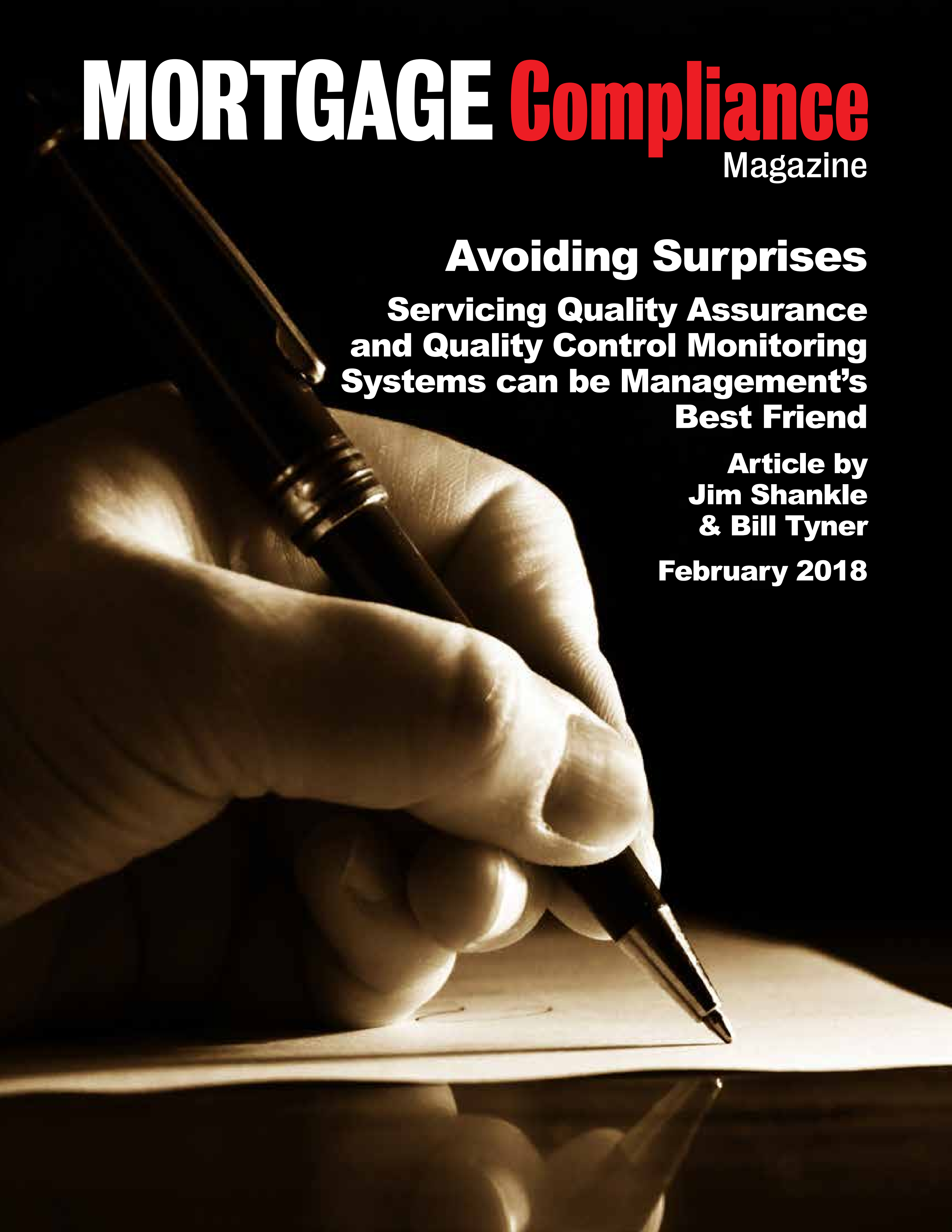

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Avoiding Surprises

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AVOIDING SURPRISES

Servicing Quality Assurance and Quality Control Monitoring Systems can be Management's Best Friend

BY JIM SHANKLE AND BILL TYNER

As loan servicers face competitive challenges and increased regulatory and investor scrutiny, management must rely on internal systems to provide ongoing feedback on critical servicing components. Establishing internal monitoring systems should be an integral part of the management structure for all loan servicers. In addition to the regulatory and investor quality control requirements that mandate the ongoing monitoring of servicing activities, loan servicers are encouraged to enhance current processes to properly manage the various risks associated with servicing.

Quality Assurance (QA) functions are often embedded within the business line, the first line of defense. Quality Control (QC) usually also resides in the business line in larger organizations. It may reside within the risk management or the compliance function in smaller organizations. A primary objective of these monitoring systems is to prevent the surprise element which can often result in significant operational, regulatory, reputational, and financial burdens if not detected on a timely basis.

A common perception within the industry is to refer to the servicing QA and QC functions as one, when in fact, each should serve a unique and critical role in managing loan servicing. Loan servicers must ensure that all aspects of servicing are compliant not only with applicable regulatory and investor requirements, but also are monitored for efficiencies and potential errors. By establishing both a QA and a QC function, the internal control structure is strengthened and can provide management with an effective early warning mechanism. The QA function, by its nature, is a preventive control; whereas, QC tends to be a detective control; identifying issues that have occurred after the fact.

There often are similarities in how QA and QC functions conduct and report results of the ongoing monitoring each function performs. Both functions tend to rely on checklists to ensure that key controls and processes are reviewed with the results presented via charts/graphs as well as reports detailing performance trends within the various processes under review. If structured properly, QA results can significantly impact the depth of coverage for QC sample selection and identify areas of concern requiring an increased focus.

When developing the criteria for QA monitoring, a common approach is to identify the key processes within the workflow of each servicing area to ensure those controls that directly impact regulatory/compliance, financial, reputational, information, and emerging risks are an integral part of the QA process. As part of the QA monitoring, evaluating the performance of servicing staff within critical operating functions can inform root causes of identified deficiencies. Many loan servicers utilize performance scorecards which evaluate the potential severity and probability/frequency of errors, along with an assessment of the effectiveness of established controls. The scorecard criteria should be based upon management's expectations and include definitions of acceptable performance (i.e., pass/fail or specific grading criteria) as well as remediation plans should the results of the risk-based monitoring be deemed unacceptable. Incorporating scorecards into the performance review process is a proven tool that helps management ensure quality and compliance are maintained and errors are minimized.

Most of the servicing operations included in business line QA programs dovetail well with QC monitoring. Both QA and QC functions will address the same operations; however, the QA role tends to be more of a performance drill down effort, again with the intent to prevent any systemic issues from occurring. Once QA has identified significant issues, the remediation plan is to immediately start corrective actions which will likely involve policy and procedure updates, operating system enhancements, or disciplinary actions. Coordinating the QA results with QC's scheduled monitoring can alleviate duplication of effort in some cases.

Not all QA reviews require specific account-level transactional testing. An effective QA control that is commonly implemented within the accounting, agency custodial accounts, and investor reporting functions is the creation of a reconciliation certification program. All general ledger and custodial/investor related accounts requiring an ongoing reconciliation are identified and assigned to a responsible party, with required reconciliation frequency and dates last reconciled noted, any reconciling differences, and a listing of aged reconciling items noted on each certification, along with an indication that the reconciliations have been reviewed by a manager.

Another aspect of QA is the establishment of Key Performance Indicators (KPIs). KPIs provide management a benchmark to compare internal performance factors with peers in the servicing industry. The KPI comparisons can identify areas within servicing where efficiencies can be improved to control overall costs through process improvements, automation, re-structuring, or organizational changes. There are numerous categories of KPIs for all aspects of both performing and non-performing portfolios. There are several professional organizations that provide regularly updated peer data for comparison purposes. Common KPIs utilized in managing the business include:

- Number of loans serviced by employee - also can be segmented as desired to reflect location, product, or servicing function
- Loan Servicing: Unit cost - measures the average cost incurred to service a single mortgage loan over a defined time (total servicing cost divided by average number of loans in servicing portfolio over same period)
- Servicing portfolio by FICO score (can analyze desired score ranges);
- Servicing profit per loan serviced
- Default servicing - also can be segmented to analyze loss mitigation efforts; bankruptcy; deed-in-lieu; short sales; foreclosures (as a percentage of total servicing expense or a Per Unit cost)
- Law firm expenses as a percentage of total servicing expense
- Number of customer servicing complaints

Servicing QC is generally a more structured process than QA primarily due to investor and regulatory requirements that have been in existence ▻

for some time. In addition to addressing all the pertinent investor requirements and relevant mortgage loan servicing laws and regulations, incorporating internal policies and procedures, that may not necessarily be required by investors, into the QC process should be considered as well. The types of loans being serviced will impact the monitoring requirements of the QC program as products such as fixed rate, ARMs, HELOCs, reverse mortgages, and higher-priced mortgages will each have unique attributes that should be reviewed. In addition, investor requirements may differ, requiring customized testing for each investor. For instance, FHA/VA loans have different servicing requirements, as do GSE and portfolio loans.

Typically, for reporting purposes, lenders segregate FHA and VA loans from Fannie Mae, Freddie Mac, and portfolio loans (non-GSE and private investors), which will ensure that each tranche/segment of the loans being serviced are reviewed for adherence to specific requirements.

In most instances, loan servicing QC plans have not reached the maturity level of loan origination post-closing QC requirements. GSE's have primarily focused on providing guidance on how lenders must construct their origination QC programs. Within Fannie Mae's Servicing Guide, there are currently two pages devoted to mortgage loan servicing QC, as compared to 35 pages devoted to the originations post-closing QC requirements in Fannie Mae's Selling Guide. The servicing and QC requirements for FHA and VA loans are much more stringent as specific expectations are clearly identified by HUD and VA.

Comprehensive servicing QC programs that encompass the entire life cycle of servicing generally include testing transactions that address the following characteristics or servicing events:

- Payment processing
- Billing statement disclosures
- Fees/charges
- Escrow processing
- ARM notifications
- Mortgage insurance (PMI)
- Loan payoffs
- Customer inquiries/disputes
- Servicemembers Civil Relief Act (SCRA)
- Collections
- Servicing transfers and loan boarding
- Credit bureau reporting
- Loss mitigation programs (loan modifications, deed-in-lieu, reinstatements, short sales)
- Successor in Interest
- Deceased borrowers
- Bankruptcy
- Foreclosure

The same emphasis should be afforded to QC reviews on performing loans as well as non-performing loans, with the possible exception of FHA and VA portfolios, which are heavily focused on non-performing loans.

For those servicing arrangements that involve sub-servicers, the loan servicer that owns the Mortgage Servicing Rights (MSRs) has the responsibility to ensure that the QC process is effective and compliant from both an investor and regulatory perspective. Service Level Agreements (SLA) between the loan servicer and sub-servicer should permit the owner of the MSRs the ability to periodically audit the sub-servicer, via onsite visitations or ongoing scorecard monitoring or both. An increased focus by regulators regarding third-party vendor oversight and compliance with the loan servicer's Compliance Management System require the sub-servicer be reviewed frequently.

All QC programs developed should include a tracking mechanism to monitor the corrective actions implemented. Additionally, the QC process should provide a source for analyzing trends that may result in revisions to existing policies and procedures and enhanced training of servicing personnel.

Effective QA and QC functions provide a valuable resource for managing loan servicing. Establishing the right tone at the top allowing for clearly defined expectations and the sharing of results can only benefit the organization through ongoing monitoring as well as identifying opportunities to increase efficiencies.

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