
Mortgage Banking — Servicing Program

Examination Objectives

To assess the adequacy of the servicing systems and internal controls.

To determine the profitability and risks of the mortgage servicing operation.

To assess the accuracy of the PMSR assets reported as regulatory capital.

Examination Procedures

Perform the following examination steps to ensure that the mortgage servicing is profitable, complies with regulatory limits, and does not pose dangers to the thrift. Those steps that do not apply may be omitted, however, a notation should be made as to why they do not apply.

Level I

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| 1. Determine the characteristics of the servicing portfolio paying specific attention to the investors (GNMA, FNMA, FHLMC, private), the types of mortgages, the delinquency rates including 30-day delinquencies, the amount of mortgages in foreclosure, and the amount of REO. | |
| 2. Review the previous report of examination and all servicing-related exceptions noted and determine if management has taken appropriate corrective action. | |
| 3. Obtain the organization chart and determine the experience and qualifications of key servicing personnel. Evaluate whether they can adequately handle the amounts and types of servicing. | |
| 4. Review the most recent set of management reports outlining operating results for the servicing unit. Determine if the detail is sufficient for management. | |

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5. Review the most recent analysis of servicing costs per mortgage for each mortgage type and determine if the analysis includes all marginal, fixed, overhead, management, and indirect servicing costs. Determine if marginal costs are calculated for servicing and if it excludes overhead and fixed expenses. Estimate the servicing operation's current and future profitability.

6. Determine if the thrift assesses the financial capacity of all servicing sellers, private guarantors, and major subservicers annually.

7. Review sales and purchases of servicing since the last examination to:

- Determine whether the board of directors approved these transactions in advance;
 - Assess the adequacy of due diligence activities performed prior to funding bulk purchases or sales;
 - Determine whether servicing sales and purchases have been with or without recourse and whether there have been any implied, partial, or verbal recourse agreements; and
 - Verify that comprehensive sales and servicing agreements are maintained for each purchase and sale.
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8. Verify that a disaster recovery plan is in place that covers all major servicing and subservicing functions.

9. Review available audit reports from private investors, FNMA, FHLMC, GNMA, FHA, VA, and state agencies to determine if violations of their servicing policies have been found and then determine if those violations have been corrected. Determine if the thrift meets or is in danger of failing these agencies' requirements for custodial accounts.

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10. Evaluate the safeguards for holding mortgage documents. Determine if the documents are kept in a secure area. Determine whether an adequate documentation tracking system exists.

11. Review the procedures for receiving payments, escrows, and payoffs, depositing those funds into separate custodial accounts, and disbursing payments to investors to:

- Evaluate if cashiering systems for the receipt of payments are adequately safeguarded from fraud, accidental errors, and misuse of funds;
- Assess if the duties and access to custodial accounts is properly segregated;
- Determine if systems are in place to ensure timely payments to investors;
- Determine if custodial accounts are reconciled on a timely basis;
- Ensure that funds are in financial institutions acceptable to the investors;
- Determine whether adequate controls exist over disbursements from custodial accounts; and
- Determine if a monthly report is sent to each investor that details principal, interest, and escrow collections from each mortgagor, delinquency rates, foreclosure actions, principal balances, and escrow disbursements and balances.

12. Review the escrow policies and practices and the method for determining the required escrow amount. Determine whether escrows comply with 12 U.S.C. 2609 (RESPA) limits on escrow accounts and that the servicer is using the aggregate method for escrow calculations. Determine whether an adequate annual statement showing the method of escrow correction is sent to the mortgagor.

13. Review the system for ensuring the timely payment of taxes and insurance and evaluate its effectiveness. Determine the volume of mortgages without escrows and determine how each mortgage's tax and insurance are kept current. Determine if there is adequate

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coverage under a blanket or errors and omissions insurance policy to cover against uninsured property losses and tax penalties.

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14. Review policies and procedures for collecting late payments to:
- Determine when collection efforts start (other than late notices);
 - Verify that the thrift documents all collection events;
 - Determine if collection practices agree with the servicing agreement and comply with applicable laws and regulations; and
 - Determine if late charge collections are in compliance with the servicing agreement, the mortgage, and state law.
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15. Review a sample of delinquency reports for loans 121 days delinquent to:
- Determine if foreclosure proceedings are started in a timely manner;
 - Determine if PMI companies are promptly notified of foreclosure actions;
 - Verify that forbearance agreements and payment plans are documented;
 - Determine that property inspections are performed promptly; and
 - Verify that foreclosure practices comply with investor guidelines.
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16. Review investor, late charge, and escrow advances/receivables to:
- Evaluate their collectability;
 - Determine if reimbursement claims are sent to investors promptly;
 - Determine the average foreclosure costs for each mortgage type;

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- Determine if foreclosure and late charge loss reserve accounts are adequate and charged on a timely basis; and
 - Verify that uncollectable advances, other charge-offs, recoveries, and expenses are charged directly to the reserve in a timely manner.
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17. Determine the number and dollar volume of delinquencies repurchased prior to investor requirements, evaluate the control and reporting systems in place to limit this practice, and evaluate its net effect on profitability.
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18. Determine if the excess servicing spread used in the computation of ESFR is in excess of 50bp. Investigate whether this amount was in excess of that required to sell the mortgages and leave adequate servicing and guarantee fees under market conditions at the time of the mortgage sale. If so, determine if this practice is abusive or is unsafe and unsound.
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19. Verify that the thrift is correctly calculating and reporting the 10% nonqualifying servicing and other types of servicing on the TFR. Determine if the ratio of total servicing assets (ESFR plus PMSR) to the total dollar amount of loans serviced for others (LSFO) is in excess of 200bp. If so, determine why and if it is unsafe or unsound.
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20. Review the internal quarterly market valuations of PMSR. Determine if the amount of PMSR reported in regulatory capital exceeds 50% of core capital. Determine if the excess over 50% of core capital is grandfathered.
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21. Determine if the amount of PMSR included in regulatory capital exceeds the lesser of 90% of fair market value or 100% of the remaining unamortized book value (grandfathering does not apply).
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22. Determine if the investigation of prospective new, unknown, or unregulated servicers and sub-servicers is adequate to protect the thrift. Determine if sale and servicing agreements are adequate.

23. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

24. Determine the number and dollar volume of REO by geographic location, evaluate regional concentrations, compare the volume of REO with historical levels and industry averages, and evaluate the impact of REO on profitability.

25. Review the polices, procedures, and actual practices for REO and investor owned real estate property supervision, accounting, and marketing to ensure that they are consistent with TFR instructions and investor requirements.

26. Determine if the thrift has implemented a quality control program for the servicing unit and evaluate its effectiveness.

27. Determine if the servicer's monthly bank statements and remittance reports are checked and reconciled. Determine if other audit steps are taken monthly.

28. Determine if the thrift annually: (1) checks to verify that the servicer's continued approval with the agencies and PMI companies is maintained, (2) analyzes the servicer's financial statements, (3) verifies that insurance and bond coverage remains in effect, (4) verifies mortgages and balances by direct mail to borrowers, and (5) checks the servicer's

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reported levels of delinquency and prepayments for the thrift's portfolio against reported national averages.

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29. Verify that an independent PMSR appraisal is obtained annually for thrifts with PMSR in excess of 25% of core capital that meets the independence and fair market value requirements. Review the valuations of PMSR to determine if:
- They are being performed by qualified appraisers;
 - Economic value was reported instead of fair market value;
 - The prepayment speeds used in the analysis are adequately supported;
 - Prepayments are measured by PSA, CPR, or the FHA tables;
 - The discount rates were comparable to the market on the appraisal date;
 - Servicing cost estimates were comparable to market costs;
 - The mortgages are segregated into types and interest rate segments;
 - The escrow inflation rate is realistic;
 - The reinvestment interest rates conform to the Treasury yield curve;
 - Transfer and due diligence costs are deducted;
 - The value of hedges are not included;
 - The valuation conforms to the ASA guidelines;
 - No OMSR, ESFR, or subservicing is included;
 - No PMSR over 60 days delinquent is included; and
 - The value from the NPV model is used for PMSR market value.
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30. Obtain copies of the most recent quarterly internal calculations of PMSR market value. Reconcile these amounts to the values reported on the general ledger and TFR.
- Select a sample of calculations for review. The sample should represent a cross section by mortgage type and interest rate, and should include FHA/VA mortgages, fixed-rate conventional mortgages, ARMs, and mortgage pools with interest rates near market rates as well as above market rates;
 - To ensure that the assumptions used in the internal valuation process are valid, employ the steps in No. 29 above. Review the delinquency rates to determine if they are comparable to the averages reported in the MBA Delinquency Survey. Any other atypical characteristics should be properly reflected in the valuations;
 - As a test-check, compare the assumptions in the most recent independent appraisal and the internal valuations. Any material deviations should be adequately supported;
 - If no material deficiencies are noted with respect to the model assumptions, select a small sample for calculation using the OTS Servicing Valuation Model. A sample of one government and one conventional mortgage package should be chosen for the initial review. If the model produces results similar to those reported by the thrift, no further review is necessary. If material deviations exist, however, the sample should be expanded to determine the extent of any overstatement of PMSR; and
 - In the event that a material overstatement of PMSR is discovered, the thrift should be required to recalculate the value with more appropriate assumptions, obtain an independent valuation, or write down the value of the PMSR for regulatory capital purposes.
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31. Section 573, Accounting, for PMSR and ESFR book value procedures and for table-funded See PMSR requirements.
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32. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
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Examiner's Summary, Recommendations, and Comments

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