PRICEWATERHOUSECOOPERS

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# Consumer Finance Update

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## A New Era for Home Equity

*Customers are becoming more likely than ever to tap home equity through home equity lines and loans rather than refinancing their existing first mortgage. This is primarily due to two converging factors. First, with mortgage rates coming off of all time lows, consumers are hesitant to refinance their entire mortgage balance into a higher first mortgage rate to access home equity. Second, because most home equity products often require prime based interest only payments and no closing costs, the current cost of home equity funds is in many cases lower than first mortgage funds.*

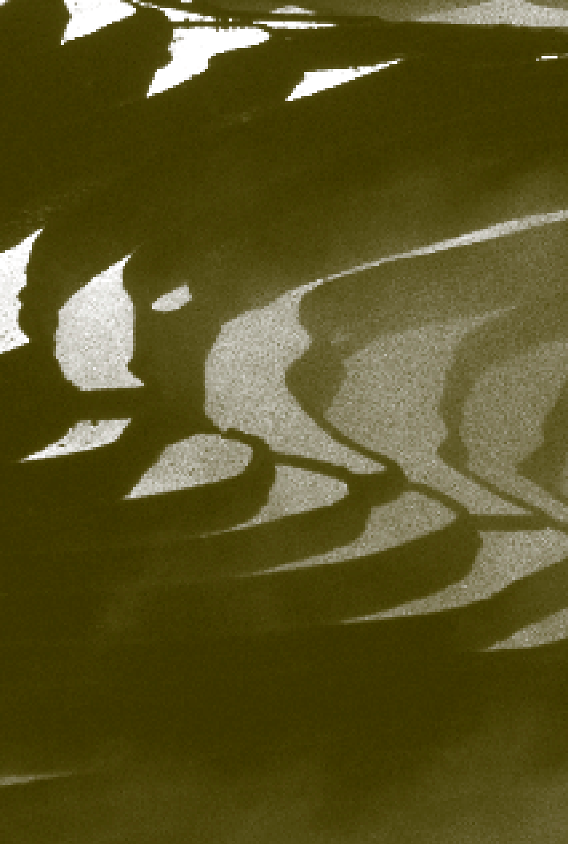
*(continued on page 2)*

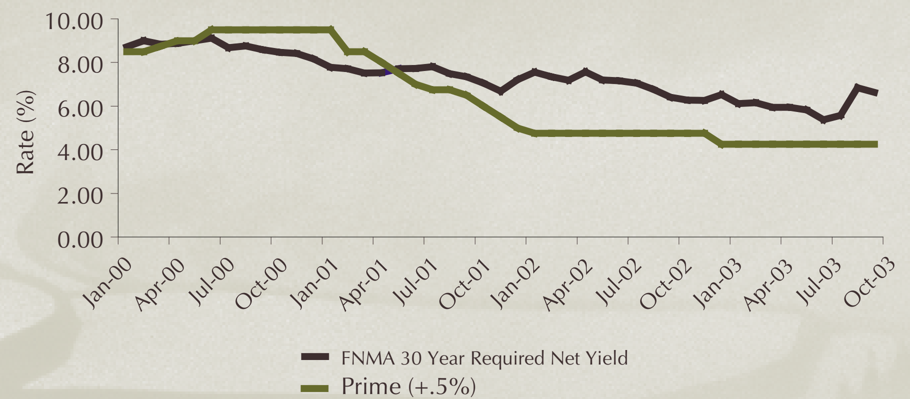
*We are pleased to present the Winter 2004 edition of our industry update!*

The year 2003 was a time of change. The most significant change for the industry was the rise, continued rise and then decline of the refinance boom. Records were set, systems were strained, and business models were reassessed. Nobody knows if we will see prolonged low interest rates or a return to higher rates. One thing is clear – high volumes are declining, which will dramatically impact operations, risk management and business strategy. Articles in this edition discuss the operational, strategic and regulatory factors we are all beginning to appreciate in this changed environment. A hot topic for many remains the level of work needed to successfully implement programs for compliance with Sarbanes-Oxley Act requirements. A number of articles discuss these impacts at a detail level and cover some emerging best practices in 404 implementation programs.

Reflective of the change theme, last July, the PricewaterhouseCoopers Mortgage Banking Services Group became the PricewaterhouseCoopers Consumer Finance Group. Why the change? Our Mortgage Banking Practice is one of the foremost providers of assurance and advisory services to the mortgage industry and is a recognized industry thought leader. During the past few years, we have accelerated our services and expertise into additional consumer asset classes such as home equity, subprime, credit cards, auto loans, student loans and manufactured housing, reflective of the more integrated approach in the industry. Our focus and attention to the details of the mortgage industry has not changed: as you will see in some of the articles in this newsletter, we are now bringing this focus to the wider industry. Therefore, welcome to the inaugural issue of Consumer Finance Update!

**Tim Ryan and Mike Seelig**
Co-chairs, Consumer Finance Group
January 2004






*Note: Assumes prime rate plus a .5% risk based add on to interest rate.*

*(Continued from cover)*

The graph above shows a historical comparison of how a prime based home equity loan would compare to first mortgage loan pricing.

As a result of this unique relationship between home equity and first mortgage rates, companies with existing home equity lending platforms are continuing to improve their service and gain market share while companies without an established home equity platform are working to develop home equity products (either internally or through wholesale relationships). Regardless of the strategy, there are some common strategic considerations when evaluating home equity operations. Getting this right now will ensure successful growth.

*Risk Management* Because of the anticipated growth in home equity products, companies have continued to place increased focus on monitoring and managing risk associated with home equity loans. In managing home equity risk, companies have applied many of the same principles used in first mortgages with several additional areas of focus. For instance, similar to credit cards, home equity line risk managers must consider the relationship between available lines and outstanding balances.

Due to this relationship and more reliable AVM and credit scoring technology, risk managers continue to monitor metrics such as current CLTV and FICO scores in an effort to forecast future liquidity and charge off activity. In addition, due to the lack of a standardized home equity secondary sales market to be leveraged in pricing and hedging home equity loans, risk managers have become more active in the management and verification of assumptions used in home equity pricing and valuation models.

In addition, we can expect to see increased regulatory scrutiny and continued media focus on the growing home equity markets.

*The Complexity of Pricing Home Equity Originations* Many companies have relied on proprietary pricing models to forecast future cash flows and apply the results of this analysis as ROE based price targets. While the pricing to a customer is generally a simple index plus a risk based margin calculation, determining this price is often complex and heavily reliant on assumptions that are updated and maintained within the proprietary model. These assumptions are becoming more and more similar to the risk based assumptions applied to conventional conforming products (e.g., estimated prepayment rates, line size, draw amount, utilization assumptions, credit, FICO, LTV, etc.). As a result, the stability of these models and the accuracy of the assumptions used in the models are of primary importance as mis-modeled assumptions or inaccurate system performance could have a P&L and economic impact.

*Securitization Market* The securitization market for home equity loans is growing and continues to mature as a viable alternative to whole loan sales and/or balance sheet retention strategies. However, there are additional costs associated with securitizing home equity loans that may not have been considered as a part of the cost assumptions used in the pricing process. As a result, many companies have begun implementing the estimated costs to securitize as an additional assumption within their pricing model. In addition, due to the servicing implications associated with the securitization of home equity loans, many companies that have traditionally retained home equity originations in their portfolio have also begun preparing for the possible changes required within servicing (e.g., P&I remittance, investor reporting, etc.) and risk management (e.g., forecasted balance sheet requirements, model assumption validation, improved metrics required for prospectus and investor reporting, etc.).

*Home Equity as a Retention Tool* Given the current interest rate environment, many companies have been aggressively targeting existing customers to offer access to home equity products. This has been considered a logical and effective strategy, as customers are perceived to be more likely to refinance their first mortgage in the future, if the same company services both the first and second mortgage.

*Systems and Operations* Again, home equity and conventional mortgage operations are very much alike when considering operational and processing system needs. Specific credit and collateral requirements have generally been implemented to ensure standardization of origination quality. However, unlike first mortgage lenders, and due to a still maturing securitization market, home equity lending does not have standardized credit requirements as defined by government agencies or the automated underwriting systems associated with ensuring compliance with these guidelines. In addition, like their conventional mortgage cousins, home equity originations have continually battled system efficiency, data integrity and capacity management issues experienced by first mortgage lenders in recent years.

*For more information on home equity strategies, risk management practices or retention strategies, please contact Peter Pollini at 207-450-9036 or at peter.c.pollini@us.pwc.com.*

# Loan Servicing:

## WHAT HAVE YOU DONE FOR IT LATELY?

*We are beginning to see an increased focus on servicing business profitability in 2004. Where originations may have driven value creation over the refinance wave, many companies expect mortgage servicing will drive value over the next two years. Putting origination pricing pressures aside for a moment, we consider some of the key factors to ensure servicing profitability: balanced cost management, delivery of customer value and loan quality.*

*Cost Management* We can consider three ways to maximize income: increase revenues, reduce costs or a combination of both. The challenge is to how to minimize costs without impeding business growth or risk management. The following tips provide some direction:

- ***Avoid blanket cost reductions.*** When a company embarks on a cost cutting initiative, the order can come down for all areas to cut 20% out of operating budgets with little or no guidance on where to cut. The consequences of such actions can be severe. For example, in a post refinance market there are some processes that will have significant excess capacity, such as loan boarding or payoff processing, and there may be some that will continue to operate at full or above full capacity, such as customer service or escrow, for a prolonged period of time. As a result, a blanket reduction could adversely impact customer service levels and escrow operations and lead to additional costs in the form of tax penalties and loss of customers and/or cross-sell opportunities. The bottom line is knowing where one can cut and by how much.
- ***Measure costs accurately.*** Organizations that have invested in robust costing systems and approaches, such as activity based costing, will enjoy an advantage over those that have not. To successfully reduce costs, the key is to understand cost composition. Traditional costing approaches often use broad based allocations that can result in the over/under costing of a product or service. As a result, what is viewed to be a high cost activity may, in fact, only be that way as a result of an erroneous cost allocation. The better

way is to analyze activity costs by using a series of attributes such as fixed/variable, discretionary/non-discretionary, etc. If management understands costs at this level then they are better positioned to make the correct decisions. For example, in targeting a process that contains a high degree of fixed costs, savings will be marginal at best as opposed to a process whose cost composition is primarily variable and discretionary. The objective here would be to target reductions at high cost, low value activities.

- ***Understand cost drivers.*** For companies to successfully manage costs, they need to understand what drives them. For example, if customer service costs are high compared to peers or even internal benchmarks, rather than eliminate cost from that department, management should analyze the source or the drivers of those costs. It may become evident that the increased customer service costs are the result of broken processes in the payment processing area or tax department. Again, a blanket cost reduction in the customer service budget would have done nothing to address the problem and, in fact, would only have served to exacerbate it.
- ***Know when and how to outsource.*** Outsourcing has become one of the hot topics in the industry today with several organizations choosing to outsource some of their customer service and back office functions offshore. While outsourcing can be an effective strategy to manage costs, it must be done correctly. We often see two common issues occurring in executing this strategy. The first is to outsource customer sensitive functions, such as call centers, without due consideration of the risks to cross sell and customer satisfaction. The bottom line is not to lose a touch point with high value customers (assuming these can be identified). The second is outsourcing without establishing the appropriate vendor performance measures. Appropriate measures should encompass service levels, quality standards and cash flow expectations. Outsourcing can be effective if done correctly. Processes that are prime candidates for outsourcing are those that are highly transactional, are deemed to be of low value and do not have a direct impact on the customer.
- ***Determine when to explore subservicing.*** It may be effective to completely outsource servicing for certain types of loans. The risks associated with this process are discussed in detail in a separate article in this newsletter, "Is Subservicing an Option for You?"

*Customer Value* The challenge for many mortgage companies is now to understand the customers they have acquired over the last two years, to deliver on the servicing relationship and to deliver on the value potential created by the customer relationship. This is a popular area for consultants and big ticket systems, but there are some basics to consider:

- ***Understand the customer base.*** What types of customers are serviced? Which are profitable? What needs to be done to make others profitable? The following provides some guidance:
  - Invest in data capture – that is, capture and store as much data as possible at the point of application. Key items to capture are income, net worth, investment details, other debt products, etc.
  - Understand customer acquisition costs and revenues at a product and channel level. A simple analysis considering channel and product can provide significant insight into where the value is being and can be created. In some cases it really is a case of 20% of the customers generating 80% of the profit.
  - Understand actual cash flow performance at a loan level. Have tools in place that can track and measure the net cash flow generated by each customer's loan(s). Analysis continues to show that behaviors drive profitability.
  - Look at customer's relationship at an entity level – that is, have the ability to identify products held through the mortgage bank, consumer bank, leasing company, etc.
- ***Segment the customer base.*** Once the tools are in place to understand profitability, acquisition costs and net cash flow performance, and to assess the overall entity relationship, the next step is to begin to segment the customer base. Segmentation involves grouping customers with similar characteristics and attributes into categories. For example, who are the most profitable or potentially profitable customers? Who are the unprofitable customers? Once this information is known, segment strategies can then be developed.
- ***Develop segment strategies.*** This is where the "rubber meets the road." This step is where the most critical part of the customer value process is brought to the forefront. With target segments identified it is

here where strategies will be worked out to develop and build relationships with top tier customers. It is here where strategies will be developed to migrate potentially profitable customers to profitable customers through increased cross-sell efforts, tiered service levels, and channel migration.

The fundamental message here is that for any company to be successful, it must understand who is its target customer. If no clear market strategy exists, then there is a risk of adverse selection – your target market becomes what everyone else does not want.

*Loan Quality* There is no question that large volumes place a strain on systems that manage loan quality. The impacts will be felt in the areas of foreclosure losses, increased delinquency costs, and increased costs associated with repurchases and indemnifications.

Given that the industry will likely face an increased level of repurchase and indemnification activity over the next few years, there are clearly some areas where servicers should be focusing their efforts in order to minimize bottom line impacts. These include:

- Integrating repurchase and indemnification processes and systems
- Ensuring that all loans with recourse from a third party are correctly flagged as such in the servicing system
- Considering holdbacks on third party originators (TPOs) that have repurchase and indemnification receivable balances outstanding
- Factoring loan quality into TPO pricing decisions
- Performing a detailed root cause analysis on all repurchase, indemnification and make-whole loans

Critical loan quality considerations for post closing include:

- Rebalancing the staffing model as origination volumes decline
- Monitoring caseloads, backlogs and error tracking trends from last six months
- Considering the benefits of a centralized post closing function
- Understanding post closing costs per loan
- Streamlining processing and the impacts of imaging
- File flowing – an initial simple process flow mapping of current processes will often identify weaknesses
- Doing it once and doing it right mentality
- Prioritizing “clean” loans
- Segmenting processes by product type
- Analyzing the scalability of operations (e.g., cross training)
- Scrutinizing deficiency resolution processes and procedures
- Establishing accountability for loan quality

Critical considerations for default and foreclosures include:

- Updating a review of accounting vs. economic loss rates
- Understanding the impacts of increasing compliance failures arising from increased volumes
- Tracking attorneys’ and agents’ performance
- Tracking write offs and aged claims
- Understanding agency expectations for loss mitigation
- Tracking loans through various stages of delinquency, loss mitigation, bankruptcy and foreclosure
- Making sure systems are talking to each other timely and accurately
- Providing a robust but healthy challenge process between finance and default asset management

The next few years represent an opportunity for servicers to become the profit champions within their organizations. Those who succeed will do so because of their ability to successfully manage costs, measure and track actual cash flows, execute on their target segments and manage their repurchase risks.

*If you are interested in learning more about this topic or would like assistance with cost management strategies, customer value strategies or loan quality, please contact Martin Touhey at 617-530-7447 or martin.e.touhey@us.pwc.com or Steve Davies at 206-398-3519 or steve.t.davies@us.pwc.com.*

# New Forces, Old Forces:

## SECONDARY MARKETING RISK MANAGEMENT

*This summer's pricing volatility in the secondary mortgage market has pushed secondary marketing risk management practices to the forefront of the minds of many executive management teams.*

There is no doubt that secondary marketing is a complex area. There is also no doubt that secondary marketing hedging decisions and pricing strategies affect virtually all aspects of the origination process and contribute heavily to the profitability of a mortgage banking entity.

In many cases the risks managed within secondary marketing are fully mitigated using complex systems and well documented procedures to assess positions and identify losses to be managed at varying shifts in the yield curve. However, even with the complex modeling utilized by many firms, secondary marketing decisions are reliant on a host of factors that the risk manager may not control. Often these risks include:

- A sudden movement in mortgage backed security rates or other benchmark rates leading to losses in inaccurately hedged portfolios. This risk is often heightened when management has authorized the position to remain un-hedged or "long" in an effort to capitalize on an improving rate environment.
- A poorly defined hedge strategy, and corresponding external risk monitoring program, leading to excessive losses or gains. A well defined risk management policy, with clearly defined roles and responsibilities surrounding the monitoring of exposure limits, and escalation procedures when tolerances are exceeded, is required.
- A sudden movement in rates that results in unanticipated increases or decreases in loan volume. If this movement is not addressed and key assumptions are not adjusted (e.g., fallout) in a timely manner, risk management decisions can be made in error and based on inaccurate information.
- The timely receipt of information. Accurate information is essential to sound risk management decisions. If data and assumptions are not defined appropriately, excessive losses (or gains) may be realized.

In addition, traditional risk areas need continued focus:

- Third party limits
- Phantom locks
- Management awareness around sensitivities
- Premium pricing caps
- Tracking of exceptions
- P&l attribution
- Policy requirements in volatile rate environments
- Broker and correspondent tracking
- Fall out modeling
- Rate registration

Many of these issues are industry issues, meaning that the nature of change in the industry requires risk managers to adapt to a dynamic and often unpredictable environment. As a result, some additional control considerations when assessing risk management practices within secondary marketing include:

- The effectiveness of hedge strategies in a changing rate environment
- Current model and assumption validation processes (e.g., accuracy of fallout, formal change management policies, hedge allocation/ratio calculations, etc.)

- Maximization of best execution modeling
- The ability to identify operational issues outside of secondary marketing's control, leading to secondary marketing activities (e.g., global rate lock extensions due to ongoing volume constraints on operational personnel)
- Data integrity coming from source systems
- The ability to track changes at a detailed level, and isolate anomalies in daily and monthly profit and loss results in an effort to provide risk managers a tool to understand and explain the results of risk management decisions

As a result of recent interest rate volatility and related volume impacts, corporate monitoring and oversight of secondary marketing results has increased significantly. Below, we have provided several steps to help ensure that secondary marketing risk management objectives are being met and interest rate risk is being managed:

- Perform an independent assessment of current state risks and controls.
- Create formal model and assumption validation procedures to ensure the accuracy of data being used for risk management decisions.
- Ensure departmental policies/procedures are up to date and being administered.
- Confirm reporting lines to ensure the appropriate levels of segregation of duties in the oversight and monitoring of risk.
- Review current reporting practices to ensure that needed information is being received to make informed decisions. In many cases, this information is also used to support decisions made in managing risk within the portfolio.
- Review all accounting policies to ensure they reflect recent accounting pronouncements.
- Confirm accounting, risk management and secondary operation functions are communicating with each other on a real-time basis.
- Understand peer practice - no one is alone.

The ability to accurately attribute changes in value at the loan or commitment level is emerging as a critical best practice in addressing and measuring many of the risks discussed in this article. The impact of recent interest rate volatility has increased scrutiny of the current risk management strategy and has highlighted the need to know, at a detail level, how various factors interact to drive changes in value. As a result of this volatility, and due to a concurring need to understand changes in value, many industry participants have recognized that there is an opportunity to drive better business performance through the following:

- Tracking and analyzing profit/loss attribution at a loan and individual assumption/metric level
- Comparing actual and expected loan yields
- Identifying and addressing operational constraints to maximizing loan profitability
- Determining the correct source for income and expenditure associated with pipeline risk management, and allocating these to the source

*If you would like further information on these or other secondary marketing issues, or would like to participate in secondary marketing peer benchmarking surveys facilitated by PricewaterhouseCoopers, please contact Peter Pollini at 207-450-9036 or peter.c.pollini@us.pwc.com or Steve Davies at 206-398-3519 or steve.t.davies@us.pwc.com.*

News Alert

## Fairbanks Capital Settlement Leads to New Servicing Practices and Prohibited Practices

The FTC and HUD recently announced a $40 million settlement with Fairbanks Capital Corp., one of the nation's largest servicers of subprime mortgage loans, for alleged violations of several federal laws that protect consumers from unfair and deceptive practices as well as alleged servicing activities. The Settlement Order, pending final court approval, along with providing consumer remedies and monetary relief, also requires the Company to adhere to specific servicing standards to protect current and future borrowers.

The FTC and HUD, through this settlement, have provided notice to ***all*** mortgage servicers to heed the guidelines set forth in the settlement. Furthermore, FTC chairman Timothy Muris stated recently that rather than publishing guidelines to define "predatory servicing," the FTC will proceed with investigations on a case by case basis.

Many of these practices should be widely known from existing legislation. However, there are several new and more stringent requirements identified in this agreement. In addition, while the settlement provides clear guidelines for servicing subprime mortgage loans, many of the standards would be also relevant for servicers of prime portfolios.

The section below summarizes the servicing practices required as detailed in the Settlement Order and may be a useful reference in identifying servicing best practices that should be adhered to by all mortgage servicers. The settlement:

- requires the Company to accept partial payments from most customers and apply most mortgage payments first to principal and interest;
- prohibits force placing insurance when it is known that the consumer has insurance or fail to take reasonable action to determine whether the customer has insurance;
- prohibits charging unauthorized fees, and places limits on specific fees;
- requires the Company to acknowledge, investigate, and resolve consumer disputes timely;
- requires the Company to provide timely billing information, including an itemization of fees charged;
- prohibits taking any foreclosure actions unless they have reviewed the consumer's loan records to verify that the consumer failed to make three full monthly payments, confirmed that the consumer has not been subject to any illegal practices, and investigated and resolved any consumer disputes;
- prohibits assessing late fees, when the full payment is paid on time, when the only delinquency is attributable to the late fee(s) assessed on earlier monthly payments (i.e., pyramiding of late charges);
- prohibits enforcing certain waiver provisions in forbearance agreements that consumers had to sign to prevent foreclosure.

The settlement also stipulates strict compliance with respect to the following legislation:

- Federal Trade Commission Act ("FTC Act"), 15 U.S.C. §§ 41-58, as amended;
- Fair Debt Collection Practices Act ("FDCPA"), 15 U.S.C. §§ 1601-1692, as amended;
- Fair Credit Reporting Act ("FCRA"), 15 U.S.C. §§ 1681-1681u, as amended;
- The Real Estate Settlement Procedures Act ("RESPA"), 12 U.S.C. §§ 2601-2617, as amended, or its implementing Regulation X, 24 C.F.R. Pt 3500, as amended.

All facts and terms contained in this document were derived from the following source:
Order Preliminary Approving Stipulated Final Judgment and Order ("Settlement Order"); United States of America, Plaintiff v. Fairbanks Capital Corp., Fairbanks Capital Holding Corp., and Thomas D. Basmajian, Defendant ("Fairbanks"). United States District Court for the District of Massachusetts.

*For further details about the recent development and the potential impacts to your business, please contact John Kowalak at 646-471-3519 or at john.kowalak@us.pwc.com or Kristen Westaway at 678-419-1264 or at kristen.j.westaway@us.pwc.com*

# 404 and the Consumer Finance Industry

AN EARLY ASSESSMENT OF BEST PRACTICES

*Overview: The Sarbanes-Oxley Act was signed into law on July 30, 2002. In this article we consider emerging trends in implementing programs for compliance.*

Section 404 requires management, on an annual basis, to:

- State their responsibility for establishing and maintaining an adequate internal control structure and procedures over financial reporting.
- Complete a formal self assessment of the effectiveness of such internal control structure and procedures.
- Engage its auditors to assess and report on management's assessment.

In recognition of the level of preparation needed by the industry to become fully compliant with its requirements, the SEC has extended the effective date of Section 404 compliance into 2004.

Many industry participants are looking at the deadline extension as an opportunity to get prepared:

- Companies have continued the momentum in building the infrastructure to identify significant general ledger accounts and disclosures as well as the processes related to those accounts and disclosures. This is the foundation of the assessment process and serves to identify the magnitude of the compliance effort. This also assures that there is a clear understanding of how the processes around the accounts and disclosures map to the financial statements.
- Companies are now working to complete self-assessments based upon the determination of significant accounts and disclosures. Existing risk management tools have been updated or utilized where possible.
- Specific focus has been on process, internal control structure, management self-testing procedures, and highly specialized areas (leasing, valuations, credit, modeling, etc.).
- Any control issues ("gaps") identified are being prioritized for immediate resolution.

- The process is beginning to result in more formalized operational risk management processes that are aligned to financial control – everyone is now on the hook for controls.

## *Lessons Learned from Early Implementation Efforts*

***Aggressive Project Management.*** Assessment areas need to be completed on time and on budget. This includes evaluating specific deadlines for assessments and progress reporting, and identifying the "hand-off" points where one assessment ends and another begins. Best practices also include the use of a steering committee to review and approve findings and to communicate the findings to senior management, disclosure committee and audit committees.

An executive sponsor should take ownership of the initiative. This person's role typically involves:

- Performing all key communication to the organization
- Ensuring appropriate steering committee set up
- Ensuring remediation efforts occur where necessary

***Tone at the Top.*** Successful early compliance efforts have had significant support from senior management – initially and continually. Management communications to employees have made it clear that it is the company's responsibility and duty to have an effective internal control structure. This is the responsibility of the company's financial departments and operations as there also needs to be operational accountability for financial disclosures.

***Auditor Communication.*** The external auditors will ultimately have to sign off on management's assessment. Frequent communication on the company's assessment approach and progress provide for checkpoints during the initiative.

***Mapping.*** The magnitude of the mapping exercise should not be underestimated. In many cases legacy general ledger systems have made it inconvenient to generate the account description information needed to determine the significance of individual accounts. Time is also needed to review the significant account determinations with senior management and operations.

For consumer finance companies this has been one of the more challenging processes. Unlike a manufacturing company, there is often a complex interrelationship between operational processes or business functions and various financial statement line items. As such, the mapping process can be complex and needs to be well thought through with complete management buy-in from the outset. It should also be subject to continued review and updates.

***Prioritization.*** Best practices include upfront agreement on assessment areas and prioritization. Highest risk areas should be started first to manage risks and allow for timely resolution of higher risk areas.

***Leveraging Existing Information.*** Many financial institutions have considerable flow charting, operational narratives and policy and procedure information that can facilitate the review of a control area and fulfil the documentation requirements needed for section 404 compliance. This includes internal audit, compliance department and FDICIA documentation.

Where these are not available, companies have drawn on industry expertise to ensure that baseline control expectations are consistent with industry best practices.

***Partnership with Management.*** The evaluation of the design and testing can be done in conjunction with the business owners but facilitated by controls experts. This combines technical control assessment abilities with operational focus.

***Remediation.*** Agreement on any remediation plans occurs at the steering committee level and considers external auditors' consultation. This helps to assure that appropriate resources are allocated to close any gaps identified. Remediation plan steps typically may include:

- Redesign of process flow
- Enhanced segregation of duties
- Documentation of or changes to policies and procedures

A well planned 404 initiative:

- Assures that employees become knowledgeable of control issues
- Focuses on areas that are considered the highest risk and assists in prioritizing efforts
- Provides feedback to management and the external auditors on the adequacy of scope and testing of areas
- Channels resources to necessary remediation efforts
- Ensures that the assessment team will be dedicated and focused, thus ensuring that there are no surprises and that all key dates are met
- Assures quality
- Includes frequent dialogue with auditors

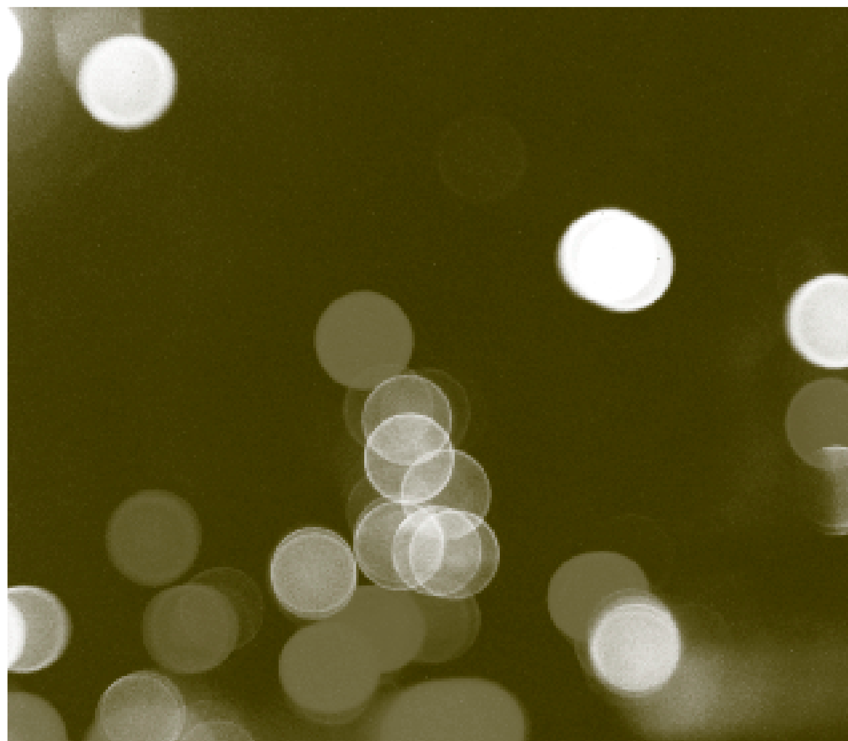
Project teams should also be aware that guidance for auditors on meeting 404 requirements have not yet been finalized by the PCAOB.

*For more information on the Sarbanes-Oxley Act, please contact Tony Muoio at 856-296-1867 or anthony.muoio@us.pwc.com or John DelPonti at 704-344-7583 or john.delponti@us.pwc.com. The PricewaterhouseCoopers global website (www.pwc.com) contains a link to news and information regarding the Sarbanes-Oxley Act, including the text of the law and the supporting SEC regulations; our firm's comments on both; PwC webcasts and white papers; and analysis and commentary.*

# After the Party

STRATEGIC CONSIDERATIONS IN CONSUMER FINANCE

*For some companies, strategic needs are clear – antiquated systems and inefficient processes must be tackled. For others, it is a weak purchase market strategy that was continually neglected during the refinance boom and must now be addressed, and addressed quickly. Regardless of a company's needs, there is one consistent theme – this is no time to slow down, regardless of what the numbers say.*



### *1. Growing the Business*

In addition to the operational and systematic enhancements being considered to improve operational productivity, reduce regulatory exposure and reduce costs, companies have also begun to reassess their origination strategies. In many cases, the short-term goal is to maintain current production volume rather than increase production. These companies are now reassessing the benefits of traditional growth strategies. Some considerations include:

- Organic growth strategies (e.g., establishment of additional retail offices)
- Affiliated Business Arrangements ("ABA's")
- Product profitability analysis to identify and strategically market the company's most profitable products
- Improved emphasis on home equity originations as a source of accessing consumer equity while home equity rates have remained, in many cases, lower than first mortgage financing
- Detailed and individualized analysis of local, regional and national growth to establish a corporate wide strategy that may vary by state, region, etc. – often this analysis is based on the product profitability analysis identified above
- An increase in the breadth of product offerings, including focusing on cross selling and product bundling efforts to expand the share of the borrowers' wallets
- A push for less interest-rate sensitive products such as manufactured housing, ARM products and subprime loans
- Reassessment of e-business strategies that were all but forgotten after the most recent refinance wave
- Reconsideration of acquisition as a means of growth as many small brokerages that have developed successful regional businesses are considering exiting the business. Often these brokers are located in a traditionally underserved area making the acquisition strategy even more appealing

### *2. Operational and Systems Efficiency*

Most companies have been down this path several times before:

***"We've found the perfect system. It meets all of our needs. And our initial estimate is that we will increase productivity by 30%!"***

Due to the complexity associated with implementing a mortgage origination system, this statement often leads to either the implementation of a scaled down version of what was expected or the continued maintenance and use of the existing legacy system. Many of these companies also often miss the benefits of operational and procedural, not technological, enhancements as their focus is on automation and controls and not on existing operational efficiencies that would be enhanced with increased automation. In a time of growing competition, reduced margins and an increased need

for reliable technological controls, the need for sound technology and operational management processes to improve system and operational inefficiencies may become more critical and costly than ever.

In addition, companies that have grown through acquisition over the past several years and have maintained multiple, yet antiquated, systems are facing tough decisions when looking to consolidate to a single system. In many cases, these companies are looking to increase automated controls, but do not want the challenges associated with programming, training and implementing an entirely new system with all the bells and whistles. However, these are the types of controls that internal auditors, external auditors and regulators now require. As a result, many companies are realizing that improved systems and information are essential in preparing for and managing 2003 FDICIA and Sarbanes-Oxley in 2004.

### *3. Regulatory and Accounting Compliance*

There have been dramatic changes in the regulatory environment in the last two years including:

- Model validation
- Interagency Guidance on Mortgage Banking
- Sarbanes-Oxley
- HUD/FTC expectations arising from Fairbanks settlement
- Revised auditor guidance from AT501 and proposed standards from the PCAOB
- Basel II proposals
- Various accounting developments, including FIN46, FAS149, interest rate lock commitment recognition issues and others

Some of these are economy wide, but all are significant given the complexities associated with the industry. As a result, many companies have enterprise wide risk management programs in place or under development that have been impacted in some way by the following strategic considerations:

- Managing existing and new risk management programs (e.g., FDICIA and 404)
- Reviewing the relationships among internal audit, the audit committee, control assessment committees, management, external auditors, disclosure committees, etc.
- Developing an integrated approach to risk management (market, interest, credit, operational, legal, reputational, etc.)
- Understanding the company's risk appetite in the new environment

Although mortgage volume has dropped over the past several months, many mortgage companies remain busy realigning themselves with the new corporate, regulatory and competitive environment.

*If you need assistance in developing your strategy(s) or are interested in improving the metrics you use to track the success of your strategy(s), please contact Peter Pollini at 207-450-9036 or peter.c.pollini@us.pwc.com or Steve Davies at 206-398-3519 or steve.t.davies@us.pwc.com.*

# Model Validation Program

A KEY TOOL FOR SARBANES-OXLEY SECTION 404 INTERNAL CONTROLS ASSESSMENTS

*In the previous issue of this newsletter, we shared some thoughts about managing financial and economic model risk management. Specifically, we discussed the expectations for model validation outlined by the Office of Comptroller of the Currency (OCC). OCC Bulletin 2000-16 discusses regulatory guidance for elements of a sound model validation program and the scope of model validation procedures. The Sarbanes-Oxley Act of 2002 heightens the need for a model validation program. In this article, we discuss how a model validation program can assist management with their assessment of the internal controls and financial reporting procedures.*

Financial institutions rely heavily on financial and economic models for financial reporting applications, such as financial instrument valuation and loan loss forecasting and reserving. The level of sophistication of these models varies greatly. Regardless, model usage exposes an organization to some level of model risk. For example, model errors may cause a valuation model to incorrectly estimate the fair market value of a financial asset. Based on our experience, model errors are typically caused by one or more of the following factors:

- Data quality/integrity issues
- Poor/incorrect model design and development
- Inexperienced model owners/developers
- Little or no internal controls
- Little or no ongoing model validation

To adequately assess internal controls and financial reporting procedures as required by Section 404 of the Sarbanes-Oxley Act, management should be aware of both the models that are instrumental to financial reporting and the internal controls environment for those models. We recommend that management perform three steps to help them assess the adequacy of their internal controls for models used in financial reporting procedures.

### 1. Identify Models Used in Financial Reporting Processes

A useful method for identifying models that are key elements of financial reporting processes is to map financial statement line items back to source data and systems. This mapping, which is becoming a standard exercise within the Sarbanes-Oxley preparedness process, should enable management to recognize models that directly influence financial statement line items and develop an inventory of such models. Most financial institutions that have performed this type of mapping exercise have developed an extensive inventory of models that require an in-depth review of model risks and controls. Given the large inventory of models that will likely require further review, management may want to consider prioritizing model reviews based on the materiality of the financial statement line item a model impacts or management's initial assessment of a model's controls (or lack thereof).

### 2. Develop a Model Validation Policy

Management should establish a formal model validation policy to provide a framework for a model validation program. The model validation policy should articulate key elements of a model validation program such as:

- Policy scope defining what a model is and outlining the types of models to which the model validation policy applies

News Alert

## Elimination of Paper Mortgage Insurance Certificates ("MIC")

In an effort to expand its use of technology and increase efficiencies related to the processing of FHA loans, the Department of Housing and Urban Development recently issued Mortgagee Letter 2003-17 – "Elimination of Paper Mortgage Insurance Certificates and Data Integrity Improvement."

This Mortgagee Letter provides those guidelines by which lenders can leverage electronic Mortgage Insurance Certificates to ensure the ownership and insured status of loans. HUD predicts that this new policy will save the agency and participating lenders time and money. In fact, per HUD news release 03-110, the agency expects the availability of electronic MICs could save the industry $80 million per year. Implementation of the new electronic MICs was effective on or about November 15, 2003. However, HUD notes that implementation of an electronic MIC does not change expectations surrounding loan eligibility or insuring requirements.

As a result, the FHA now requires lenders to download MIC documents from the agency's FHA Connections web site. These electronic documents can be obtained at the loan or batch level using the case query or mass case query functionality within FHA Connections. This functionality allows lenders to obtain a list of cases endorsed within a specific time period.

*If you would like more information related to HUD requirements surrounding electronic Mortgage Insurance Certificates, visit the HUD web site at www.hud.gov. If you would like more information on increasing efficiency within your government insuring or general post closing processes, please contact Peter Pollini at 207-450-9036 or peter.c.pollini@us.pwc.com.*

- Roles and responsibilities for key departments/committees, model developers/owners, and Internal Audit in the model validation process (A key regulatory expectation when defining roles and responsibilities in the model validation process is that model reviewers should be independent of model developers.)
- Model documentation standards outlining the minimum level of model documentation required before a model can be reviewed and used in a production environment
- Model validation standards outlining the model review standards to be used in the model review process and the requirements for documenting the results of the model review
- Model validation requirements outlining the model review and approval requirements to be applied before a new model can be used in a production environment as well as requirements for ensuring that model risks and controls are assessed on an ongoing basis

A model validation policy can help ensure that model reviews are performed at a level of detail and frequency necessary for management to assess the internal control environment for models as part of the certification process for Sarbanes-Oxley Section 404.

### *3. Perform Model Reviews and Assess Model Controls Environment*

Using the standards articulated in a model validation policy as described above, model reviewers should review the models from the inventory of models that impact financial statement line items. Management should ensure that a model reviewer has the appropriate level of modeling subject matter expertise that is commensurate with the complexity of a model being reviewed. The model review procedures and findings should be documented to provide evidence of testing of the internal controls environment for each model. Management should use the findings from the model review process to form an assessment of the internal controls framework for models that impact financial reporting. Management should also establish and track action plans for addressing any model control weaknesses identified in the model review process.

Establishing a model validation program will provide significant assistance to financial institutions when assessing the internal controls environment for models used in the financial reporting process. What is your organization's plan for assessing your internal controls environment for key financial and economic models as required by Sarbanes-Oxley Section 404?

*PricewaterhouseCoopers has a team of experts available to answer your questions about model validation and perform reviews of a wide range of model applications. Please contact Steve Robertson at 314-206-8125 or steve.robertson@us.pwc.com or Ric Pace at 202-414-1690 or ric.pace@us.pwc.com with any questions or comments.*

# Is Subservicing an Option for You?

*Mortgage servicing rights have reached historically low levels over the last year. One of the challenges for originators that are not strategic investors in MSRs is when to sell the servicing rights, especially when MSR prices have begun to rise as mortgage rates rise.*

Many of these companies, however, may not have the infrastructure to effectively support the servicing of loans and often look to a third party subservicer as an alternative to building a servicing platform. In evaluating whether subservicing is a viable option, companies must understand the level of services provided by the subservicer and the costs associated with these service levels.

Subservicers have enhanced their cost systems over the years to receive a proper return for their services in a competitive marketplace. They have evolved from offering services at a bundled rate per loan to separating their charges based upon a company's specific needs. Before making the decision to subservice, consider the following:

- Is the company experiencing a high level of refinance activity? Subservicers generally charge a fee for a loan set up and a loan removal. Companies must consider this cost of churning the portfolio during a period where they may be retaining customers through offering refinances.
- Companies should review their levels of expected late fees and ancillary income. Subservicers generally negotiate the level of fees they retain in the servicing collection process. If a company anticipates a significant ratio of delinquencies, late fees may be important to retain.
- Review the expected level of loans that will be referred to foreclosure. Defaulted loans are expensive to service. In order to recover these operating costs, subservicers will assess a fee for delinquent loans or in some stage of default. Companies should compare the additional costs of processing defaulted loans or indemnifying a new servicer against the charges assessed for such activity by the subservicer.
- How large is the company's adjustable rate mortgage portfolio? Subservicers add a premium to their fees for ARM loans versus fixed rate loans.
- Are mortgage payments accepted at loan or bank branch offices? If so, work out the flow of funds movement before entering into a subservicing agreement. A well thought out plan of how payments will be forwarded to the subservicer for application will significantly reduce potential customer service complaints.
- Can data be transmitted electronically versus manually? Subservicers will generally provide a more favorable pricing arrangement if they can receive their information electronically.
- Review standard management reporting requirements. Ad hoc reports are generally provided by the subservicer at an additional cost.
- Consider whether the company sells loans to investors or holds loans as an investment. Subservicers often charge a fee for investor transfers.
- Determine in advance the content of agreed upon procedures to monitor the activities of the subservicer through audit reviews or other periodic reviews.
- Finally, review the subservicer fees to be assessed to deconvert or terminate the relationship and determine whether the periods presented by the subservicer for compensation are acceptable.

There can be many other factors that enter into the establishment of the fee structure and relationship with a subservicer. Those presented summarize the factors we have seen companies run the risk of overlooking in creating the relationship. Subservicers provide a useful service to the "non servicer." It is crucial both parties understand each other's expectations in entering into a subservicing relationship.

*For more information regarding subservicing or other servicing related questions, please contact John Adams at 617-530-7458 or john.m.adams@us.pwc.com.*

# Fraud

## THE FORGOTTEN EXPOSURE

*Increased technological innovation in the consumer finance industry has led to procedural efficiencies, improved scalability and an increased focus on borrowers and their payment patterns. Technological innovation has also led to advancements in tools used to identify and track loan fraud. In many cases, this is good news as consistently high origination volume and now, with rates rising, an increased pressure to meet revenue expectations, has increased the risk of a company's exposure to fraud. Unfortunately for most companies, technological advancement has also benefited those committing the fraudulent acts.*

There is a perception in the industry that fraud occurrence and severity is increasing, though to what extent is difficult to quantify for many reasons. First, it is difficult to identify and then prove fraudulent activities with such high volumes, as loans with and without fraud will have common characteristics. However, companies seem to have found some consistency in defining fraud despite varying risk management practices. Generally, companies consider fraud to be any intentional act that deceives, misrepresents or increases financial risk. Second, some loans identified as fraudulent continue to perform. As is often the case with fraud for property, (it is common to distinguish fraud by for profit vs. for property fraud), it is difficult to estimate economic losses due to fraud as those losses may or may not be realized. Finally, due to a lack of detailed historical tracking of identified fraud, many companies do not have reliable historical information to effectively perform their quantification analysis. As a result of these issues, in addition to identifying and managing fraud, many companies have begun focusing on developing policies to standardize their methodology for quantifying the financial exposure resulting from fraudulent activities.

Criminals continue to adapt and refine their fraud schemes. Whether it is a property flip, a straw buyer scheme or a case of identity theft, the pace at which fraud is committed is often aided by technological advancements. As a result, companies have started dedicating additional resources to assist in fraud prevention, detection and operational awareness. Unfortunately, attempts to systematically identify fraudulent loans are complicated by the fact that non-fraudulent loans possess characteristics similar to fraudulent and non-performing loans. Although increased resources have been devoted to systematic identification of fraudulent activity, many companies continue to find significant success with increased, focused fraud awareness training for front-end personnel. Some common steps used to identify fraud during the origination process include:

- Re-verification of credit and verbal verification of income and employment conducted on 100% of broker-originated loans
- Continued use of tax returns in validating the authenticity of a borrower (tax returns are not relied on as heavily as in the past due to an increase in reduced doc programs)
- Risk triggers in processing systems to determine when to use the IRS Form 4506
- Increased reliance on technology and third party fraud detection technology to validate application data

- Closing protection letters combined with closing agent validation/approval processes to maintain approved closing agent lists
- The expanded use of AVMs as part of the underwriting process to assist in identifying loans with inflated values
- Social security number checks with companies utilizing SSN tools on all loans, rather than isolating loans with high-risk characteristics. This generally appears to be a manual process performed by the underwriting staff
- Diligence in the setting, clearing and waiving of loan conditions

Although traditional borrower, broker and vendor fraud continue to be the primary targets of fraud awareness and testing programs, recent regulatory requirements have placed additional emphasis on management, internal audit, risk management and fraud units to ensure the accuracy of financial statements and the controls supporting those statements. Many of these new regulations include specific references to the prevention of management fraud in financial statements. For instance, Section 302 of the Sarbanes-Oxley Act requires chief executive officers and chief financial officers to represent that the financial statements of the company fairly represent, in all material respects, the financial position of the company. In addition, the Act requires that fraud (material or not) involving anyone with a significant role in managing or monitoring internal controls be disclosed to the Audit Committee and auditors. Similar to the Sarbanes-Oxley Act, SAS 99 was implemented in October 2002 and requires external auditors to identify risks that may result in a material misstatement due to fraud. The statement also outlines key processes auditors should consider in performing their analysis related to the SAS.

Due to the implications associated with a fraud committed by management, many companies have included language in corporate codes of conduct and employment contracts to enforce the importance of honest and ethical behavior when making management decisions. Many companies have taken this a step further by reviewing management incentive plans and restructuring them to avoid promotion of unethical behavior for personal gain. In addition, many companies now include background checks as part of the new hire process for senior and executive level employees.

Similar to the Sarbanes-Oxley Act and SAS 99, both which consider controls around fraud affecting financial reporting, the Patriot Act, established post September 11, 2001, includes language to prevent money laundering activities – a form of fraud – in an attempt to combat terrorism (see the separate article on the Patriot Act in this newsletter).

As a result of the increased risk resulting from record volumes, technological improvements and regulatory requirements associated with fraud prevention, companies continue to develop strategies, improve metrics and devote resources to the identification and management of fraudulent activities. However, until fraud managers can accurately estimate the potential losses associated with fraud as well as determine the systematic and staffing resources needed to support a robust fraud detection and management program, additional resources will be difficult to justify.

***During November 2003, PwC published "Key Elements of Antifraud Programs and Controls: A White Paper." This white paper provides general or summary information about aspects of the Sarbanes-Oxley Act of 2002 and current and proposed rules, regulations and standards of the U.S. Securities and Exchange Commission, Public Company Accounting Oversight Board and national securities exchanges and associations.***

*For more information on developing a fraud strategy, improving the metrics used to track fraud or assistance in quantifying the projected losses associated with fraud, or to obtain a copy of the White Paper, please contact Peter Pollini at 207-450-9036 or at peter.c.pollini@us.pwc.com.*

Briefs

## The USA Patriot Act: Implementation Update

The Patriot Act expands the scope of the Bank Secrecy Act of 1982 by requiring financial institutions to establish anti-money laundering programs and by providing enhanced civil liability immunity for financial institutions.

For many consumer finance companies, the chief information officer (CIO) has assumed a key role in driving Patriot Act compliance. Key items for the CIO to consider include:

- Amend the privacy policy – The first step in being proactive is amending the privacy policy to state that information will be given to law enforcement when required by law. The best protection against litigation is to have a company wide policy that states what happens if and when law enforcement asks for data. This should be set at the executive level and distributed to each and every employee. Getting everyone on the same page is of the utmost importance. The policy should be stated very clearly and precisely to avoid any confusion. A good policy designates one person to handle law enforcement requests.
- Be aware of your options – Ensure that requests for sensitive data are appropriately evaluated.
- Save time by keeping data accessible – Requests usually deal with data that is approximately 12 months old. Keep this data accessible on servers where it can be quickly retrieved. Instead of funneling older data to storage devices that may take the IT staff hours to get to, keep data that is about a year old in repositories that are somewhat optimized for data retrieval.
- Develop systems that are able to cross check names on government watch lists – Can you imagine manually checking millions of rows of data to see if names or institutions appear on any of a number of government watch lists? Several software solutions now on the market allow cross-checking data against government-supplied watch lists to be very easy and scalable. Keep in mind that one of the compliance criteria for Section 326 is to determine whether the person appears on any list of suspected or known terrorists or terrorist organizations.

*For more information regarding the Patriot Act, please contact Beji Varghese at 678-522-6658 or at beji.m.varghese@us.pwc.com.*

## 404 Considerations for the Tax Practitioner

While the conventional approach may be to treat tax as a completely separate area to be assessed under Section 404 of the Sarbanes-Oxley Act, an alternative approach would integrate key elements of tax risk and controls with the relevant area or activity being evaluated by the financial accountants. Key integrated areas that would merit an integrated approach would be mortgage servicing rights, securitization processes and hedging risk management activities.

For example, a mortgage banker who is evaluating risk and controls over its hedging activities and accounting policies may want to consider integrating the tax treatment of this area. Key controls areas would include an assessment of items such as whether the asset being hedged qualifies for hedge treatment for tax purposes and whether the transaction has been properly identified as such. As a reminder, the tax rules require this identification to be made separately for tax purposes and reliance on the financial statement identification would not be sufficient. Failure to properly identify hedges for tax purposes could result in income character mismatches, ordinary gain and capital loss. The result could be capital losses that are deductible only against capital gain income and the risk of an improperly accounted for deferred tax asset. In addition, failure to identify a transaction as a hedge for tax purposes could also result in a timing mismatch requiring the recognition of gain or loss on the hedge without the recognition of the offsetting asset position.

This integrated approach to Section 404 provides the registrant with a more complete picture of its control environment in key areas and allows for earlier recognition of complex and potentially troublesome tax areas.

*For more information on managing tax areas under Sarbanes-Oxley 404, please contact Susan Mooradian at 202-414-1584, Tom Lodge at 617-530-7335, Jim Damato at 213-830-8244 or Gale Blackburn at 704-344-7572.*

# Sarbanes-Oxley, the CIO and the IT Organization

*A key component of the Sarbanes-Oxley legislation is management's responsibility to establish adequate controls, policies, procedures and documentation to ensure the validity and completeness of the financial reports. Companies are recognizing that this extends beyond departmental operating controls to the policies and procedures of the underlying technology used to calculate and store data. Many consumer finance companies are turning to the chief information officer (CIO) to facilitate the understanding and implementation of the controls, policies, and procedures that will ensure underlying systems store and produce accurate and complete financial data.*

## *What Can the CIO Do?*

The SEC identifies the COSO framework by name as a methodology for achieving compliance. The COSO framework defines five areas, which when implemented, can help support the requirements as set forth in the Sarbanes-Oxley legislation. These five areas and their impacts for the CIO are as follows:

- ***Risk Assessment.*** Before a CIO can implement the necessary controls, he or she must first assess and understand the areas of risk affecting the completeness and validity of the financial reports. The CIO must examine how the company's systems are being used and the current level and accuracy of existing documentation. Once the areas of risk are identified, they will drive the definition of the other four areas of the COSO framework.
- ***Control Environment.*** An environment in which the employees take ownership for the success of their projects will encourage them to escalate issues and concerns, and feel that their time and efforts contribute to the success of the organization. This is the foundation on which the IT organization will thrive. Employees should cross train with design, implementation, quality assurance and deployment teams to better understand the entire technology lifecycle.

- ***Control Activities.*** Design, implementation and quality assurance testing teams should be independent. By separating these three components of the enterprise, the CIO will be more likely to recognize design flaws, and to identify fraudulent or malicious activities before they affect financial reports. ERP and CRM systems that collect data, but feed into manual spreadsheets are prone to human error. The organization will need to document usage rules and create an audit trail for each system that contributes financial information. Further, written policies should define the security protocols, technical specifications, business requirements and other documentation expected for each project.
- ***Monitoring.*** Auditing processes and schedules should be developed to address the high risk areas within the IT organization. IT personnel should perform frequent internal audits. In addition, personnel from outside the IT organization should perform audits on a schedule that is appropriate to the level of risk in a specific area. Management should clearly understand and be held responsible for the outcome of these audits.
- ***Information and Communication.*** Without timely, accurate information, it will be difficult for the CIO to proactively identify and address areas of risk. He or she will be unable to react to issues as they occur. The CIO must demonstrate to the CFO an understanding of what needs to be done to comply with Sarbanes-Oxley and how to get there.

## Conclusion

The IT architecture and the systems that support the business processes are the backbone of an organization. The corporate CIO has an uphill battle and the deadlines are approaching fast, but with careful assessment and planning, it is not too late yet to put in place the required controls. At that time, the CIO will be able to effectively support ongoing 404 compliance processes.

*For more information regarding the effects of Sarbanes-Oxley on the CIO, please contact Beji Varghese at 678-522-6658 or at beji.m.varghese@us.pwc.com.*

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