterly compare the servicer's delinquency and prepayment rates to the national averages from the MBA delinquency survey;
- Annually verify mortgages, property owners, and loan balances by direct mail;
- Annually review the servicer's independent audit and financial reports;
- Annually check the servicer's E&O and D&O insurance, and surety bond; and
- Annually verify continued approval by PMI companies, HUD, FNMA, FHLMC, and GNMA.

Discovery of any of these problems should result in immediate thrift action. If fraud or diversion of funds is detected, the thrift should move immediately to transfer payments and bank accounts to its name or another servicer and should transfer the servicing for cause as soon as possible. For other less serious problems, usually working with the servicer to correct the problems is the best solution. Thrifts, however, should not be hesitant to transfer servicing for cause if any of the provisions of the servicing agreement are not followed or if the servicer does not correct problems promptly after notice.

Primary Regulatory Concerns

Our primary concerns with mortgage servicing operations usually are servicing sales with recourse, prepayments, loss of the servicing, swapping retained servicing for PMSR, excessive amounts of PMSR included in regulatory capital, abusive ESFR practices, operational cost risks, and poor servicing transfers or inadequate servicing.

<u>Recourse Servicing</u>. Of primary concern to regulators are servicing agreements that require servicers to pay the credit losses on mortgage foreclosures. Normally servicers are responsible for losses as a result of their own mistakes, but the owner of the mortgage is responsible for losses from normal foreclosures. These losses are called credit losses. Under almost all of the purchase programs of FNMA and FHLMC, those organizations hold the risk of credit losses, however, each agency has some recourse servicing programs.

GNMA servicing, which contains almost all of the FHA and VA mortgages made today and some FMHA mortgages, requires servicers to absorb any losses in excess of the amount paid by FHA insurance or VA guarantees. Since VA no-bid losses have become large and commonplace, VA/GNMA recourse losses can be significant and average in excess of $5,000 per no-bid after the VA has paid its guarantee. FHA/GNMA servicing contains a much smaller, but still significant amount of recourse losses in the form of unreimbursed costs.

Both FNMA and FHLMC sales and servicing agreements hold the current servicer responsible for origination defects or servicing errors. This applies even if the current servicer merely purchased the servicing and did not originate the mortgage or make the servicing error. These agreements are often used to require servicers to repurchase mortgages that have gone into foreclosure. Such repurchases usually produce large servicer losses.

In sales to other investors, the examiner should verify that no type of full or partial recourse back to the servicer exists or that any recourse is covered by an enforceable agreement with a financially strong seller. Common types of recourse include buy-back agreements (both written and verbal), credit loss indemnifications, prepayment indemnifications, and yield guarantees. Any sale that does not transfer all of the risks and rewards of ownership should be considered at least partial recourse. If a sale of the servicing is with recourse, the seller must account for the transaction as a financing and not a sale. (See Section 573, Accounting.)

Prepayments. Regulators are concerned with the prepayment risk attached to mortgage servicing especially where the thrift has capitalized either ESFR or PMSR. This is because increases in the prepayment speed above the estimates used in initially calculating the value of those assets produce immediate and direct losses for the thrift. Also, prepayment losses from OMSR or retained off-balance-sheet servicing must be considered a loss since these are valuable assets that can be sold for a profit. Prepayment risk is difficult to hedge except for the natural hedging effects of the thrift's own mortgage portfolio and an active origination system. (See Section 541, Hedging.)

Loss of Servicing. Loss of mortgage servicing for cause can occur under most servicing agreements in three ways. This occurs when the servicer: (1) diverts mortgage payments or commits any other type of fraud or illegal action; (2) fails to adequately service the mortgages in accordance with the servicing agreement; or (3) does not adhere to the financial strength or other general requirements of the servicing agreement. When servicing is transferred from a servicer for cause, the servicer receives no compensation even though a valuable asset has been taken away. Because of the financial loss and the terrible publicity involved, most servicers go to extremes to avoid the loss of servicing for cause.

Under most conditions that do not involve fraud or embezzlement, investors commonly give the servicer enough time to sell the servicing to an acceptable servicer. This is usually done under threat of loss for cause if the sale does not occur within the required time frame. Other less extreme measures that investors take to cure violations of servicing agreements include requiring the servicer to move the escrow custodial accounts to a stronger financial institution, the use of custodial agents, the use of tax payment services, or hiring subservicers. The movement of escrow funds from a thrift can be devastating if those funds are a large percentage of total deposits.

FNMA, FHLMC, and GNMA all try to work with servicers to correct deficiencies and meet their servicing requirements. These organizations generally treat thrifts as customers and seek to preserve and enhance the seller/servicer or issuer relationship whenever possible. Usually small dips in the level of capital below requirements or temporarily not having adequate directors and officers liability insurance are not major problems. In most situations these organizations will even leave the servicing with a thrift after it has been placed into a conservatorship by the OTS. The critical issue for these agencies is usually whether any mortgage related money is in any danger.

FNMA, FHLMC, and GNMA all consider the loss of an adequate financial strength rating for thrifts that hold escrow custody accounts as a serious violation. Currently FNMA and FHLMC require, for both escrow and P&I custodial accounts, an insured depository with an IDC Financial Publishing (DDC) rating of 75 or better, or a Thompson Bank Watch (TBW) rating of C or better. GNMA requires a minimum rating for their depositories from Thompson Bank Watch of C, Moody's of P-3, or Standard and Poor's of A-3. FHLMC and GNMA allow some other types of ratings in addition to these basic ones as stated in their seller/servicer or issuer guides.

<u>Swapping Retained Servicing for PMSR</u>. The objective of many servicing trades is not to add to the value of their servicing portfolio, but to convert retained servicing (OMSR) from off-balance-sheet assets to PMSR which are on-balance-sheet assets. The conversion process requires the retained servicing to be sold and the proceeds taken into income while capitalizing the purchase price of the PMSR that replaces it.

Small errors in calculating the value of PMSR can become actual losses quickly from not only prepayment risk and market changes, but also from errors in any of the estimates used to calculate the PMSR purchase price. The more aggressive the PMSR price paid, the more likely that it is to be over-valued and subsequently require charge-offs. Even if PMSR purchases are completed at realistic prices, the costs of the broker used to sell the retained servicing rights, the costs of performing due diligence, and the costs of transferring the PMSR are significant. None of these risks or costs are incurred if the thrift retains the off-balance-sheet servicing and takes its servicing profits into income as they are earned.

<u>Excessive Amounts of PMSR Included in Regulatory Capital</u>. Under FIRREA, FDICIA, and OTS Capital Regulations, PMSR are limited for inclusion in regulatory capital to the lower of 90% of their fair market value or 100% of the remaining unamortized principal balance. Also, the amount of PMSR included in regulatory capital may not exceed 50% of core capital unless grandfathered. The 10% haircut, the 50% limit, and 100% risk-weight category for PMSR under the risk-based capital rule, all make the ownership of PMSR inadvisable for thrifts that have minimal capital levels. That is not to say that OTS does not support mortgage servicing for others. We do, however, large amounts of PMSR relative to capital is a risk that only thrifts with adequate to strong capital positions can afford.

<u>Excessive Amounts of ESFR</u>. In spite of the fact that GAAP classifies ESFR as tangible assets, our experience with this asset has not been good. Many thrifts have failed with one of the main contributing factors being grossly overstated ESFR. In addition to the initial valuation issues and quarterly impairment tests, the practice of putting mortgages into unnecessarily low interest-rate securities appears to be a major indicator of abuse. *The repeated creation of more than 50bp of excess servicing spread, that was present valued to calculate ESFR, strongly indicates abuse based on experience with other thrifts.* (See Section 573, Accounting, for the valuation guidelines for ESFR.)

<u>Operational Costs</u>. These are the risks that thrifts take when they make substantial investments in buildings, computer systems, and personnel for either servicing or subservicing. The risks are that the amount of servicing will not remain constant or grow in order to hold down per mortgage servicing costs and that the future costs of these overhead items on a per mortgage basis will exceed their value compared to alternative costs. Another part of operational cost risks are the servicing cost estimates used to purchase PMSR. If future servicing expenses rise substantially faster than projected, future losses could be built into PMSR purchases. The enormous costs of in-house computer systems for mortgage servicing are a particularly large risk for all but the largest servicers.

<u>Poor Servicing Transfers and Inadequate Servicing</u>. The Cranston-Gonzalez National Affordable Housing Act of 1990, among other things, amends RESPA to protect mortgagors during transfers of mortgage servicing. The requirements are all basic to good mortgage servicing; however, the abusive practices of some servicers triggered the amendment. Borrowers must be given adequate notice of transfers, the name of the new servicer, a toll-free telephone number to call to ask questions or report problems, any late charges as a result of the transfer must be waived, and the new servicer must be generally responsive to problems

caused by the transfer. Violations of this law and other types of poor or abusive servicing such as violations on the limit of escrow amounts required by the servicer are often reported to the OTS Consumer Compliance Area.

Conclusion

Servicing is the primary earning asset of mortgage banking operations, however, it must be actively managed by experienced professionals to preserve its maximum value. Transactions that only increase the book value of servicing should be avoided and, whenever possible, servicing income should only be recognized as earned. In addition, excessive concentrations of capital in servicing assets, overstated values of servicing, and exposure to recourse and prepayment risk should all be avoided.

REFERENCES

American Society of Appraisers, *Principal of Appraisal and Code of Ethics*

Barrentine, Lott, and Associates, *Servicing Valuation Model Tutorial Version III*

Cranston-Gonzalez National Affordable Housing Act of 1990

Federal Deposit Insurance Corporation Improvement Act (FDICIA)

FHLMC Servicer's Guide

FNMA Servicer, MBS, and Multifamily Guides

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

GNMA I & II MBS Issuer/ Servicer Publications

Mortgage Bankers Association, *National Delinquency Survey and Cost Studies*

Real Estate Settlement and Procedures Act (RESPA)