Mortgage and Asset Servicing for International Transactions

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Introduction

At its most basic, the asset servicer in a securitization is responsible for collecting the funds from obligors and securely distributing them to the appropriate parties. Perhaps because of the apparent simplicity of the function, the servicing role is often taken for granted by both issuers and investors, who often prefer to focus on the performance of the asset pool, the structure of the deal, and the price at which the bonds will be sold. According to the rating agency Standard & Poor's, however, servicing is the most critical element in a transaction, and becomes ever more important as securitization becomes increasingly complex.[1] S&P cautions investors to carefully analyze the strength and capabilities of the servicer of mortgage and asset-backed securities, and suggests that the quality of the servicing will be an important factor in its own ratings analysis.

As financial institutions around the globe begin to explore the potential of securitization as a funding alternative, their ability to effectively service the assets will in many cases be the single largest determinant as to whether or not they are successful in taking a deal through to completion. In order to issue a rated mortgage or asset-backed security, most institutions will need to pass a thorough rating agency review of their servicing operations, or will be forced to outsource this critical function to an institution that has already acquired a rating agency ranking. Clearing the initial rating agency hurdle is just the beginning, and institutions will find that access to scaleable servicing operations capable of supporting rapid growth will give them significant advantages over their competitors.

Building asset servicing operations that meet these needs requires time and good planning, but is ultimately essential to establishing a successful modern program of asset securitization.

Many financial institutions around the world have built their business originating loans for their own balance sheet and have created servicing operations that meet their internal needs, but not necessarily those of structured finance investors and international rating agencies. In many such cases, significant operational changes will be necessary before the rating agencies will assign a rating to a proposed transaction. This creates quite a challenge for those institutions that are otherwise ready to attempt securitization, since making the necessary changes can take months and require highly specialized expertise related to information systems, securitization, the ratings process, as well as knowledge of the local market.

This expertise can be hard to come by. Rating agencies, while pleased to share their opinions on the sufficiency of a servicing operation, will not accept formal advisory assignments to help upgrade the operation. Most Wall Street investment banks, while skilled in the structuring and distribution of mortgage and asset-backed securities, will offer superficial advice, but may not work with and guide the institution through the process of adapting their operations to meet securitization requirements. One solution may be the hiring of a specialized advisory firm focused on helping institutions in emerging markets prepare for securitization.

[1] *Efficient Servicing Key to Complex Structured Financings,* Standard & Poor's Ratings Direct 11/28/00.

In a securitization, asset servicing describes the function of collecting on loans or other assets and remitting the funds to the trustee on the transaction. In addition, servicing includes all other activities related to this function, including accounting, reconciliation, and investor reporting. Clearly in any securitized transaction servicing represents an important link between the investor and the borrower and the competency and efficiency of the servicing operation can have a real impact on the performance of the assets and on the bonds they secure.

When analyzing securitizations as part of the ratings process, rating agencies place particular emphasis on servicing. While structured finance deals are designed to be independent of the credit of the originating institution, servicing adds an element of operating risk to the transaction that must be carefully examined, since failure of the servicer can have a large negative impact on the credit quality of the deal.[2]

In most transactions, the servicing is carried out by the originator of the asset, even after the assets have been sold. In transactions where assets from numerous institutions are acquired and pooled, each institution will likely retain the *primary servicing* responsibilities for assets it has originated, and it will be the responsibility of a *master servicer* to aggregate the funds and data from the individual subservicers, while ensuring that they continue to meet required performance standards. Loans in default may be outsourced to a *special servicer*, an operation with a particular expertise in working with non-performing assets.

Minimum servicing fees are usually set by the rating agencies, who seek to ensure that servicers are at least covering their costs to service, and that, in the event of a servicer default, a replacement servicer will be willing to assume the servicing responsibilities.[3]

Primary Loan Servicing

The long history of the mortgage-backed securities market in the US has shown the degree to which loan servicing influences asset and deal performance. During the savings and loan crisis of the early 1990s, banking failures caused servicing problems that in turn caused deals to deteriorate and even default in some cases. For example, Guardian Savings and Loan issued several series of mortgage-backed securities, some of which were bond insured by Financial Security Assurance (FSA), and some of which were structured as senior/subordinated bonds.

When Guardian failed, FSA was able to have the servicing transferred on the bond insured deals, and the deals continued to perform. The senior/subordinated bonds, however, remained with the failing servicer and suffered enormous loss severities as a result of inferior servicing. The once investment grade bonds were

[2] Rating agencies are more likely to rate a transaction if the local market has more than one acceptable servicer. This provides a level of comfort that, in the event of a servicing failure, a quality replacement servicer could be used with little disruption for bond holders. In some cases, a back-up servicer must be contracted before a deal is rated. In such cases, the contracted replacement is known as a "hot back-up servicer," and may be given regular access to the servicing data from the deal.

[3] In the US, where a large percentage of mortgage loans are sold, servicing fees have become the primary income stream for many companies, and loan servicing rights are routinely traded in the secondary market.

downgraded to junk status.[4] The diverging performance of otherwise similar mortgage pools provided a clear example of the importance of quality servicing on asset and bond performance.

The responsibilities of a primary loan servicer will vary somewhat depending upon the asset class and the local market, but may include these important functions:

- Setting up loans on a servicing computer system;
- Accepting and processing loan payments from borrowers;
- Remitting payments to investors and trustees;
- Reconciling bank accounts and loan balances;
- Ensuring current payment of property taxes and insurance;
- Performing escrow analysis;
- Obtaining and evaluating property inspections;
- Collecting on delinquent accounts;
- Processing foreclosures;
- Managing accounts of debtors in bankruptcy;
- Maintaining, administering, and liquidating real estate owned (REO) properties;
- Advancing delinquent principal and interest to the extent deemed recoverable.

Master Servicing

Master servicing may be performed by a primary servicer, or by a separate master servicing company. It is the role of the master servicer to aggregate cash and data from one or more primary servicers on a transaction. In the US, the rating agencies typically require a master servicer be involved in transactions where there are three or more primary servicers. Typical functions performed by the master servicer include:

- Loan accounting;
- Portfolio management;
- Maintaining subservicer compliance;
- Cash flow advancing;
- Investor reporting.

Special Servicing

Special servicing refers to servicing operations that focus on very specific tasks, or unique asset classes. For example, the category of special servicing includes companies that specialize in working out distressed real estate assets, a job that requires a high degree of expertise and specialization. Special servicers are higher cost institutions that would be too expensive for servicing large portfolios of performing loans, but are effective at maximizing the returns on portfolios of defaulted mortgages either by getting them to re-perform, or by foreclosing, managing, and selling REO properties in a highly efficient manner. Another example of special servicing would be an operation focused on a particular asset-class or class of real estate. In the US this includes servicers of municipal property tax liens, franchise loans, or legal settlements.

Rating Agency Servicing Review

Before a rating agency will agree to place a rating on a mortgage or asset-backed transaction, it will need to approve, or "rank," the servicing operations to ensure they meet minimum credit standards and do not expose a

[4] By definition, the term "junk bonds" refers to bonds with ratings lower than BBB-, the lowest rating for investment grade bonds.

transaction to undue risks.[5] This is the case for both US and international transactions.[6] Rating agency servicing reviews are in-depth and comprehensive, and for first time issuers require a significant amount of preparation. S&P, for example, requires that a servicer meet minimum standards for management and organization, loan administration, and financial performance, and an unacceptable ranking in any area can prevent a servicer from participating in a transaction. While each company and each review will vary to some degree, the rating agency review is likely to cover the following areas in detail:

Management and Organization

1. Evaluation of the depth and experience of management in all critical areas, including the length of time each position has been filled.

2. Evaluation of ongoing internal training programs in all relevant areas, including the degree to which management and employees are adequately trained in:

   a) Computers and technology
   a) Management
   a) Banking
   a) Regulatory
   a) Internal procedures

3. Evaluation of the use of management information systems for managing the business, improving efficiency, and controlling risk.

4. Evaluation of documented loan servicing procedures, including the process by which they are maintained and updated, and how changes are approved, disseminated, and implemented.

5. Evaluation of the internal audit function and results.

6. Evaluation of insurance coverages and regulatory compliance.

Loan Administration

Analysis of servicing functions, including the degree of automation and its contribution to overall efficiency as measured by efficiency ratios such as servicing costs per loan and loan serviced per employee. Functions analyzed include:

a) Payment processing
b) Investor reporting
c) Account administration and reconciliation (accounting)
d) Escrows and tax administration
e) Insurance tracking
f) Delinquent collections and loan workouts
g) Foreclosures and REO management

Financial Performance

- Includes an analysis of historical financial performance, including loan loss analysis, risk management measures, and profitability.

Other Associated Risks

Evaluation of exposures to the risks associated with asset servicing, including:

a) Exposures to errors and omissions liability, to the extent not covered by appropriate insurance policies;

[5] S&P provides four overall ranking categories: 'Strong,' 'Above Average,' Average,' and 'Below Average.' Operations must achieve an overall ranking of 'Average' to be considered suitable for a rated transaction.

[6] In most cases, the agencies will allow unranked primary servicers on a transaction, provided the master servicer has been approved.

b) Exposures to loan prepayments, which could lead to unexpected declines in servicing fee revenue;
c) Exposures to risks of breaching servicer reps and warranties through non-compliance with servicing guidelines.[7]

Preparing for Securitization

Many financial institutions have historically originated loans for their own balance sheets, building servicing operations that meet internal needs, but not necessarily developed with securitization in mind. Such operations, even if performing well, may lack important functions, have undocumented policies and procedures, or fail to track data elements deemed essential for securitizations,[8] and thus require some adaptation in order to meet investor and rating requirements. For example, loan servicing in many banks is not segregated in any way from other bank functions, such as loan origination, lacking dedicated personnel or segregated accounting. While performance history might indicate that the servicing is strong, such an operation would have a difficult time gaining rating agency approval without significant changes to its organizational structure.

Institutions contemplating a securitization program can save valuable time by conducting a thorough feasibility study of their origination, servicing, and investor reporting capabilities before starting the rating agency review process. A well conceived study will identify any changes or enhancements that may be necessary to meet rating agency and international capital market standards, ensuring such changes are designed an implemented before the rating agencies are brought in, thus expediting the approval process and shortening the timeline to securitization.

The following example provides an idea of the information that should be organized and analyzed in a series of steps towards the ultimate goal: the creation of a program blueprint that will successfully pass rating agency and investor review.

Program Review

The process should begin with a detailed analysis of the lending program and existing servicing operations. An example of information that should be organized and made available for analysis is outlined below. While the list may seem daunting and take time to put together, similar information will probably be requested by the rating agencies as part of their review. Preparing and reviewing this critical information will streamline the approval process later.

Organizational and Financial Overview

- Organizational structure of mortgage operation showing functional departments and key employees and describing their respective roles.
- Resumes or C.V.s of operations management and key employees.
- Prior 2 years audited financial statements.
- 3 year history of mortgage origination volume.
- 3 year history of mortgage servicing volume.
- Current year and future projections of origination and servicing volume.

General Portfolio Information

- General stratification reports of the complete mortgage portfolio, including, at a minimum, loan-to-value, year of origination,

[7] Among other risks, servicer non-compliance can expose investors to the voiding of financial guarantees that may be in place on a transaction.

[8] For more information on critical data elements, see the AGS Financial article "The Importance of Data in International Securitizations."

property type, geographic information by city.
- Data tape of the loan portfolio in standard securitization format.
- Mortgage product descriptions in English.

Loan Origination Information
- Organization chart of loan origination function.
- Copy of the mortgage underwriting guidelines in English.
- Description of loan underwriting approval authority levels.

Loan Servicing Information
- Organization chart of loan servicing function.
- Copy of servicing procedures in English (if available).
- Description of loan workout and loss mitigation procedures.
- Description of loan workout and restructuring approval levels.
- Description of cash handling procedures on loan payments, from the point the borrower makes the payment to receipt in the investors cash accounts.
- Description of software systems used in servicing and reporting on mortgage loans.
- Description of disaster recovery plan for servicing system.
- Description of mechanism for advancing on delinquent loan payments.
- Description of procedures for tracking and reconciling advances on delinquent loan payments.

Investor Reporting Information
- Samples of reports to be provided to investors and trustee on the portfolio
- Samples of reports provided in actual/actual and scheduled/schedule format
- Sample trial balance reports.

This information should be analyzed in the context of securitization in order to identify necessary changes that may need to be made in order to pass the rating agency review as well as to highlight specific operational functions that require more attention in a physical on-site review.

The second component of the feasibility study should be a physical on-site review covering all major functional areas of the mortgage operation, including:

- Management
- Loan Servicing
- Loan Origination
- Default Management
- System Review and Investor Reporting
- Loan File Review

The review should be conducted from the perspective of securitization and rating agency standards, so as to detect deficiencies in the operation that need to be corrected in order to successfully launch a securitization program.

Servicing Case Study: AGS Financial and BHN

The following case study provides examples of the issues faced by a mortgage servicer in an emerging market country and how many of these issues were overcome. At the conclusion of the engagement the mortgage servicer received the approval of the international rating agencies.

In 1995, AGS Financial ("AGS") was engaged as an advisor to Banco Hipotecario Nacional ("BHN"), the state-owned mortgage bank of Argentina, to assist in the development of their mortgage securitization program. The following example briefly outlines the work AGS performed on behalf of BHN to help their servicing operations meet rating agency requirements, thus providing a platform for one of the most successful international securitization programs to date.

Objective of Engagement

BHN needed technical advice in the development of their mortgage securitization program. Of primary concern was BHN's ability to accurately monitor the application of mortgage payments, the remittance of funds, the collection of delinquent loans, the foreclosure process, the movement of legal documents, and the reporting of information from BHN's 40 primary servicers.

AGS Accomplishments

AGS developed and implemented BHN's master servicing policies and procedures to meet international standards. During the 13-month engagement, AGS accomplished the following:

- Introduced BHN to the requirements of reporting and servicing according to international standards.
- Designed a system to collect servicing data from 40 primary servicers.
- Designed a standard tape layout for capture and maintenance of loan data.
- Created a master servicing system that produces standard monthly remittance reports for the trustee, rating agencies, investment banks and investors.
- Developed master servicing procedures to service loans to the requirements of the international markets.
- Developed procedures to monitor the application of mortgage payments, remittance of funds, collection of delinquent loans, the foreclosure process, movement of legal documents and reporting of information.
- Designed staffing plan for master servicing area, including job descriptions and functional responsibilities.
- Provided training for each responsibility for the master servicing department.
- Organized rating agency reviews of master servicing function.

Overall Results

As a result of AGS's work under this engagement, BHN’s master servicing operation successfully passed rating agency reviews. Utilizing its servicing platform as a foundation, in October 1996 BHN successfully issued the first ever cross-border mortgage securitization from an emerging market country and has since become an active issuer of international MBS. Five transactions have been issued and rated investment grade, above Argentine sovereign risk.

Summary

Quality asset servicing is an essential component to a successful program of asset securitization, and one that the credit rating agencies scrutinize carefully. Institutions interested in pursuing securitization should prepare by conducting a thorough feasibility study and make the operational changes necessary to meet rating agency servicing requirements.

AGS Financial is an investment banking and advisory firm specializing in securitization and structured finance. Among other services, AGS assists financial institutions with the design and implementation of data recapture programs, and the customization of loan servicing, data tracking, and investor reporting systems.

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