



Accounting and Operational Alternatives for Delinquent and Foreclosed Loans

Steve Davies, John Adams

December 13, 2002 Dallas



Contents

1. Foreclosure Accounting

- a. Overview
- b. Priorities of an asset management group
- c. Priorities of a finance group
- d. Disconnects between finance and asset management
- e. How to address these differences

Contents

2. Early buyout programs

- a. Lower rates and impact
- b. Rolling 30's (impact of new rules)
- c. Accounting practices for interest accrual
and related reserves
- d. Buyout Strategies

Contents

3. PwC Survey- Industry Practices in Foreclosures

- a. Foreclosure reserves
- b. Early pool buyouts
- c. Foreclosure loss recognition
- d. Loss analysis

4. Increased reliance on loss mitigation tactics

5. Update on credit and allowance for loan losses

Foreclosure Accounting

Foreclosure expenses represent one of the more significant cost elements in the mortgage industry but the recognition of losses varies significantly among mortgage companies.

The recognition and presentation of foreclosure expenses are impacted by several factors including

- (1) How the company's foreclosure reserve is established
- (2) The impact of early pool buyout programs
- (3) How interest is accrued for loans bought out of GNMA pools
- (4) The timing and methodology in analyzing and writing off foreclosure advances

Foreclosure Accounting

- There is a very heavy burden of regulatory requirements from states, investors and insurers (especially FHA and VA)
- Seemingly inconsequential operational practices can result in huge financial losses for the mortgage bank
- Many of the large servicers have lost \$millions through the need for closer management of this area

Foreclosure Accounting

- Technology developments have helped but the industry is still moving toward more effective loan level asset management
- Many of the large foreclosure related losses incurred by mortgage companies have come as a surprise to management
- This is in part a result of differences in understanding and priorities between the asset management group and the finance function

Priorities of an asset management group

- Meet all investor requirements to mitigate borrower default
- Prosecute foreclosure in accordance with investor requirements
- Minimize cost to servicer of managing default process
- Recover all advances on a timely basis
- Manage workflow process to avoid bottlenecks and ensure effective handoffs

Priorities of a finance group

- Minimize accounting losses per loan
- Timely identification and quantification of foreclosure loss exposures
- Timely recovery of advances
- Ensure portfolio loan exposures are within parent/ regulatory requirements

Disconnects between finance and asset management group

- Differences in priorities:
- Finance - minimize losses and recover advances on a timely basis
- Asset management - meet investor performance requirements
- These are not always incongruous e.g. Freddie Mac Tier 1 status results in additional financial benefits to the mortgage bank

How to address these differences

- What could the asset management group be doing:
 - Better focus on financial data
 - aging of advances
 - reconcile average economic and accounting losses
 - accounting losses included as part of cost center analysis
 - late fees
 - financial quantification of default pipeline (not just loan counts)
 - Better focus on financial milestones
 - first action compliance percentage
 - aging since LDDI, foreclosure sale

How to address these differences

- What could the asset management group be doing (cont):
 - Financial quantification of backlogs
 - FHA, VA loans supplemental claims pending
 - Analysis of economic losses between controllable/avoidable and non-controllable/unavoidable
 - Incorporation of GNMA early pool buyout benefits into overall asset management group performance

How to address these differences

- What could the finance group be doing:
 - Encourage understanding within Asset Management of financial risks and exposures
 - Ensure key compliance metrics are tracked and incorporate these into monthly management reporting
 - Understand financial implications of non-compliance with investor requirements
 - Reconcile economic and accounting losses; analyzing controllable and non-controllable losses
 - Reconcile default management monthly reporting to quantified exposures

How to address these differences

- What could the finance group be doing (cont):
 - Develop processes to track loan losses at the loan level
 - Perform regular review of loss analysis results
 - Separate average loan loss exposures into year of LPI, state, investor, non-owner occupied to track pipeline exposures, or perform similar analysis below the aggregate portfolio level
 - Regular cost/benefit analysis of potential early pool buyout loans

Management Reporting

- The following metrics need to be tracked by management to monitor performance and correct any process issues:
 - Aging of advances
 - Reconciling average economic and accounting losses
 - Accounting losses included as part of cost center analysis
 - Late fees
 - Financial quantification of default pipeline (not just loan counts)
 - First action compliance percentage
 - Aging since LDDI, foreclosure sale

Management Reporting (cont)

- The following metrics need to be tracked by management to monitor performance and correct any process issues(cont):
 - Financial quantification of backlogs
 - FHA, VA loans supplemental claims pending
 - Analysis of economic losses between controllable/avoidable and non-controllable/unavoidable
 - Incorporation of GNMA early pool buyout benefits into overall asset management group performance

Early Pool Buyouts

Why servicers have the option

- The GNMA MBS Guide explicitly grants the issuer the option, and without Ginnie Mae's prior authorization, the right to repurchase any pooled loan for an amount equal to 100 percent of the loan remaining principal balance when for four consecutive months, at least one missed payment remains uncured, or when no payment is made for three consecutive months
- This option is included in all GNMA I and GNMA II securitizations
- The issuer cannot change, alter, or relinquish this option

Early Pool Buyouts

Implementation of an early pool buyout program provides mortgage banks the opportunity to improve earnings and to lower portfolio credit risk by remarketing loans that are bought out to third parties that are willing to accept FHA and VA foreclosure loss risk.

Those processes crucial to the implementation and administration of a loan buyout program include the following:

- Monthly identification and selection of loans to be bought out of GNMA pools prior to foreclosure sale date
- Decision of whether to buy out either loans delinquent for 90 days or loans delinquent for 3 consecutive months (see recent program changes below)
- Determination of funds available for buyout and targeted interest rate spreads

Early Pool Buyouts

Those processes crucial to the implementation and administration of a loan buyout program include the following (cont)

- Identification of corporate accountability to administer the buyout program
- Evaluating whether to pool reinstated loans for sale to third party or securitization
- Selection of a third party to sell reinstated loans
- Development of an appropriate set of management reports
- Development of models to predict behavior of a loan regarding payoff, foreclosure, bankruptcy, and reinstatement

Early Pool Buyouts

Additionally, loan buyout programs need sound accounting procedures for the following:

- Application of monthly mortgage payments received subsequent to the loan buyout
- Application of claims proceeds from the VA and FHA and related general ledger postings
- Loss analysis and clearing of corporate advances

Early Pool Buyouts

Accounting issues:

- Loans selected for buyout are transferred from GNMA investors
- Advanced principal and interest is capitalized on the general ledger
- Interest to be collected from either the borrower or the government is accrued for months subsequent to the buyout date
- Payments received for bought out loans are credited to principal and accrued interest
- Loans that are current are transferred out of buyout accounts
- Loans subsequently sold because of reinstatement are recorded as loan sales
- First claim proceeds are received and applied to principal and accrued interest balances outstanding
- Second claim proceeds are applied to remaining balances outstanding

Early Pool Buyouts

Recent program changes:

- Ginnie Mae released All Participants Memorandum 02-24 on November 6, 2002 announcing a key change to its buyout program. For Ginnie Mae pools with an issue date January 1, 2003 or later, servicers will be allowed to repurchase a pooled loan only if the borrower has missed three consecutive payments. Currently, servicers can repurchase a pooled loan when one missed payment remains uncured for four consecutive months. Existing Ginnie Mae pools will not be affected by this program change.
- Companies should update any systems or tools used to identify pooled loans that are eligible for repurchase to account for the Ginnie Mae program change. Ginnie Mae servicing pricing may be impacted by the program change as well. Servicers and investors should keep the program change in mind when comparing Ginnie Mae prepayment speeds for pre-2003 vintages to 2003 and later vintages.

Early Pool Buyouts - Accounting

The rising use of EPBO's has implications in the accounting treatment of government insured loans:

- Interest accrual recognition - Is interest accrued as a loan receivable from a mortgagor or is interest accrued as a claim receivable from VA or HUD?
- How are reinstatement probabilities impacting the interest accrual?
- How do estimated expected interest curtailments by HUD and VA affect the interest accrual?
- When are out-of-pocket expenses expensed for loans referred to foreclosure?

Accounting for EPBOs

Guidance is provided by FAS 140

- The EPBO provisions are considered Removal of Accounts Provisions (“ROAP’s”)
- Once a loan subject to a ROAP becomes eligible for removal, the issuer must account for the loan as repurchased from the pool, regardless of whether the loan has been actually repurchased or not
- The Issuer records an asset with a corresponding liability
- FAS 140 lacks guidance on precisely how the ROAPs should be accounted for on an ongoing basis

Accounting for EPBOs

Ongoing Accounting Issues

- FAS 140 is not clear on how the following should be accounted for once an asset subject to a ROAP is recorded:
 - Servicing rights recorded related to the “theoretically” repurchased assets
 - Interest income accrual on these loans
 - Imputing interest expense on the non-interest bearing liability recorded for the “theoretical” repurchase
 - How payments received would be recorded
 - How loans no longer subject to a ROAP would be treated (i.e., once a loan reinstates and is no longer eligible for repurchase)

Accounting for EPBOs

- To address these and other issues, EITF 02-09 was drafted. The EITF in summary looks to address:
 - *how beneficial interests will be accounted for and whether there should be any income statement impact of applying paragraph 55 of FAS 140 for contingent calls and ROAPS, and*
 - *whether loan loss reserves should be initially recorded when they are re-recognized under the provisions of paragraph 55 of FAS 140.*
- However, several practical concerns were raised about the EITF conclusions and it is currently back under review.

Accounting for EPBOs

- While EITF 02-09 is still under review, there is a tentative agreement that when a loan is synthetically repurchased under a default ROAP that the servicing right should not be reversed.

PwC Survey-Industry Practices in Foreclosures

PricewaterhouseCoopers compiled information from fourteen of the largest mortgage companies to provide a general framework of common practices among mortgage companies so as to compare their losses to the mortgage industry

The following observations were made from the information received

PwC Survey-Industry Practices in Foreclosures

- **Foreclosure Reserves**

Responsibility for calculating the reserve predominately rests with the company's corporate accounting/ finance unit

A majority of respondents establish reserves at a rate per loan based upon historical loss experience

Several servicers establish their reserves based upon a specific identification of losses within the existing portfolio. This is the preferred method among servicers that have developed more sophisticated models to capture foreclosure and accounting data

PwC Survey-Industry Practices in Foreclosures

- **Foreclosure Reserves**

A majority of servicers establish a reserve for foreclosure losses based upon the loan's delinquency or foreclosure status. Most of the servicers increase the loss requirement on the loan as its credit quality deteriorates

Respondents are split as to whether to establish a reserve for conventional loan losses

PwC Survey-Industry Practices in Foreclosures

- **Early Pool Buyouts**

Most servicers utilize an early pool buyout strategy generally buying loans out of pools at 90 or 120 days

Servicers are split as to whether they hold their buyouts as an investment or sell these loans

Government claims accruals are generally driven by the sophistication of their servicing system and other modeling tools available

PwC Survey-Industry Practices in Foreclosures

- **Interest Accrual Practices- GNMA Buyouts**

Seventy-five percent of the servicers accrue interest on GNMA pool buyouts, with the majority accruing at the VA and FHA program recovery rates for the applicable period that is recoverable

A majority of the respondents initiate the claims accrual at the date of buyout. Not accruing interest will understate the accounting loss associated with a government claim

Half the respondents factor into their interest accruals and related reserves an adjustment for historically developed reinstatement probabilities

PwC Survey-Industry Practices in Foreclosures

- **Recognition of Foreclosure Losses**

The write off of foreclosure losses is generally an asset administration function. The life cycle of a write off will range between one to two years

The timing of a write off can have a significant impact on those companies that develop foreclosure reserves based upon historical loss experience

Unrecognized losses imbedded in the foreclosure pipeline may be understating required reserves

PwC Survey- Industry Practices in Foreclosures

- **Analysis of Loss Information**

Current industry practice is trending toward more detailed information to analyze the components of unrecoverable interest

However, only half the respondents present unrecoverable interest in detailed categories associated with curtailment reasons as well as the “noncontrollable” program losses for FHA two month’s interest and debenture to note rate differences

Half the respondents present disallowed out of pocket expenses in detailed sub-categories by reason in presenting information to management

PwC Survey-Industry Practices in Foreclosures

- **Considerations in Analyzing Losses**

FHA losses impacted by:

- Policies for accruing interest on pool buyouts
- UPB of a foreclosed FHA loan
- The quality of operations of the servicer in mitigating curtailed interest losses

Common reasons for foreclosure losses:

- Untimely initiation of first foreclosure legal action
- Untimely reinstatement of foreclosure action on a discharged bankruptcy
- Delayed conveyance due to property and preservation issues
- Higher losses in “judicial” foreclosure states resulting from servicing errors during increased time to process foreclosures

PwC Survey-Industry Practices in Foreclosures

- **Emerging Trends**

- Record levels of foreclosures
- Record levels of bankruptcies
- Higher level of investor expectations (Repurchase demands)
- Cash out refinances- additional risk

Increased Reliance on Loss Mitigation Tactics

- Government insurers (VA and FHA) and agencies (FHLMC, FNMA) are the most aggressive users of loss mitigation techniques
- Fee incentives and higher claim reimbursement rates are available to servicers providing effective loss mitigation to their borrowers
- Loss mitigation techniques are being applied to a larger portion of the servicing portfolio
- Best execution models are becoming more sophisticated in identifying borrowers for loss mitigation
- Effective loss mitigation can delay or substantially eliminate REO losses
- REO losses can average 35 to 45 % of a loan's carrying value

Credit and allowance for loan losses

- The management of problem loans continues to occupy a significant amount of time and resource for most financial institutions.
- Many mortgage companies have to some degree a pool of portfolio owned loans that are impacted.
- Challenges to reconcile safety and soundness with consistency concerns.
- New rules will mean more focus on process and documentation surrounding the allowance methodology.

Credit and allowance for loan losses

- Several initiatives in this area:
 - Joint FFIEC/SEC effort to improve documentation guidance that resulted in issuance of a staff accounting bulletin (SAB) and policy statement (PS)
 - AICPA project to develop accounting guidance on the recognition and measurement of the provision, as well as improvements in disclosures that resulted in a recent exposure draft (ED)

Credit and allowance for loan losses

- Several initiatives in this area (cont):
 - FFIEC/SEC guidance: important elements of these two documents concerned the level of detailed documentation required to support the allowance, including the desire to see improvements in institutions' written analysis of the economic events, data, risks and judgments made by management.
 - AICPA: Proposed Statement of Position—Allowance for Credit Losses (the “ED”), that addresses certain accounting and disclosure issues related to the allowance.
 - SEC MD&A Disclosures - proposed rule on critical accounting disclosures would apply to the ALLL for many institutions

Credit and allowance for loan losses

- AICPA ED:
 - **Unallocated reserves** may be difficult to support, although SEC guidance says such reserves are not inconsistent with GAAP.
 - **Coverage period**—The ED implicitly notes that few, if any, companies have adequately justified the coverage period for the different segments of their portfolio. It introduces the concept of a loss emergence period (the period of time between the incurrence of a loss and the confirmation of the loss), and places more burden on financial institutions to demonstrate that “coverage periods” currently used are in accordance with this guidance.
 - **Measurement approach**—The ED provides that incurred losses for FAS 5 should be measured based on the present value of expected future cash flows. It also acknowledges the practice of utilizing default probabilities, loss given default and exposure at default to derive estimates of expected losses.

Credit and allowance for loan losses

- AICPA ED:
 - **Concepts of observable data and directionally consistent**—The ED introduces new terms such as “observable data” and “directionally consistent.” The observable data requirements could potentially raise the bar on documentation of loan impairment measurement and will be more burdensome to financial institutions.
 - **Disclosures**—The ED provides for expanded qualitative and quantitative disclosures. Financial institutions could be required to disclose loan balances by credit risk grades, which would be a significant change from current practice.
 - Needs to be cleared by FASB and much work continues – PwC is actively involved in the process.

Credit and allowance for loan losses

- The Basel Accord and Sarbanes-Oxley combined have significant implications for financial institutions, including raising the bar in terms of the depth, breadth and integrity of data, and the quality of internal controls. A few key implications include:
 - The new Basel Accord will demand an attitude toward risk data similar to that expected for financial and accounting data;
 - It will be essential to provide consistent audit trails from calculated, aggregate risk measures back to source transactions;
 - Roles of finance, operational and risk management functions may have to be redefined;

Credit and allowance for loan losses

- The Basel Accord and Sarbanes-Oxley combined have significant implications for financial institutions, including raising the bar in terms of the depth, breadth and integrity of data, and the quality of internal controls. A few key implications include (cont):
 - Many companies will be starting from scratch in redesigning their regulatory reporting systems;
 - Operating and control environments within which risk and capital are managed will need to be stable and robust;
 - Even if a company chooses not to implement the advanced measurement approaches, increased pressure on “disclosure and control processes” will require advancement in many of the same risk management capabilities; and
 - Failure to measure up will be viewed negatively by shareholders, analysts and banking regulators.

Conclusion

Default remains one of the most complex areas outside of MSR asset management

Finance and asset management functions must reconcile goals and performance measures

The most successful mortgage companies take advantage of technology to manage delinquent assets at the loan level, combined with a relatively aggressive Early Pool Buyout Strategy



Your worlds



Our people