

Methodology

*Operational Risk Assessment for  
U.S. RMBS Servicers*

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*Insight beyond the rating.*

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# Operational Risk Assessment for U.S. RMBS Servicers

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# Operational Risk Assessment for U.S. RMBS Servicers

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## INTRODUCTION

DBRS operational risk assessment procedures for U.S. Residential Mortgage-Backed Securities (RMBS) servicers are designed to evaluate the quality of the parties that service or conduct backup servicing on the loans that are about to be securitized or have previously been securitized in a transaction rated by DBRS. While DBRS does not assign formal ratings to these processes, it does conduct operational risk reviews to determine if a servicer is acceptable and incorporates the results of the review into the rating process for new transactions and into the surveillance process for outstanding transactions rated by DBRS.

DBRS begins the initial servicer review process by scheduling a date to conduct an on-site visit of the company. Once a date is confirmed, DBRS sends a sample agenda that outlines the topics to be covered during the meeting which includes a list of documents to be provided such as organizational charts, financial statements and performance statistics (Exhibit I). During the on-site review, DBRS meets with senior management to discuss the servicing operations, tour the facilities and review system demonstrations, as appropriate. The on-site review typically takes one to two days, depending on the product(s) being serviced and number of servicing sites. DBRS assesses the information gathered through the review process, along with its surveillance data and industry statistics to determine if a servicer is acceptable. In instances where DBRS determines that the servicer is below average, issuers may incorporate certain structural enhancements into a proposed transaction such as additional credit support, dynamic triggers or the presence of a warm or hot backup servicer in order for DBRS to be able to rate the transaction.

DBRS conducts periodic reviews of the servicer as part of the ongoing monitoring of outstanding transactions or in cases when unexpected events warrant such as the sale of the operation or a servicer filing for bankruptcy. The reviews are intended to bring DBRS up to date on any changes that have taken place since the last operational risk review and highlight any material changes to the operation or its management. The review may be accomplished through a conference call, meeting with senior management or by an on-site visit to the servicer. The type of review needed is typically determined based on the length of time since the last on-site review, the performance of the rated transactions and the materiality of any changes within the organization. Any findings from the update review are incorporated into the surveillance process in addition to being included in the analysis for new transactions.

In cases when the servicer or its parent is rated or internally assessed by DBRS at below investment grade or if DBRS believes that, while not imminent, there is a potential risk that the servicing may need to be transferred at a future date, issuers may incorporate a warm backup servicer as a transaction party. Some reasons for the inclusion of a warm backup servicer could be: the company is up for sale, senior management recently departed, lines of credit were not renewed or now have more restrictive covenants, or delinquency levels are trending upward and there is concern about potentially hitting servicing transfer triggers in a transaction. Certain reasons for the inclusion of a hot backup servicer could be: if a servicer is relatively new to the servicing business, lacks experience servicing the product being securitized, has fewer than 10,000 loans in its portfolio or the servicer or its parent is a below investment grade rated entity. In the event that DBRS determines that a servicer is unacceptable, it may refuse to rate the deal.



## SERVICER REVIEW PROCESS

The servicer review process typically involves an analysis of the following:

1. Company and Management
2. Financial Condition
3. Loan Administration
4. Customer Service
5. Escrow
6. Default Management
  - Collections
  - Loss Mitigation
  - Bankruptcy
  - Foreclosure
  - Real Estate Owned (REO)
  - Advancing
7. Investor Reporting
8. Technology

For liquidating trust structures, the process focuses on the company's strategy for handling various types of delinquent loans and its success rate in getting those loans to re-perform through foreclosure or sold through the REO process as quickly as possible.

## COMPANY AND MANAGEMENT

DBRS believes that no servicing operation can be successful without a strong seasoned management team that possesses demonstrated expertise in the product(s) they are servicing. As a result, DBRS views favorably those servicers whose management team possesses greater than ten years of industry experience. Additionally, DBRS believes that in order to appropriately evaluate a servicer, they should have at least 10,000 loans in their portfolio and have been servicing those loans for a minimum of one year. Furthermore, adequate capacity and resources to handle fluctuations in loan volume are of paramount importance.

DBRS also believes internal assessments and quality-control reviews are critical in recognizing procedural errors that may not be easily detectable. These reviews can be used to identify trends, training opportunities and exception practices. Frequent checks can assist management in quickly instituting changes to areas needing improvement, as well as benchmarking those results to performance. In addition to the aforementioned reviews, a monitoring process should be in place to ensure that the servicer is in compliance with all applicable laws, rules and regulations and that all employees in customer-facing positions are appropriately trained.

## FINANCIAL CONDITION

DBRS reviews the servicer's financial condition to determine whether the servicer has sufficient resources and to assess the likelihood of a servicing transfer, servicer bankruptcy or other potential interruption in cash flow to a transaction such as the servicer's ability to make advances.

In cases where DBRS does not maintain a public rating of the entity performing a servicing role, the DBRS Financial Institutions Group provides an internal assessment (IA) of the relevant institution. The IA will be monitored over the life of the transaction and DBRS will notify the relevant institution if any such ongoing internal assessment results in a downgrade. In certain cases, DBRS may rely on public ratings assigned and monitored by other credit rating agencies.

Some items that are reviewed as part of this process may include:

- Company ownership structure
- Management experience



- Corporate rating of any parent company (if applicable)
- Internal and external audit results
- Revenue sources including servicing fees and lines of credit
- Costs to service
- Litigation (past, present and expected)
- Existing business strategy and strategic initiatives
- Recent or planned mergers or acquisitions
- Recent or planned transfer of servicing rights
- Securitization history and future plans

Any financial stress identified can elicit servicing problems either immediately, as in the case of a servicer bankruptcy, or lead to a slow degradation of the performance of the collateral. Therefore, the servicer's financial condition weighs on all aspects of DBRS analysis of RMBS transactions including the evaluation of proposed credit enhancement levels and the presence of proposed structural safeguards.

## LOAN ADMINISTRATION

DBRS reviews the loan administration area to assess servicers boarding accuracy, data integrity, application of payments to borrower accounts and exception rates. Servicers with large numbers of un-reconciled items in suspense accounts indicate a fundamental problem with the cash management operation. As a result, DBRS views favorably those servicers with a high level of automation and a low tolerance for un-applied funds. Additionally, DBRS reviews the servicer's efforts towards compliance with regulatory guidelines and industry best practices. Furthermore, the servicer's portfolio is reviewed for changes in size, product type or delinquency to determine if more frequent reviews or management calls might be necessary to monitor the performance of the portfolio.

## CUSTOMER SERVICE

DBRS reviews the customer service area to see how well the servicer responds to customer inquiries and in some instances performs early stage collection calls. Performance metrics such as call hold times and abandonment rates are reviewed to determine if the department is appropriately staffed or if certain call blockage features are in place to prevent customers from being able to speak to a representative. Furthermore, a monitoring process should be in place to ensure that the servicer is in compliance with all applicable laws, rules and regulations and that all employees in customer-facing positions are appropriately trained.

## ESCROW

The escrow area is reviewed to determine how effective a company's procedures and controls are for the payment of real estate taxes and insurance in addition to tracking real estate tax payments for non-escrowed accounts. Consequently, firms that have lost properties to tax sale due to non-payment of taxes are not viewed favorably by DBRS. Many firms today outsource their escrow department; in these instances DBRS would review the company's management of the vendor relationships in addition to ensuring the existence of a back-up plan in the event the relationship was terminated.

## DEFAULT MANAGEMENT

The effectiveness of a servicer's operation has a direct impact on security performance and ultimately losses to the RMBS investor. A servicer's strategy for handling loans in default as well as its ability to closely manage loans in foreclosure and bankruptcy can stabilize or improve pool performance. The marketing of real estate owned (REO) properties, as well as ultimate disposition timelines and cost containment, can also determine a servicer's capabilities, particularly as many already carry a large number of REO properties on their books.

Many servicers use predictive dialer systems that incorporate behavioral scores to identify and prioritize the riskiest borrowers. Collection efforts generally escalate in intensity as accounts roll to more advanced



delinquency categories. Depending on the stage of delinquency, the servicer may offer a forbearance or modification plan that can include a reduced interest rate, capitalization of monies owed or debt forgiveness, in addition to a formal payment schedule, to help the account become current. In instances where a borrower acknowledges that he or she cannot afford to remain in the home, the servicer often uses a short sale as an alternative to the foreclosure process. In this instance, the borrower agrees to sell the home for an amount less than the full payoff on the loan and is released from the lien.

DBRS views favorably those servicers that have predictable performance and strong monitoring procedures for delinquent accounts. Once an account becomes delinquent, effective collection procedures can minimize losses to investors. Accordingly, DBRS evaluates the quality of the collections strategy and staff in order to determine their success rates in contacting borrowers and determining their ability and willingness to pay. Additionally, in certain instances, the servicer may be responsible for the advancing of principal and interest to the trust to the extent it is deemed recoverable. As a result, DBRS evaluates the servicer's advancing policies and procedures to determine if they are reasonable and not causing over advancing, which can result in higher loss severities.

## INVESTOR REPORTING

DBRS reviews the investor reporting function to see if they have a track record of timely and accurate remittances to trustees and/or master servicers. Consequently, DBRS views favorably those servicers who have never had to restate a remittance report. Additionally, when available, DBRS reviews the rankings provided by the government sponsored entities (GSEs) for this function.

## TECHNOLOGY

Technology resources are an integral component of the servicer review process. While DBRS does not subscribe to specific systems architecture, adequate systems controls, consumer privacy protection and backup procedures, including disaster recovery and business continuity plans, are considered critical processes and should be in place. Furthermore, servicers must ensure that any offshore vendors are monitored and a backup plan is in place to ensure minimal downtime. Over the past few years, leveraging the Internet has enabled many firms to operate effectively in the mortgage business. Servicers have used the Internet for marketing, customer service and the dissemination of pertinent information, such as payment reminders or inquiries relating to refinances, modifications or payoffs. As a result, DBRS expects servicers to have the appropriate staff and controls in place to ensure website availability, account maintenance and enhancements. Sophisticated technology, with robust functionality, is viewed favorably by DBRS as it often helps bring large efficiencies to the servicing operations in addition to more predictability in terms of loan performance.

## MASTER SERVICER

A master servicer is responsible for collecting loan data from primary servicers, calculating the expected principal and interest payments that should be remitted and reconciling any differences with the servicers. A master servicer is also responsible for making principal and interest advances in the event the primary servicer fails to do so. As a result, financial condition is of utmost importance when evaluating a master servicer. Additionally, master servicers need to report and remit funds timely and accurately to the trustee. Therefore, DBRS expects master servicers to be able to handle non-traditional products such as option adjustable rate mortgages and complex deal structures.

## SPECIAL SERVICER

The special servicer is tasked with returning delinquent loans to a performing status or quickly disposing of loans that are non-performing. As a result, DBRS places particular emphasis on the years of experience and default management expertise of the special servicers. Of significant importance is the ability of the servicer to manage delinquency roll rates, offer effective workouts and minimize recidivism rates. DBRS views favorably those servicers that employ sophisticated decision-making software to facilitate and track the loss mitigation process. Furthermore, a special servicer's ability to quickly liquidate REO properties at acceptable loss severities is paramount.



## WARM BACKUP SERVICER

A warm backup servicer is responsible for performing all of the activities necessary to ensure that in the event of a default or bankruptcy of the current servicer they would be able to take over all of the primary servicing responsibilities outlined in the pooling and servicing agreement within a short period of time (typically 30-120 days). In an effort to prepare for the transfer, the warm backup servicer typically conducts an on-site visit of the company, maps all of the data fields to their servicing system and receives monthly data tapes of the transactions to ensure minimal downtime.

## HOT BACKUP SERVICER

A hot backup servicer is responsible for performing all of the activities necessary to ensure that in the event of a default or bankruptcy of the current servicer they would be able to immediately take over all of the primary servicing responsibilities outlined in the pooling and servicing agreement. In an effort to prepare for the transfer, the hot backup servicer typically conducts an on-site visit of the company, maps all of the data fields to their servicing system and receives daily/monthly data tapes of the transactions to ensure minimal downtime. The hot back up servicer is also responsible for tying out with the servicer on all remittance reports to ensure they are accurate in addition to monitoring the on-going performance of the servicer.

## RULE 17g-5

SEC Rule 17g-5(a)(3) imposes special disclosure requirements on certain types of structured finance (SF) products or instruments (SF instruments) initiated on or after June 2, 2010. Composite ratings are outside the scope of this rule and take into account various component factors as well as the rankings of a servicer or the ratings of providers of credit, liquidity or other support for the rating on the SF instrument.

DBRS considers reviews of servicers or other support providers (referred to as composite ratings) that are the product of a separate engagement, unrelated to the terms or timing of any SF instrument and undertaken for independent purposes or as part of its on-going surveillance process to fall outside the scope of Rule 17g-5(a)(3). For more information regarding DBRS policies regarding this rule, please refer to the DBRS website at [DBRS.com](http://DBRS.com).

## CONCLUSION

DBRS recognizes that servicer performance is a key component in rating RMBS transactions and conducting appropriate surveillance. As a result, DBRS continues to refine and adjust its operational risk assessment procedures for U.S. servicers, as necessary, in an effort to incorporate any changes or issues that arise in the marketplace. As noted above, DBRS does not assign formal ratings to these processes; however, it does consider the results of its reviews as part of the rating and surveillance processes.



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## Exhibit I - Operational Risk Agenda for U.S. RMBS Servicers

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### *Company and Management*

- Company history, ownership and operating experience.
- Financial condition/profitability.
- Management experience.
- Staffing, training and retention rates.
- Portfolio size and composition.
- Strategic initiatives.
- Litigation (past, present and expected).
- Cause of termination (if applicable).
- Recent or planned mergers or acquisitions.
- Recent or planned transfer of servicing (rights), if any.
- Runoff rates.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Have you been or are you now the subject of any regulatory action? If so, discuss any findings.
- Securitization history and future plans.

### *Loan Administration*

- New loan boarding process.
- Procedures for boarding accuracy and data integrity.
- Reset notification.
- Cash management procedures and controls.
- Payment processing and controls.
- Exception and suspense management.
- Account reconciliation and timing.
- Post-closing quality reviews.

### *Customer Service*

- Procedures for responding to customer inquiries.
- Strategy and technology.
- Call volume and average time to answer.
- Number of representatives and ratio to call volume.
- Level of call blockage, if any.
- Response times for inquiries.

### *Escrow Administration*

- Percent of portfolio escrowed for taxes and insurance.
- Dollar value and number of tax penalties paid over the last two years.
- Dollar value of tax penalties that had to be reimbursed because of servicer error.
- Force-placed insurance policies and procedures.
- Procedures for tracking insurance coverage, cancellations and expirations for non-escrowed accounts.
- Number of properties lost due to non-payment of taxes.

### *Collections*

- Collection strategies for early-, middle- and late-stage collections.
- Explanation of call and notice cycles by product type.
- Account-to-collector ratio.
- Right-party contact rate.
- Hold time and abandonment rates.



- Use of credit and behavioral scoring and other technology.
- Policies regarding modifications, forbearance and deferrals.
- Delinquency, roll and cure rates.
- Property inspections and current property valuation procedures.
- Eviction procedures.
- Charge-off process.
- Use of technology.

#### *Loss Mitigation*

- Significant changes (past or planned) in procedures or emphasis regarding workout strategies or timelines.
- Repayment plan, modification and forbearance plan procedures.
- Recidivism rates.
- Use of deed in lieu, short sales and cash for keys procedures.
- Procedures and timelines for property evaluation (condition and value).
- Approach to fraud detection.
- Insurance claim curtailment rates.

#### *Bankruptcy*

- Bankruptcy procedures and technology.
- Number of loans in Chapter 7, Chapter 11 and Chapter 13.
- Percentage of loans performing under the bankruptcy plan.
- Attorney selection process.
- Number of loans with cram-downs.

#### *Foreclosure*

- Foreclosure process and initiation, non-judicial and judicial states.
- Compliance with timelines by state.
- Property preservation and valuation.
- Bidding instructions.
- Property evaluation, maintenance, repairs and inspections.
- Percent of foreclosure sold through a third party.

#### *Real Estate Owned (REO)*

- Number and dollar of loans in portfolio.
- Eviction processes (use of cash for keys or other incentives as necessary).
- Broker selection and pricing strategy.
- Property evaluation (condition and value).
- Property management.
- Liquidation methods and marketing plan and strategy for disposition (e.g., auctions, renting, etc.).
- Insurance-claims processing.
- Filing of borrower judgments.
- Recovery rates.

#### *Advancing*

- Procedures and systems for advancing.
- Advance tracking and reporting.
- Stop advance calculations and procedures.
- Non-recoverable advance calculations and practices.
- History of non-recoverable or non-customary advances.



### *Investor Reporting*

- Procedures for dissemination of reports to investors and trustees.
- Average number of investors remitted to on a monthly basis (last 12 months).
- Average dollar of monthly remittances (last 12 months).
- Number of late remittances in the last 12 months.
- Are accounts commingled? If so, how long?

### *Technology*

- Core servicing system strengths and weaknesses.
- Capacity remaining in the servicing system.
- Web site availability, usage and security.
- Procedures for vendor selection and oversight.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.

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