Mortgage series on management estimates

Nobody is perfect and neither are estimates. Management must exercise judgment to select the inputs used when arriving at an estimate. If inputs to the estimation process are fairly objective, the approximation may be more precise. Some of the significant inputs used to develop the estimates for repurchase reserves, compensatory fee liabilities and servicing advances may be more objective, especially as more historical data is known. Other inputs, however, can be more subjective as they predict borrower, investor and other third party behavior. Predicting this behavior can be a challenge, as the patterns may change based on factors in the current environment.

Our Mortgage Series on Management Estimates brings you perspectives on certain management estimates that can be important to mortgage and servicing operations. Our first paper provided background on these areas as well as an accounting primer. Our second paper focuses on some of the operational aspects of repurchase reserves, compensatory fees and servicing advances. For each of these estimates, you'll find:

- An overview of some of the operational challenges
- The regulatory and counterparty requirements
- Examples of processes related to the operational execution
- Accounting estimation methods, analysis and inputs related to the development of the estimate
- Considerations that may lead to better practices in managing the operational processes involved with these estimations

Managing these estimates involves operational challenges to coordinate incoming demands from investors and regulators along with outgoing actions related to recovery and appeal. Coordinating this orchestra of activity and events is an ever-evolving process, and one which often has management, investors and analysts asking, "why is this so complex?" Let's take a look.

Repurchase or putback requests

The documents and contracts which govern the sale of a mortgage loan contain a variety of representations and warranties ("reps and warrants") made by the seller. These may relate to the seller itself or the condition of the loan upon sale. Additionally, the terms and conditions of the reps and warrants will vary, as different counterparties to the transaction negotiate these individually with the seller. A Government Sponsored Entity ("GSE") outlines their reps and warrants within their respective servicing guide.[1] On private-label transactions ("PLS"), these reps and warrants are commonly included within the transaction documents (e.g., purchase and sale agreements). Finally, in a transaction where a financial guaranty is provided (often by a monoline[2] insurer (MI)) there are also stipulations within that guarantee agreement.

[1] Refer to the Fannie Mae Single Family 2012 Servicing Guide at https://www.fanniemae.com/singlefamily/servicing and Freddie Mac Single-Family Seller/Servicer Guide at http://www.freddiemac.com/sell/guide/.

[2] A monoline refers to a business that focuses its operations in a specific area to deliver one particular good or service (i.e., mortgage insurance).

Although reps and warrants exist at the point of sale, the process and nature of a claim related to breach of reps and warrants may vary based on the counterparties involved and the nature of the sale transaction. Upon discovery of a breach in those reps and warrants, the counterparty (i.e., GSEs, investors, or monoline insurers) may have the right to demand the mortgage originator provide a remedy such as repurchasing the defective loan or indemnifying (or making-whole) the buyer.

Upon receipt of a repurchase demand or inquiry for additional loan information, the seller begins the process to decide either to execute the repurchase or alternatively file an appeal with the counterparty. This may involve researching the reason for the demand and searching for additional information about the loan. On an individual loan basis, this may not appear a daunting task, but, when extrapolated across the volume of requests and various inbound sources, it can become much more cumbersome. Because of these challenges, companies may consider what framework exists for dealing with this process holistically, how to drive consistency across the organization, and linking the activities to the process for developing the accounting estimate.

Requirements

Each GSE, within their servicing guide, lists certain reps and warrants related to: the lender, the sale of servicing and the sale of the mortgage loans. Common examples include, but are not limited to:

1. Noncompliance or inability to supply satisfactory evidence of compliance with a requirement, term or condition of the purchase document
2. Delivery of a mortgage that is not of investment quality
3. False warranties or representations in the purchase documents
4. Failure to provide information that is true, complete and accurate
5. Cancellation or denial of mortgage insurance due to fraud, misrepresentation or omission of a material fact, or for any other reason related to the eligibility of the mortgage for mortgage insurance[3]

Alleged breaches of these conditions may include questions around the validity of the lien, ownership of the loan, compliance with loan criteria stipulated in the sale agreement or with federal, state and local laws.

In the case of loans sold to parties other than the GSEs, originators may be required to repurchase mortgage loans, indemnify or reimburse the securitization trust, investor or insurer for credit losses incurred on loans in the event of a breach of specified contractual reps or warrants that are not remedied within a period after notice is received. Reps and warrants associated with non-GSE transactions can vary and may not be as specific as those outlined by the GSEs. Alleged breaches may include fraud of a party to the loan transaction or misrepresentation of data provided to the purchaser or insurer. The latter could include a wide range of challenges to the presentation of information within the agreement of sale. Also, because many private transactions involve multiple investors, there is often a minimum threshold of investors needed before the trustee can pursue repurchase or other remedies. Generally, the contractual liability to repurchase typically arises only if there is a breach of the representations and warranties that materially and adversely affects the interest of the investor, or investors, or of the MI or other financial guarantor (as applicable) in the loan.

Reps and warrants related to insurance, both for monoline/financial guaranty and mortgage insurance, may impact the stipulated reps and warrants with the purchaser or investor. For example, an MI company may rescind or deny coverage based on terms within the original insurance policy. Once an MI company rescinds insurance, a GSE can leverage the rescission decision to put the loan back to the seller. If the seller is not successful in its negotiation with the MI company, repurchase may be necessary.

Process

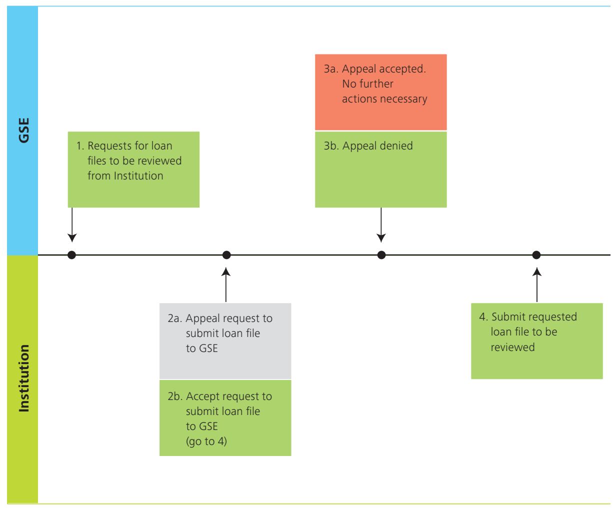
Mortgage originators may receive inbound inquiries and requests from multiple sources to repurchase a loan. Most of these requests are generated as a result of individual contractual breaches with the counterparty. Because each of these contractual requirements can differ among counterparties, the process to respond to the repurchase request may also differ.

[3] Information obtained from the Freddie Mac Seller/Servicer Guide at http://www.freddiemac.com/sell/guide/

To illustrate the process, we present the general timeline and process for originators and a GSE during a repurchase request.

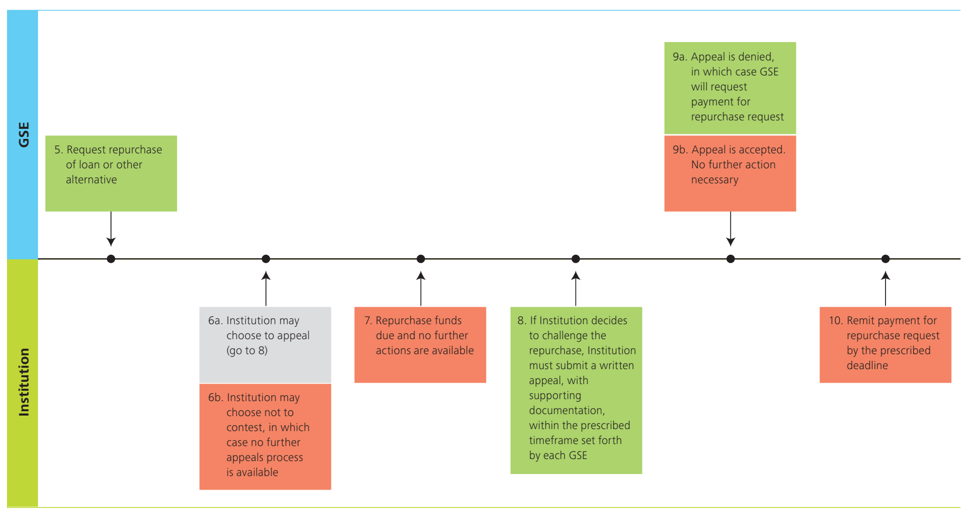
Loan file request

Institution may challenge the request from the GSE for the loan files to be reviewed through an appeals process.



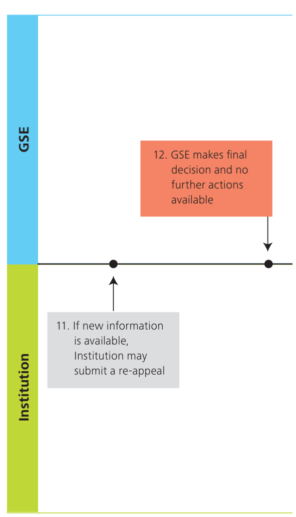
Repurchase request/appeal

Depending on the results of the loan file appeal, the Institution may submit their loan files to be reviewed by the GSE. Upon review, the GSE may discover a breach in which the GSE will demand that the Institution provide a remedy (e.g., repurchase defective loan) or alternative. The institution may appeal this demand through an official appeals process within the prescribed timeframe as outlined within the respective GSE servicing guide (this timeframe may range from 30–90 days depending on the GSE).



Re-appeal

If the Institution's first appeal of the repurchase request is denied by the GSE, the Institution may submit a re-appeal only if new information is available. Generally, the Institution is given 15 days to submit a re-appeal.



Note: Please note that the illustration above represents a sequence of events, but is not spaced to scale or time.

Proceed to next step, unless otherwise noted   No further actions necessary   Decision to be made by the Institution

Depending on the nature of the alleged breach, the seller may be able to provide additional documentation to support an appeal. In other circumstances, such as rescission of MI insurance on the loan, borrower fraud or misrepresentation, obtaining the support needed for a successful appeal may be difficult. Upon agreement to the repurchase request, and assuming that the originator did not settle through a make-whole provision, the originator is likely to remit payment and record the loan on their balance sheet.

The process for handling non-GSE repurchase demands vary by counterparty. For example, as noted above, in certain private transactions, the process is lengthened by the time it takes to gather the requisite number of investors to initiate a repurchase demand. Additionally, the trustee may need to gather information that would evidence that the servicers' activities have had a negative material impact to the investors. The governing contracts related to non-GSE transactions may not include prescribed timeframes for each segment of the process and may not carry penalties for non-compliance.

Given the repurchase process, the length of time and involvement required can be long and strenuous on the operations for companies undergoing an appeals process due to the various steps required, as well as the numerous sources from which a repurchase request may be coming from. Additionally, tracking information at a loan level can be challenging, but may assist in identifying multiple claims against a single loan. As the supporting documentation and timing varies by counterparty, an originator may want to consider how it can operationalize the appeals process and triangulate the various activities across the organization into one consistent process.

Accounting impact

Taking into consideration all of the various processes above, tracking the data necessary to produce information for appeals, as well as the status of each individual loan, and fitting this information to the type of breach related to the repurchase request, provides for a complex accounting estimate.

The repurchase reserve liability is an estimate of the cost that could be incurred by the originator as a result of a successful counterparty repurchase demand. This demand may be requested by the counterparty to the extent they believe the originator or the loan characteristics violated any of the original contractual reps and warrants. The accounting estimate for this liability should consider the current obligation as of the reporting date and take into consideration all of the reps and warrants activities on-going within the originator. Since many of these activities are managed by counterparty, the estimate should consider assumptions specific to that counterparty, including recent repurchase experience and any known trends. Loan level data and outcomes, such as borrower patterns or home value changes, may be helpful when evaluating incurred losses within groups of loans of similar characteristics. The complexity of the estimate will vary based on the nature of an originators portfolio and the nature of the reps and warrants given.

Although estimates will vary among originators, common assumptions used to estimate the repurchase reserve liability and range of possible loss for reps and warrants exposures are generally based on then current available information and may include assumptions such as historical claims (e.g., demands/requests), settlement experience, default expectations and patterns, home price assumptions, GSE investor and other third party behavior, types of defects or breaches with mortgage loans and general economic factors. Assumptions related to expected loan file requests and MI rescissions and denials may impact the probability of future claims. Information on home prices and borrower delinquency and default may be derived from other predictive modeling used within the originator. If global settlements have been reached with certain counterparties, these may impact the reserve estimate for certain groups of loans.

Compensatory fee liabilities

GSEs typically have specific rights that may be exercised in the event a given servicer is not servicing loans in compliance with the contracted servicing agreements or is otherwise determined to not be fulfilling applicable contractual obligations. In these instances, the GSEs have a contractual right to levy compensatory fees on the mortgage servicer. Certain compensatory fees may also be levied when mortgage loans delivered to the GSE fail to meet certain loan quality metrics. GSE activity in this area has increased in recent years as a result of the 2011 FHFA Servicer Alignment Initiative, which established a uniform GSE framework for servicing delinquent mortgages, including the prescribed monetary penalties for servicer nonperformance.[4]

[4] The Servicing Alignment Initiative is an FHFA-led effort to establish consistent policies and processes for the servicing of delinquent loans owned or guaranteed by Fannie Mae and Freddie Mac. http://www.fhfa.gov/webfiles/21190/SAI42811.pdf

The GSEs have recently published updates to their servicer requirements relating to compensatory fees and allowable foreclosures as a result of the high amount of defaulted loans requiring foreclosure processing. The GSEs' framework details an expected timeline to foreclosure by state, which allows for certain non-controllable delays due to circumstances beyond a servicer's control such as bankruptcy, litigation and the time during which a borrower has participated in a qualifying modification program (i.e., a trial period). If the actual controllable timeline to foreclosure exceeds the expectation set forth in the framework, the GSE may assess a compensatory fee based on the unpaid principal balance ("UPB") of the mortgage loan, the applicable pass-through rate, the length of the delay and any additional costs that are directly attributable to the delay. Upon receipt of a compensatory fee assessment, mortgage servicers must make the decision to either pay the fee or alternatively file an appeal with evidence that the delays were non-controllable and, therefore, not subject to the compensatory fee.

Requirements

If a GSE believes that a servicer is failing to comply with relevant servicing requirements, it may pursue a variety of remedies, either to correct a specific problem or to improve the servicer's overall performance. One possible remedy is the imposition of a compensatory fee to provide compensation for damages and to emphasize the importance of the servicer's performance. Sometimes, a compensatory fee will relate to the action the servicer took (or failed to take) for a specific mortgage loan. At other times, the compensatory fee may relate to the effect that the servicer's deficiencies may have on cash flow. The updated GSE framework provides guidelines for performance and outlines certain situations in which a compensatory fee may be assessed. Common examples include, but are not limited to:

- Delayed remittances of claim proceeds
- Disallowed foreclosure costs or curtailed interest
- Unauthorized transfers of servicing
- Late remittance of monthly collections
- Excessive amounts of delinquent installments
- Delays in liquidation process
- Late submission of annual financial statements/reports
- Delayed time to foreclosure

Process

When a property is foreclosed, the GSEs will determine whether a compensatory fee should be assessed on the property as a result of the information that has been provided to them with regard to the timeline of the mortgage servicing activities. If the GSEs believe that the timeline exceeded the state requirements as a result of controllable delays, a compensatory fee may be assessed. This fee assessment is transmitted to the servicer. Servicers will generally perform a series of steps in evaluating the fees assessed. These can include:

1. Recalculation of the fee assessed through:
   a. Agreeing to the pass-thru rate, the UPB and the total days to foreclosure to the servicer system of record
   b. Recalculating the length of the delay by reference to the latest state specific expected timeline to foreclosure and the total days to foreclosure identified in the system of record
   c. Mathematically recalculating the fee assessed

2. Assessment of the total days to foreclosure for any non-controllable delays not taken into consideration in the length of the delay identified in the fee calculation through:
    a. Referencing the servicing system of record and any third party information that would help identify and support timeframes in which the defaulted loan may have been in litigation, bankruptcy and/or in a trial period for a qualified modification program
    b. Recalculating the expected length of delay, if any, through subtracting any identified non-controllable delays from the total timeline

After performing the above calculations, the servicer may have enough information to determine if they are in agreement with the fee assessment. If the servicer's calculations reflect the same results as the current fee assessment, the servicer should process the payment of the fee to the GSE. If the servicer's calculation supports a fee that is less than what has been assessed by the GSE, the servicer may request a partial appeal of the fee. If the servicer's calculation shows that there was no controllable delay in foreclosure processing, the servicer may request a full appeal of the fee to the GSE. In order to support either a partial or a full appeal, the servicer is required to provide the timelines (including relevant supporting documentation) of any non-controllable delays not previously provided to the GSE.

Once appeals are submitted, the GSEs will evaluate the appeals and the support provided and will either accept the appeal (or partial appeal) or will reject the appeal. If the appeal is rejected due to a lack of documented support, the servicer may file a re-appeal if they are able to remit the documentation necessary to support the appeal. If the re-appeal is rejected, that decision is final. Upon completion of the appeal process, any fees where the appeals were rejected should be processed for payment.

Accounting impact

Compensatory fees are recorded as a liability when the fees become probable and estimable of payment. Due to the operational process by which the fees are assessed by the GSEs, evaluated by the servicers, appealed and potentially re-appealed, it can be difficult to determine when the fee is probable and estimable of payment. It may be difficult to estimate the fee prior to when the actual foreclosure takes place, and in some circumstances, experience with GSE activity and assessments may differ even in the case of controllable delays. Therefore, determining when the liability is probable can be challenging.

In estimating the liability, the servicer should consider both the amount of fees assessed and the probability of payment. The probability may differ depending on the timing of the estimation. The fee amount initially assessed could be quite different from the actual amount expected to be paid by the servicer. Once the servicer has evaluated and determined which fees they believe should be appealed, the estimate would be further refined. Accordingly, the inputs to the accounting estimate rely on information on the status of the compensatory fee assessment process provided by the servicing department. Open dialog and transparency of information between the departments is encouraged. Having an aligned understanding of the operations, potential exposure and associated accounting and reporting requirements may assist in facilitating the process to develop the accounting estimate.

Servicing advances

Servicing advances are receivable balances held by mortgage servicers to account for the potential recovery of certain funds they have advanced to investors, taxing authorities, insurance companies and other third parties on behalf of a delinquent borrower. These funds are advanced to protect the interests of the investor and are generally recoverable at a level of priority from the liquidation proceeds of a foreclosed property. There has been an increase in time to foreclosure in the past few years and also an increase in publicly disclosed servicing advance balances. This, combined with the decrease in home values, has led to circumstances where the liquidation proceeds on the foreclosed property may not be sufficient to provide full recovery to the investor and to also pay back the servicer for the funds advanced. Accordingly, servicer advances have come under increased scrutiny by investors and the nature, amount and timing of the advances are often evaluated closely in the current environment to determine whether the servicer should be entitled to recovery.

Along with the compensatory fees assessed by the GSEs discussed above, trends have shown that servicing advance balances and reserves for non-recovery have also increased due to delayed time to foreclose for defaulted loans. Over the last five years, disclosed servicing advance receivables for large mortgage servicers appear to have gone from negligible balances before 2008 to over $24 billion combined in 2012.[5]

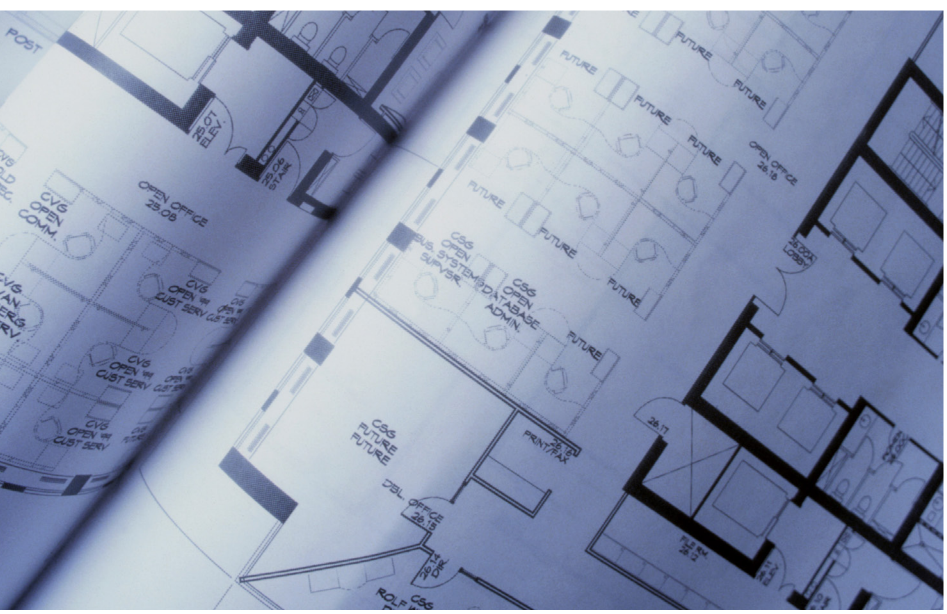
[5] Information obtained from the 2012 10-K filings at www.sec.gov for each respective servicer

Requirements

Servicing advances occur when mortgage servicers advance certain funds for delinquent loans. Specifically there are three different types of advances: principal and interest (P&I) payments, taxes and insurance (T&I), and other fees.

P&I advances are made by the servicer to the investor (or to the securitization trust) on behalf of the borrower when the borrower becomes delinquent on payment. Obligations to advance P&I are specific to contractual servicing arrangements. For some private label securities ("PLS"), P&I is only required to be advanced to the extent it is considered recoverable. Recoverability of P&I advances also can vary based on specific contractual requirements. Generally, P&I advances are recoverable from:

- The borrower if the borrower becomes current on their mortgage or if amounts are capitalized in a qualifying modification
- For loans in certain securitization trusts, the trust cash flows in the subsequent month after advance
- The liquidation proceeds from the foreclosed property
- The investor, if liquidation proceeds are not adequate for recovery and the servicing contract allows recovery from the investors



P&I advances could become unrecoverable for a variety of reasons, including if the funds in the trust are not sufficient for recovery, if the liquidation proceeds are not sufficient to provide recoverability in full and if the advances are curtailed by the investor due to perceived noncompliance with servicing requirements.

T&I payments are advanced by the servicer to the taxing authorities and to the insurance companies when the borrower stops making their payments in order to keep the property in good standing and protected against loss for purposes of maximizing returns to the investor. T&I advances are generally recoverable from the borrower if they become current on the loan, through liquidation proceeds of the foreclosed property and/or from the investor depending on the specific nature of the contractual servicer relationships. T&I advances may become unrecoverable for a variety of reasons, including if the liquidation proceeds are not sufficient to provide recoverability in full and if the advances are curtailed by the investor. In addition, certain tax penalties may need to be paid by the servicer if tax payments are not made timely by the borrower in some jurisdictions. If the servicer does not become aware of these unpaid tax payments, penalties can be assessed which the servicer will be responsible to advance money to pay. There is generally a limit on how many tax penalty advances are contractually recoverable by the servicer.

Other fees can also be advanced by servicers on delinquent loans as necessary to process the loan through delinquency, obtain necessary property appraisals, initiate and move through legal proceedings related to foreclosure, provide property preservation services and prepare and market the property for sale after foreclosure. These other fees can become unrecoverable if the liquidation proceeds are not sufficient to provide recoverability in full and if the advances are determined to not be recoverable by the investor. Investors may determine that certain fees incurred are not recoverable because they may not be in compliance with the servicing contracts. For example, some servicing contracts will put a limit on the dollar amount recoverable related to property preservation. Any amounts above the limit will not be recoverable by the servicer.

In many servicing relationships, the servicer has a contractual obligation to advance P&I to the investor when the borrower stops making payments. In addition, the servicer can have a fiduciary responsibility to the investor to keep the property in good standing by making appropriate tax and insurance payments. Finally, in order to prepare the property for foreclosure and disposition, the servicer will also incur additional costs associated with managing a delinquent and defaulted loan including certain legal fees, property preservation costs, etc. Advances can be recoverable from the borrower if the loan becomes re-performing, can be recoverable through forbearance if the borrower qualifies for a modification, can be recovered from the liquidation proceeds of the foreclosed property and in some circumstances can be recoverable from the investor.

Process

Once a loan becomes delinquent (i.e., the borrower misses its remittance of P&I to the servicer), the servicer will begin to advance funds to the investor (or to the Trust, if applicable). Each month that the borrower misses a payment, the servicer will advance the contractual P&I. If the loan is in a Trust, the servicer will generally be entitled to recover the P&I advance through the pooled cash flow in the month after the advance was made. For loans in certain PLS and loans that are held by private investors, the servicer may only have an obligation to advance P&I that is probable of recovery. In these cases, servicers often employ a "stop advance" process to identify the point at which recovery would no longer be considered probable. For loans in PLS, servicers should consider both current and future trust loss severities to determine whether P&I advances are ultimately recoverable from the pooled cash flows. Servicers generally monitor the underlying collateral fair value to determine if advances should be stopped. As a loan becomes more delinquent, T&I and other fees may also be advanced. The recovery of these other advances may limit recoverability of P&I from pooled trust cash flows or from collateral liquidation proceeds. Accordingly, stop advance processes may also consider the recovery of other advances.

As a critical component of the stop advance process is the consideration of collateral value, the methods used to estimate these values should be evaluated for pertinence. There are a variety of methods used for estimating property fair values. Servicers will often leverage automated valuation models, broker price opinions and/or a home price index as the base for the collateral value. Given the nature of the collateral as a foreclosed property, oftentimes a "haircut" will be relevant on the benchmark fair value to reflect the distressed nature of the property. Haircuts will likely vary by metropolitan area and would likely consider historical experience of sales price on distressed properties compared with similar non-distressed properties.

Similarly, T&I advances should be made to taxing authorities and insurance companies to protect the property when a borrower stops paying. Borrower escrow accounts allow the servicer to make payments for taxes and insurance on the borrower's behalf and provide the servicer the visibility into any borrower non-payment of taxes and insurance. The existence of escrow accounts gives more information to servicers to monitor missed T&I payments by the borrower and allows the servicer to advance these payments to the relevant authorities to prevent tax penalties for missed payments. If a borrower is not escrowed it can be difficult to know if these payments are being made timely which, in certain taxing jurisdictions, could result in tax penalties being assessed. These tax penalties will then typically be paid by the servicer to avoid any tax liens on the property. However, many servicing contracts will limit the recoverability by the servicer of tax penalties. Generally the first penalty can be recoverable, but the expectations are that the servicer will become aware of the T&I delinquency prior to the occurrence of the second missed payment. Accordingly, it can be critical for servicers to establish processes to monitor timely tax payments for non-escrowed borrowers as T&I delinquency may occur independently of P&I payments. Homeowners' insurance premiums will also typically be advanced by the servicer if the borrower has stopped making payments in order to protect the property for the benefit of the investor.

A variety of activities are often necessary to manage a defaulted loan through the foreclosure process and then to prepare a foreclosed property for sale. Most often, this will involve the servicer engaging vendors to assist in the performance of these defaulted servicing activities. These vendors can include:

- **Appraisers** — There can be a need for regular property appraisals for a loan in default. Fees paid to appraisers are advanced by the servicer and are typically recoverable from the liquidation proceeds of the property or from the investor. Typically, one appraisal fee a month is recoverable.
- **Attorneys** — The foreclosure process involves specific legal actions that must be taken in order to claim title to the collateral underlying the defaulted mortgage loan. Foreclosure attorneys are engaged by the servicer to perform these legal activities and the servicer advances payment to these attorneys for services performed. These advances are recoverable by the servicer, but may also have limitations on recoverability based on overall servicing performance and specific fee caps.
- **Security firms** — Upon foreclosure, the acquired property is typically secured to protect the collateral value. This can involve hiring a security firm to perform necessary activities or to install necessary products in order to help prevent vandalism or other damage to the property. Advances to such firms are recoverable by the servicer, but may be subject to certain limitations for recovery.
- **Property preservation companies and realtors** — If the servicer is responsible for maintaining the property after foreclosure, preparing it for sale and ultimately executing the sale, certain additional fees related to the real estate may be incurred. The recoverability of some of these specific fees may be capped either individually or in the aggregate. Extended delays in liquidating the property could cause increased total fees which could put the servicer at risk of hitting certain caps.

Fees paid to these vendors are considered “other fee advances” and can become quite cumbersome to manage because they are often comprised of numerous smaller payments to many different vendors. Each transaction necessitates an associated journal entry to record a debit for the receivable (if the amount is recoverable) or expense (if the amount is not recoverable) and a credit to reflect the

This emphasizes the importance of effective internal controls in the tracking and coding processes for these advances, as information regarding reaching limits is used in decision making and/or asset recoverability and reserve analyses.

distribution of cash. Often these entries are not made directly into a general ledger, but rather into a separate database or tracking system that may feed the general ledger. Servicers often use a coding mechanism to identify fees of a similar nature in relation to their recoverability in accordance with the relevant servicing agreement. This coding can become critical to determining whether or not certain fees may be recoverable. For example, if there is a lifetime dollar cap on the amount recoverable for "property preservation," the total recoverability can become limited if other fee types (such as appraisals or security related fees) are also coded to property preservation. Larger servicing operations may employ operational general ledgers that leverage the modules of the existing general ledger platform when recording journal entries related to these fee transactions. Open dialog and transparency of information between the vendor management department and the servicing requirements around recoverability is encouraged. Having an aligned understanding of what is recoverable should allow front-end operations the ability to make more strategic decisions around engaging vendors and advancing fees.

Recovery of fee advances is accomplished in one of two ways depending on whether the servicer directly receives the liquidation proceeds of the foreclosed property. Generally, the servicer recovers fees either through:

- The servicer foreclosing on a property, executing a sale and recovering amounts directly from the liquidation proceeds prior to remitting the remaining amounts to the investor or
- The subsequent servicer (which may be a specialty servicer or in the case of GSE loans, the GSEs) upon liquidation of the property, through a claims process.

If the servicer is liquidating the property, recovery of advances may happen timely in relation to the sale. Upon remittance of any remaining amounts to the investor, the servicer also remits a liquidation proceed reconciliation which would outline any advances and other fees that are retained by the servicer in the calculation of the investor payable amount. The investor may challenge amounts retained, and the servicer will then respond to the investor accordingly in determining whether any additional amounts need to be remitted to the investor.

If the subsequent servicer is liquidating the property, recovery by the servicer of advanced amounts may be more delayed as the servicer will need to make a claim to the subsequent servicer. If the subsequent servicer challenges the claim, only amounts that are agreed to as recoverable may be remitted to the servicer and any other claims may be denied and an appeal process may need to be instituted by the servicer in an attempt to claim additional amounts the servicer believes should be recoverable.

Accounting impact

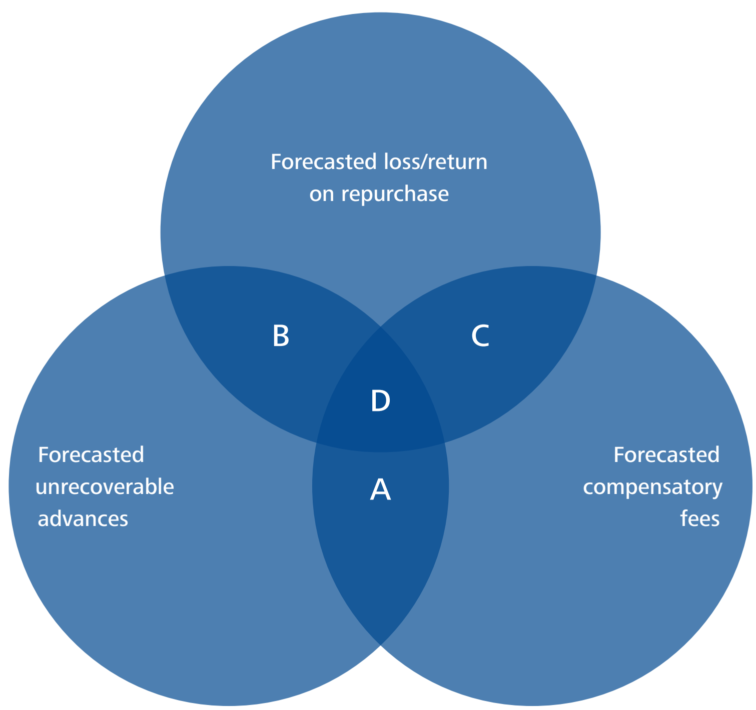
The advances (i.e., P&I, T&I and other fees) made by the servicer on behalf of the borrower and advanced to third parties lead to the recording of a servicing advance receivable. Recoverability is assessed periodically and can be dependent on alignment of servicing practices with the relevant servicing agreements and may differ among investors. Subsequent to initial recording of a servicing advance receivable, recoverability should be re-assessed each period. If recoverability is not expected, a reserve, or contra-asset, is recorded to reduce the balance of the servicing advance receivable. The assumptions used to estimate non-recoverability are generally reflective of the circumstances of the current environment (i.e., past performance, emerging trends, specific known reserves). Data aggregation and analysis is essential to create meaningful reserves which can be difficult given the volumes of data that likely exist, particularly related to other fees. As servicers rely heavily on data to estimate recoverability, value may be derived through enhanced data collection and analysis processes to support claims, appeals and accounting. Furthermore, aligning the vendor management department, the servicing operations, the claims and recovery departments and the accounting department may provide better visibility of the collectability of amounts advanced and may help inform decisions around recoverability estimations.

Operational considerations and leading practices

The processes described above around managing repurchase requests, recovering servicing advances and responding to compensatory fee assessments are often performed independently of one another. Some originators and servicers may even isolate discrete processes within each of these areas. Servicers (particularly servicers that are also originators) may find it beneficial to approach these areas holistically related to both loss mitigation and operational efficiencies. For example, actions by MI companies to deny, rescind or curtail mortgage insurance may impact recoverability of servicing advances and may initiate a repurchase demand by the investor. Servicers have an opportunity to centralize the process for response to the MI companies and can structure the nature of the response to consider potential downstream impacts. Investors may also be making multiple demands on the same loan (i.e., repurchase demand, compensatory fee, servicing advance curtailment). By having a holistic view of these processes, servicers could have an opportunity to make informed decisions about the strategic path to follow toward resolution.

Oftentimes, servicers are reactive to the actions taken by MI companies, investors and other parties surrounding repurchase requests, compensatory fee assessments and servicing advance curtailments. However, servicers have an opportunity to use their experiences to perhaps be predictive with loans in default. There may be opportunities to make strategic decisions around repurchase demands that may mitigate losses that could be incurred on curtailed servicing advances and compensatory fee assessments. For example a servicer may choose to repurchase a loan rather than risk paying a compensatory fee, incurring additional servicing costs or risk not recovering all the fees advanced if they believe that the fair value of the loan approximates the repurchase price. This could be particularly relevant for certain geographic areas with attractive loan-to-value ratios that may predict minimal losses upon repurchase and sale. Other opportunities may exist around strategic decisions to sell servicing or to subservice the servicing activities of defaulted loans to specialty servicers that may be able to more efficiently manage movement of loans through the foreclosure process minimizing costs.

In conclusion, servicers have opportunities to mitigate possible losses related to repurchase demands, compensatory fees and servicing advance curtailments. Having an end-to-end view of the individual processes discussed above, as well as their interrelationship to one another, may be critical for servicers to achieving this mitigation process. Combined with accurate, accessible and agile data, it may be possible to manage these complex processes efficiently and economically.



A = Combined future costs to service

B, C, D = Opportunity to minimize losses

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