Methodology

Operational Risk Assessment for U.S. RMBS Originators

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Operational Risk Assessment for U.S. RMBS Originators

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Scope and Limitations

This report describes the DBRS approach to evaluating the quality of the parties that originate the loans that are about to be 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 an originator is acceptable and incorporates the results of the review into the rating process. It is important to note that the methods described herein may not be applicable in all asset classes. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted as prescribing a rigid template, but understood in the context of the dynamic environment in which it is intended to be applied.

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INTRODUCTION
DBRS typically begins the initial originator review process by sending a questionnaire to the company that outlines the topics to be covered during discussions with management and includes a list of documents to be provided such as organizational charts, financial statements and underwriting guidelines (Exhibit 1). In instances where DBRS determines that the originator is below average, issuers may incorporate certain structural enhancements into a proposed transaction such as additional credit support or a third-party firm to provide the requisite representations and warranties in order for DBRS to be able to rate the transaction. In the event that DBRS determines that an originator is unacceptable, it may refuse to rate the deal.

ORIGINATOR REVIEW PROCESS
The originator review process typically involves a review and analysis of the following:
(1) Company and management.
(2) Financial condition.
(3) Controls and compliance.
(4) Origination and sourcing.
(5) Underwriting guidelines.
(6) Valuation practices.
(7) Technology.

COMPANY AND MANAGEMENT
DBRS believes that a seasoned management team that possesses demonstrated expertise in the product(s) they are originating is essential. As a result, DBRS views those originators whose management team possesses greater than ten years of industry experience favorably. Additionally, DBRS believes that the participation of the credit risk management, quality control (QC), legal and compliance departments in the origination and underwriting process is important in order to identify and mitigate risk. Furthermore, adequate capacity and resources to handle fluctuations in credit card volume are of importance.

FINANCIAL CONDITION
DBRS typically reviews an originator’s financial condition or considers compensating factors. In its analysis, DBRS generally classifies an originator as investment grade or non-investment grade. Review of the originator may include an internal assessment consistent with DBRS policies (please see DBRS’s “Internal Assessments Global Policy”). To the extent that no public rating is maintained on the originator and no internal assessment is performed, DBRS generally assumes that the originator is non-investment grade.
Some items that are reviewed as part of this process may include:
• Company ownership structure.
• Business lines.
• Management experience.
• Corporate rating of any parent company, if applicable.
• Industry competitive landscape and company position.
• Internal and external audit results.
• Financial statements.
• Revenue sources 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 transfers.
• Securitization history and future plans.

CONTROLS AND COMPLIANCE
DBRS believes that internal assessments and QC reviews are important 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 can assist originators in complying with all applicable laws, rules and regulations as well as training programs for employees in customer-facing positions.

DBRS views favorably the participation of the credit risk management, QC, legal and compliance departments in the origination and underwriting process in order to identify and mitigate attendant risks. DBRS also views favorably those originators that are not the subject of any regulatory or state investigation(s) and have few borrower complaints filed with the Consumer Financial Protection Bureau. Minimal or no repurchases due to breaches of representations and warranties are considered as well as procedures for vendor selection and oversight.

ORIGINATION AND SOURCING
DBRS reviews the origination and sourcing channels to determine if the originator has a clearly defined strategy. Sales and marketing practices that include preapprovals are also typically reviewed to determine the screening process. Origination practices that include regular performance tracking and QC reviews are viewed favorably by DBRS. Furthermore, procedures that ensure new account setup accuracy and data integrity are important to minimize errors. As a result, DBRS views favorably those originators with a high level of automation and established procedures for compliance with regulatory guidelines and industry best practices.

UNDERWRITING GUIDELINES
An originator’s appetite for risk and the underlying quality of its underwriting guidelines can have an impact on deal performance; therefore, DBRS typically uses both a qualitative and quantitative approach to conduct its originator reviews and make comparisons among originators.

DBRS views favorably those originators that have established guidelines and use reliable means to accurately assess a borrower’s income and employment. An originator’s exception and override practices can help to assess the quality of the originations, in addition to, historical performance and repurchase volume.

Furthermore, sophisticated technology and fraud detection procedures can help prevent early payment defaults. DBRS believes that this area is important in maintaining a successful program and would, there-
fore, typically expect issuers to have formal processes surrounding fraud that are communicated regularly to staff and to employ experts to continuously update prevention strategies.

VALUATION PRACTICES
The accuracy of appraisals can severely reduce losses to RMBS investors. As a result, originators with a comprehensive property evaluation process are considered favorably by DBRS. Employing licensed appraisers that have no interest in the property and receive no benefit from or compensation for the mortgage loan’s approval or disapproval are also viewed favorably by DBRS. Since many firms outsource this function, comprehensive appraiser approval and monitoring processes as well as employing an appraisal review function in the origination process are considered important. An originator’s use of real estate brokers providing broker price opinions and automated valuation models is also typically evaluated. DBRS views favorably those firms that use these items to monitor the accuracy of their appraisal process.

TECHNOLOGY
Technology resources are an important component of the originator review process. While DBRS does not subscribe to specific systems architecture, in reviewing the originator, DBRS considers whether adequate systems controls, consumer privacy protection and backup procedures, including disaster recovery and business continuity plans, are in place. Furthermore, originators must ensure that any offshore vendors are monitored and that a backup plan is in place to facilitate minimal downtime.

Over the past few years, leveraging the Internet has enabled many firms to operate effectively in the residential mortgage-backed securities (RMBS) business. Originators have used the Internet for marketing, customer service and the dissemination of pertinent information, such as applications and approvals. As a result, DBRS expects originators to have the appropriate staff and controls in place to provide website availability, account maintenance and enhancements. Sophisticated technology with comprehensive functionality is viewed favorably by DBRS as it often brings large efficiencies to the origination operations and more predictability in terms of performance.
Exhibit I – Sample Operational Risk Questions for U.S. RMBS Originators

**Company and Management**
- Company history, ownership and operating experience.
- Financial condition/profitability.
- Ability to provide representations and warranties.
- Portfolio size and composition.
- Strategic initiatives.
- Recent or planned mergers or acquisitions.
- Risk management practices.
- Management experience.
- Number of employees and underwriters.
- Staffing, training and retention rates.
- Organizational charts.
- Use of outsourcing, temporary staff and offshore resources.
- Securitization history and future plans.
- Historical performance by origination channel.

**Controls and Compliance**
- QC and internal audit procedures.
- Internal and external audit results.
- Efforts to ensure regulatory compliance.
- Have you been or are you now the subject of a regulatory or state investigation? If so, discuss any findings.
- Have you ever been terminated or not in good standing with Fannie Mae, Freddie Mac, Federal Housing Administration (FHA) or the Government National Mortgage Association (GNMA)? If so, please explain.
- Process for interpreting and tracking state, local and federal regulatory compliance statutes, including the use of counsel and compliance software.
- Repurchases due to breaches of representations and warranties ($, # and reason).
- Litigation (past, present and expected).
- Controls for managing potential conflicts of interest associated with parties to a transaction.
- Procedures for vendor selection and oversight.
- Storage and updating of policies and procedures.

**Origination and Sourcing**
- Origination strategy and channels.
- Sales and marketing practices.
- Use of brokers, correspondents and conduits.
- Approval and monitoring processes for third-party originators and brokers.
- Delegated underwriting practices and policies.
- Procedures for ensuring new loan setup accuracy and data integrity.
- Exception and trailing documentation management.
- Post-closing quality reviews.
Underwriting Guidelines
- Underwriting policies and procedures by product and loan type.
- Is underwriting centralized?
- Recent or planned changes to underwriting guidelines.
- Approach to verifying income, assets, employment and occupancy documentation.
- Loan-to-value (LTV) and combined (CLTV) parameters.
- Qualifying rate and ratios.
- Documentation requirements.
- Occupancy and property eligibility.
- Escrow and insurance requirements.
- Use of non-traditional credit in underwriting.
- Non-U.S. citizen requirements/eligibility.
- Procedures for ensuring compliance with regulatory and predatory lending laws.
- Use of credit scoring, automated underwriting and other technology.
- Underwriter compensation structure.
- Authority levels.
- Exception and override process/practices.
- Process for completing data integrity checks.
- Fraud detection procedures and systems.
- Closing and funding process.
- Trailing documentation follow-up.

ATR/QM Compliance
- Percent of originations that conform to qualified mortgage (QM) guidelines, higher-priced QM, Non-QM loans and exempt loans by product type.
- Ongoing origination/aggregation strategy related to QM and Non-QM loans.
- Methods used to ensure the proper categorization of QM Safe Harbor, QM Rebuttable Presumption and Non-QM loans.
- Steps taken to ensure that QM processes are appropriately integrated into the origination platform.
- Discuss enhancements to training, staff and programs to ensure employee knowledge of QM requirements and underwriting processes. How is training deployed?
- Discuss any direct changes or enhancements to audit, QC and compliance staff and reviews to ensure adherence to ability-to-repay (ATR) and QM rules. Address any specific reviews performed around borrower income/asset reviews, including points and fees calculations as well as thresholds to meet ATR and QM criteria.
- Methods used to demonstrate that a loan was originated to QM standards to meet Safe Harbor status.
- How are affiliated services taken into the 3% cap consideration?
- Discuss any changes to underwriting guidelines for Non-QM or QM Rebuttable Presumption loans and the process used to consider and verify that Non-QM loans meet ATR income and asset standards.
- How is litigation risk on Rebuttable Presumption/higher-priced QM loans quantified? What resources were used to determine litigation risks?
- Discuss process, systems and QC for maintaining documentary evidence of compliance with residual income and debt-to-income calculations in the event of a borrower challenge on non-Safe Harbor loans.

Valuation Practices
- Methods and timelines used to assess property values.
- Appraiser approval process.
- Procedures for ensuring appraisal, broker price opinion and automated valuation models accuracy.
- Outsourcing practices.
- Seasoned loan property evaluation practices.
Technology

- Core origination system strengths and weaknesses (including reporting capabilities).
- Capacity remaining in the origination system.
- Website availability, usage and security.
- Security measures employed to ensure compliance with consumer privacy laws.
- Procedures for vendor selection and oversight.
- Disaster recovery/business continuity plans and success of last test.
- Frequency of full-system backup.
- Future initiatives.