Consumer Finance Update*

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In this issue

Strategic and operational best practices

The battleground for consumer banking

Globally, returns on retail (or consumer) banking have been a key driver for many financial services companies over the last two years, eclipsing corporate and investment banking returns. In the developed economies, much of this growth has come from a mortgage market boom caused by lower interest rates fuelling record consumer and personal refinancing. The US consumer landscape faces similar pressures to those faced by European and Asian bankers: worries of the housing bubble bursting, increased regulatory and operational risk, and also increased exposure to credit risks. In Asia, many local and regional institutions have been focusing aggressively on expanding their consumer banking businesses, particularly in the areas of credit cards and unsecured personal loans. However, in some countries, there are concerns over the ability of these young portfolios to weather a sudden economic downturn, given that the credit skills and scoring models of some institutions may be less developed.

Despite several waves of consolidation over the last ten years, the consumer financial services market remains fragmented. Very few banks have been truly successful in the strategy of building global international brands, and in each of the markets in which these banks operate, they face different competition. On the one hand, each geographic area will have a number of banks that may have a regional or community focus—these institutions play to their strengths of locally managed businesses that reflect the culture of the region in which they work. On the other hand, in individual countries, each product the bank offers may also be competing against monoline companies that are focused primarily on that product.

The ability for many institutions to expand into various Asian markets is restricted by licensing rules in each jurisdiction that protect local institutions.

But traditional market forces of competition and consolidation are not the only ones currently affecting consumer banks. The current economic and regulatory environments mean that there are a number of additional factors concerning market position, cross–border regulation, reputation and profitability that lenders need to tackle head on.

Profitability—new forces, old forces

Size and scale provide many opportunities for organic growth. For years, many of the larger financial institutions have been trying to build systems and tools to understand and track the actual economic performance of their assets, down to a customer level, to make better pricing and asset allocation and management decisions. Very few institutions have succeeded in doing so.

PricewaterhouseCoopers has consistently held the view that accurate measurement and accountability are key to understanding and managing business profitability. Put simply, detailed tracking and assessment of actual asset performance will drive the efficient allocation of these assets and consequently, profitable business decisions as described in the diagram.

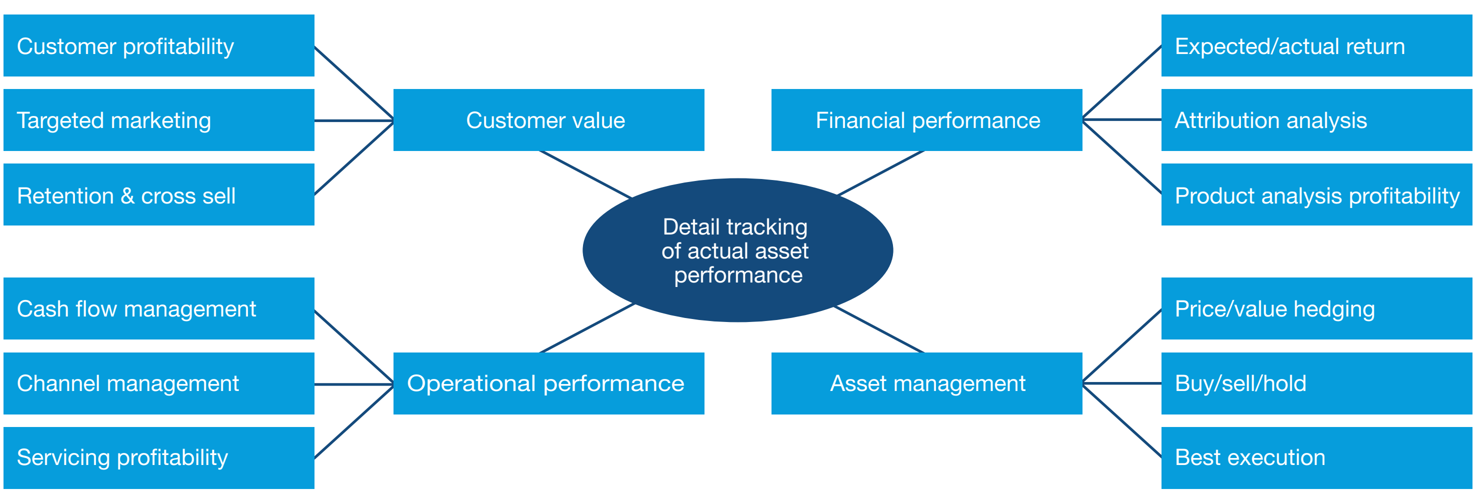
We believe this approach, which focuses on the underlying economics at a detail level, should be applied across the business:

- Channel profitability
  Measuring the underlying short and long–term return on channel investment strategies.
- Pricing
  Moving toward a pricing model that takes the better of market or economic price.
- Product configuration
  Understanding where multiple product relationships deliver incremental value and using this information to better price different configurations of product offerings.
- Value protection and margin tracking
  There is a trend to track the actual performance of expected margins to better understand the internal and external factors that drive differences.
- Capital allocation and measurement
  Appropriate measurement of risk–based capital ensures that the bank's capacity for risk is not wasted on low value business. In addition, allocating capital on a risk–adjusted basis down through the business means a better method to both measure the full economic costs of writing business and set prices accordingly.

While certain industries do track actual performance to make more informed pricing decisions (for example, airline ticketing), the consumer financial services industry is only beginning to develop and use such tools. It is clear, however, that there is a long–term trend toward economic–based pricing. But, access to the right data in the right format has always been an obstacle for many lending institutions, with the further challenge being the inability to analyze and interpret data that forms the basis of such decisions.

Once this hurdle is overcome, this approach will also provide management with the information necessary to implement, monitor and measure a balanced product portfolio that provides the desired results across the business cycle according to the institution's strategy. Investors and other stakeholders can become concerned when there is a concentration of business profits from one stream, for example, mortgage originations, which is cyclical. Successful consumer financial services companies are those that have demonstrated a track record of earnings performance across interest rate and economic cycles.

In the U.S., product specialists or smaller, more nimble niche players are already creatively analyzing data, markets and past performance to target high return segments, often overcompensating for their lack of scale efficiencies enjoyed by the largest companies. In Asia, consumer banking has traditionally focused more on generating volume, rather than customer profitability. Many are now focusing more on increasing profits through differentiating their service to customers by developing sales cultures, reconfiguring branch networks, implementing risk–based pricing and improving business processes. Many international players in Asia do not have the scale to grow organically in consumer banking and their challenge is how to identify and implement innovative ways to achieve profitable growth. This may include establishing alliances and alternative channels with local partners, developing new products, as well as consolidating back office support.



Offshoring and outsourcing

The global credit boom has been keeping financial institutions active but there is a risk that credit demand will begin to decline, intensifying the competition among the larger lenders that has been driving down margins. So far, the industry has proved remarkably successful in cutting costs through developments such as centralized loan processing. Greater use of outsourcing could offer further savings and potentially provide access to best–in–class capabilities, though there are limits to such strategies. Institutions clearly need to weigh any benefits against the potential impact on their customer relationships and reputation, especially at a time when outsourcing is attracting ever–increasing attention from regulators. Negotiating effective service level agreements and overseeing such contracts also requires particular skills and often underestimated management time.

There also needs to be a clear distinction between outsourcing processes to third parties and offshoring, i.e., moving processes offshore but continuing to manage them in house. Indeed, continuing concerns about control and management from a distance mean there is still further opportunity for offshoring amongst lenders. There has been more outsourcing to offshore suppliers but here as well concerns over service quality and security of customer data have restricted growth and some of the recent growth forecasts may prove wide of the mark.

Innovation and finding new markets

As well as cutting costs, financial institutions have increasingly been focusing on differentiating their offerings to attract customers from other institutions. In the late 90s, the concept of the mortgage–current account or offset account was introduced from Australia to Europe, and later, other parts of Asia, and took the market by storm, offering customers the chance to pay off their mortgages early or to save interest. Lately, teaser credit card rates (for example, zero percent balance transfers) have been used to attract customers to new credit card offerings, although recent evidence indicates that the level of churn in many of the developed credit card markets is reaching levels where such activity is no longer sustainable.[1]

While banks have for a number of years set up branches in overseas countries to cater to their home communities, it is telling that the larger institutions are increasingly focusing on these communities for lending services, offering superior service standards as well as access to vast global networks. HSBC, for example, has developed a Shari'a banking proposition and recently, Lloyds TSB has announced a link up with ICICI bank, one of India's largest banks, to offer banking services to the more than one million people of Indian descent living in the UK.

Regulation

The increasing burden of regulation is also having a direct impact on the profitability of consumer banking. The regulatory tide, the growing focus from nearly all regulators on the treatment of customers, and the increased burden of compliance are causing transaction costs to rise. Many now question how much protection this really provides the customer and whether the impact is actually reducing customer choice by stifling innovation. Over regulation was named as the biggest risk facing the banking industry in the recent CSFI/PwC '*Banana Skins 2005*' survey of the industry's fears on risk.

New York State Attorney General Eliot Spitzer announced an investigation of potential discriminatory practices in setting mortgage rates and fees in the U.S. Regulators in the UK are similarly looking at whether banks follow responsible lending practices. It is clear that regulatory interest is not just a passing trend and the industry must not be complacent.

For consumer banks, the real challenge is to demonstrate responsible lending in a way that is both efficient and adds to the customer experience. In the UK, the recent introduction of mortgage and general insurance regulation has led to an increasingly onerous process that has, in some cases, extended the length of a mortgage interview by a factor of four, with a corresponding detrimental effect on customer service levels. With increasing regulatory convergence across markets, the burden of compliance is likely to spread initially across Europe, then globally. Lenders will need to look at streamlining their practices to achieve the regulatory requirements as well as a competitive advantage from a consumer's perspective.

Looking over one's shoulder

Managing costs, sustaining core margins, and managing regulatory risk scan collectively be a full–time effort. However, an additional cause for concern for many consumer banking executives is the potential threat from new entrants. In many core product markets, for example mortgage, personal lending, credit cards, and retail checking or current accounts, the business models in place today are largely those that have evolved over the last twenty years. There have been a number of new entrants in each of the developed markets and many of these have tried to take on the large established institutions, some achieving relative success and some failing outright.

In Europe, the partnership approach has tended to work best for the new entrants. For example, in the UK, Tesco and the Automobile Association have both been particularly successful in selling consumer lending products through their distribution

[1] Please visit www.pwc.com/uk/preciousplastic for further information

networks and to their vast existing customer bases, by partnering with established lenders and utilizing their underwriting and back office processing experience. In the U.S., regulatory barriers have prevented significant penetration by retailers into consumer financial services, although the long–term trend is evident with significant co–branding of services and credit card partnerships: the “Wal MartMoney Center by SunTrust” concept being just one example.

In Asia, as per capita income and wealth increases, as many markets deregulate, and as restrictions on foreign players entering markets and entering into alliances with local players are lifted, competitive pressures are growing for financial institutions to increase (or even just maintain) margins and manage costs. Local banks are trying to move upmarket to take on foreign competitors who tend to focus more on the mass affluent as well as private banking sectors and leave the expensive business of providing a network of branches across the whole country to the local banks.

Understanding and managing the risks

The quality of risk management is also crucial. Those companies that have successfully navigated the interest cycle of the last five years (and can show it), that have proven credit and market risk expertise, and that can embrace compliance requirements from Sarbanes–Oxley through Basel II and even IFRS, are well placed for the future. While financial institutions have made considerable strides in recent years, CRM and other techniques have led to them being swamped in a deluge of often unfathomable data. Better filtering of data is essential. Many institutions are also struggling to deal with increasing levels of operational risk. In particular, financial crime, such as identity theft and “phishing,” is an ever more serious problem, with criminals proving more organized and sophisticated in their use of technology. In the face of pin number protection for credit cards in an increasing number of countries, more and more fraudsters are now looking to hack into internet accounts. Institutions may therefore need to look at the potential benefits of e–signatures and other security methods (such as using SMS messages). Without such precautions, the risk of undermining public confidence, if identity theft and other cyber crime becomes widespread, will impact the use of such services.

But what about the customer?

We have recently seen the re–emergence of the traditional bank branch as a “store” providing a customer experience–lenders are realizing that, with the increasing financial literacy and transparency afforded to customers by the internet, the overall customer experience is vital in order to attract and retain customers. The use of CRM techniques is increasingly being employed to achieve the industry’s holy grail of cross–selling.

Consequently, lenders are opting for executives with a proven retail background. In the U.S., lenders have for a number of years sought out experienced retailers and brand managers to help position themselves in a market where growth can sometimes be slow but the competition fierce. In the UK, this trend is catching on, with more and more consumer lenders seeking out experience from the retail market; not just experienced senior management but also recruiting branch staff from retailers such as leading supermarket chains. Retail style marketing campaigns have also been appearing with “January Sales” in the UK earlier this year.

However, can a bank’s products really be viewed as groceries waiting for customers to take them off its shelves? The products a bank sells can be highly complex and the cost to a customer and the impact on an institution’s reputation can be significant if it all goes wrong. UK institutions have not yet forgotten endowment mis–selling and the hundreds of millions of pounds they have so far paid out in compensation.

The next few years will be a critical test for the sector as the boom fuelled by mortgage refinances comes to an end. Increased consolidation, customer expectations, regulatory scrutiny and margin compression all add up to a challenging few years ahead.

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Can a consumer finance business afford not to outsource offshore?

Outsourcing is not a new concept. Lenders who have used brokers and correspondents have outsourced a portion of their sales function for years. Consumer finance companies that have utilized subservicers have effectively outsourced their servicing function. Many major banks have consolidated call center and collection functions, a form of outsourcing. Lastly, major mortgage servicers have typically outsourced the tracking and payment of property taxes and hazard insurance services to reduce their servicing cost per loan.

So what is behind the outsourcing buzz lately? It is the shift towards international outsourcing and the increased challenge of managing operational risks abroad while managing delicate reputation risks at home. The benefits can be significant and can include increased capacity, lower costs and, if executed properly, seamless customer service delivery.

The following describes how some leading companies have assessed the prospects of offshore outsourcing and the risks and rewards of using this emerging business tactic as part of the company's overall cost and service strategy.

What functions are outsourced?

Companies have different philosophies of what to outsource. Some are careful to outsource back–office functions that do not directly impact the customer experience. Some companies readily outsource customer–facing functions.

Outsourcing is not restricted to certain consumer loan asset classes. Credit card companies, unsecured lenders and mortgage companies all have outsourced business functions. In the consumer finance business, non customer facing functions that are typically outsourced include:

- IT programming and development
- Financial accounting and reconciliations
- Investor accounting and reconciliations
- Preparation of management reports
- Project management assistance
- Underwriting
- Re–underwriting (for underwriting declinations, second look programs, etc.)
- Loan audit and review functions (e.g., post closing audit and review functions)

The types of outsourced functions that interact with the customer include:

- Lead generation efforts
- Taking loan applications
- Loan fulfillment functions (loan processing)
- File imaging
- Call center customer service functions
- First and second level collection efforts

Factors that have led to offshore outsourcing

In his book, *The World is Flat*, New York Times reporter Thomas Freedman indicates that technological, political and economic factors are leading to the success of offshore outsourcing. He cites a "triple convergence." The first two are where technological enhancements such as the internet, collaborative software and fiber optic cable lines, wired throughout the world, lead businesses to adopt new habits, processes and workflows to get the most out of the new technology. The third convergence is where a whole new group of people in places like China and India are now quickly able to collaborate and compete with traditional firms.

The confluence of these factors has made it possible for consumer finance companies to outsource offshore in order to reduce their cost per loan and increase profitability levels.

Reaction to outsourced offshore functions

Companies that outsource to offshore locations must consider the reaction to outsourced offshore functions:

Customer reaction

In our practice, we have noted the following tactics companies have used to reduce adverse customer reaction:

- Some companies leave the offshoring choice to the customer. For instance, during the loan application process lenders can offers customers an onshore and offshore loan processing choice (with fee implications).
- Some companies invest heavily in language, diction, cultural and technical training. This increases customer comfort and increases the possibility that the customer's request is handled effectively and efficiently during the first call.
- Some companies locate their outsourced functions "near–shore," in places like Canada and Mexico. The language and cultural differences are considerably less, which leads to customer comfort.

Political reaction

Today companies typically manage reputation risk as part of an enterprise–wide risk assessment and management process. A form of reputation risk is the reaction that real or perceived local job loss may have on the company's standing in their community and their reputation with state and local governmental authorities, as well as the local and national press. Leading companies typically consider these factors and responses as part of an integrated project and implementation plan.

Operational and regulatory considerations

Federal and state banking authorities have been paying increasing attention to the trend and scope of outsourcing activities by financial institutions. Through the publication of supervisory guidance and onsite examinations, regulators are focused on ensuring management's processes for determining what activities can be appropriately supported by outside vendors. This includes those in foreign jurisdictions, as well as the process of vendor selection, ongoing oversight and contingency planning to ensure they are fundamentally safe and sound.

The federal banking regulators through the Federal Financial Interagency Examination Council ("FFIEC") have issued interagency guidance for banking institutions that are considering outsourcing—including foreign–based service providers. For example, the Comptroller of the Currency ("OCC") in OCC Bulletin 2002–16[2] states that:

> The board of directors and senior management are responsible for understanding the risks associated with the bank's outsourcing relationships with foreign–based service providers and ensuring that effective risk management practices are in place. In addition, management should assess how the relationship with a foreign–based service provider supports the bank's strategic goals and how the bank will manage the relationship on an ongoing basis. Specifically, before a national bank contracts for the services of a foreign–based service provider, it should properly assess the associated risks and exercise appropriate due diligence, including careful consideration of contract matters and choice of law and forum provisions. Additionally, the bank should have in place sufficient risk management policies, performance monitoring and oversight processes, expertise, and access to critical information to enable it to properly oversee the risks of the outsourcing relationship, including country and compliance risks.

The banking agencies have also trained their examiners to evaluate a bank's practices in relation to published guidance, and will consider administrative enforcement actions in instances where the strategic, risk management and/or compliance risks are not well managed. Some areas of frequent review include customer privacy, the potential for business disruption caused by political instability and the operational and financial controls surrounding the offshoring process, including maintenance and access to official books and records. Although such guidance is not imposed on non–regulated consumer finance companies, the bank regulatory guidance offers helpful insights into implementation risks and operational issues that must be managed on an ongoing basis and provides a helpful reference for good management practices.

The OCC and related guidance focuses on the fact that while financial institutions can contract with firms to outsource various aspects of their operations, the institutions cannot outsource the responsibility for the activities, or the risk of non–compliance with applicable laws and regulations. Furthermore, banks that are considering offshore outsourcing are wise to confer with their regulatory contacts during the planning phase. This will evidence management's strategic consideration of potential supervisory concerns, which management will have the ability to address through modifications to their implementation project plan.

FFIEC's "Outsourcing Technology Services Booklet" addresses the need for a comprehensive outsourcing risk management process, including such aspects as: risk assessment, selection criteria, contract review and monitoring of technology service providers:

> Consistent with the expectation that such providers are subject to the same risk management, security, privacy, and other policies that would be expected if the financial institution were conducting the activities in–house, the banking agencies can, and generally do, extend their safety and soundness examinations to include technology service provider relationships.

[2] This bulletin is one of several that relate to offshoring. Others include: OCC Bulletin 2001–47, "Third–Party Relationships: Risk Management Principles" (November 2001); OCC Advisory Letter 2000–12, "FFIEC Guidance on Risk Management of Outsourced Technology Services" (November 2000); and OCC Bulletin 2001–8, "Guidelines Establishing Standards for Safeguarding Customer Information" (February 2001).

The importance of planning and project management

Once the risks have been assessed and the board and senior management are convinced that the cost savings are real, leading companies have stringent project management plans in place to reduce implementation risk and achieve a successful outsourcing program. Some key elements of project planning to consider are listed in the table below.

Summary

In the consumer finance business, competitive pressures and changes in the political, economic and technological landscape make outsourcing to offshore locations a viable business strategy. Many leading companies have either implemented offshoring in some capacity or have used the knowledge learned during the assessment of the feasibility of outsourcing to drive efficiencies in their existing onshore processes.

For more information on outsourcing, please contact Anthony Muoio at 856–296–1867 or at anthony.muoio@us.pwc.com.

Planning item	Planning benefit
Development and refinement of imaging and /or electronic loan files	This is the starting point of being able to send lending processes offshore and also give the ability to parallel process loans to expedite cycle time
Establishing a baseline to determine existing cost levels	Allows for determination of the measurable benefit from the outsourcing process
Assessing that existing onshore process are efficient and effective before the migration process begins	Assures that inefficient processes are not exported
Addressing customer privacy and protection of customer data	Protects customer privacy and manages regulatory and reputation risk
Contingency planning for natural disasters and/or political uncertainty	Documented, tested back–up plans ensure consistency of customer service delivery and are a regulatory requirement for banks
In–depth due diligence in selecting an offshore service provider	Helps to realize cost savings and customer service benefits
Development of formalized project planning with measurable milestones	Organizes the complexity of the offshoring efforts
Staged implementation efforts/Pilot programs	Organizes the complexity of the offshoring efforts
Running parallel during the implementation period	Assesses the effectiveness and accuracy of the outsourced effort
Development of monitoring mechanisms and managing vender service levels	Provides oversight to outsourced functions

Developing your consumer finance strategy: necessity or nuisance?

Competition remains intense for available residential loan production. In part, this is a result of the ongoing contraction in production volumes. However, it is also the result of specialized product offerings, increased demand for access to home equity customers and the entrance of new participants into the marketplace. Regardless of the source, consumer needs continue to change and the market must anticipate or react to these changing needs in order to sustain or increase profitability levels.

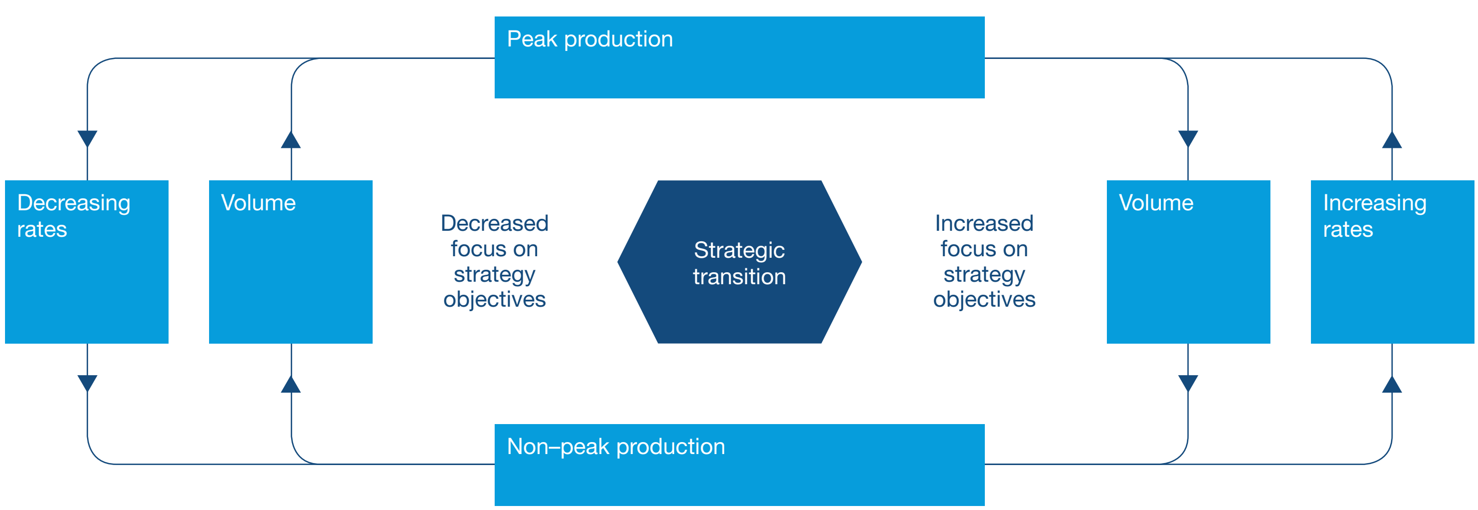
The challenge of maintaining market share in the current highly competitive market—while meeting financial expectations—is not uncommon to the residential lending industry. The current environment is not new and is indicative of the historical point in the cycle we are now experiencing.

The diagram below illustrates how increases and decreases in interest rates have an inverse relationship to production levels. The diagram further illustrates the strategic need to continually assess the current market while transitioning between defending market share and meeting the needs of a growing production franchise.

To gain an advantage in a challenging marketplace, companies often re–assess their strategic objectives and the plans designed to support and achieve those objectives. In performing these types of strategic assessments, companies attempt to answer some or all of the following questions:

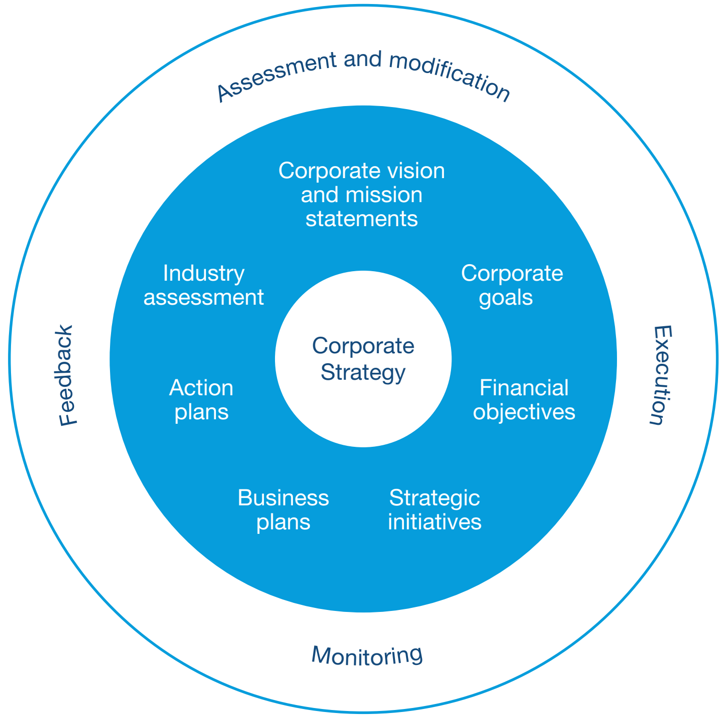
- Is our value proposition limited to the mortgage banking value chain or should we become a diversified financial services provider?
- How can we gain an edge over our competitors?
- What are our future market opportunities and how can we best take advantage of them?
- What are our strategic priorities?
- How do we measure the success of our strategy?

While each company will develop their own response to these and other important strategic questions, the approach utilized to set strategic objectives and measure success in achieving desired results is often consistent among innovators and leaders in the marketplace. The remainder of this article outlines the core activities that should be considered when developing and maintaining an effective strategic plan.



Creating the corporate strategy

There is no “right” way to facilitate a strategic planning process as corporate culture, strategic planning history and individual expectations surrounding strategic deliverables often influence the process. However, there are certain elements that should be considered when assessing or modifying a corporate strategy. The diagram below identifies common criteria considered when creating a detailed strategic plan and subsequent implementation process:



Vision and mission statements

Establishment of corporate vision and mission statements is an integral part of creating and communicating a company’s corporate culture and setting general expectations of growth. As brief statements identifying the long–term objectives of the company (vision statement) and the company’s purpose (mission statement), together the vision and mission statements are important in setting the tone for the company’s future strategy.

Industry assessment

An industry assessment provides strategic planners with an evaluation of current industry trends, market growth expectations as well as other items that should be considered when assessing the strategic opportunities and financial expectations of the organization. This assessment often draws from the company’s recent marketplace experience as well as industry research of peer practices and trends. The industry assessment is also utilized to help determine current and expected changes in the marketplace that will affect future financial performance and certain operational needs of the company.

Corporate objectives

Leveraging market information generated in the industry assessment, corporate objectives are often established to guide the business in the coming years. Using entity level expectations of corporate performance (e.g., market share and volume expectations), corporate objectives summarize the primary requirements necessary to meet financial, operational and other strategic milestones.

Strategic initiatives

To plan for and attain the goals of the company (i.e., corporate goals) strategic initiatives are often developed throughout the company or by various business units to provide targeted support in meeting corporate objectives (e.g., cost reduction initiatives). Together, these initiatives help form the road map as the company begins to implement its strategy.

Business and action plans

While planning and identification of corporate goals and strategic initiatives is often performed at the executive level, implementation is completed further down within the organization. As a result, and as an imperative step in executing the strategic plan, identification of short (initiatives currently being implemented), medium (planning of upcoming implementation initiatives) and long–term (planning of future initiatives) steps to meet strategic objectives is necessary to maintain focus on the success of the strategy while minimizing strategic complacency. To facilitate this process, business plans are often created to identify individual objectives for each line of business, milestones necessary to achieve those objectives and the individual measurements necessary to support monitoring the corporate strategy. These business plans are often further supported by individual action plans that outline key tasks and success indicators guiding implementation efforts.

However, measuring the success of these corporate objectives and strategic initiatives often proves challenging.

How do I know if my strategy is successful?

While there is no single answer to this question, establishing benchmark success milestones and key performance measurements is imperative to assessing strategic performance. As such, in determining what measurements will most effectively communicate the results of a corporate strategy, consideration should be given to traditional measurements (e.g., net income, return on equity, net interest margin, etc.) as well as those measurements that distinguish oneself from one's peers (e.g., efficiency ratios, portfolio prepayment speeds, dividends paid, cross sell success, branch infrastructure, channel results, customer satisfaction, employee retention, etc.).

The financial and operational measurements that have been designed to gauge the success of a strategy should be established and integrated into the business. These measurements should also be used to communicate the company's performance to management, investors and other interested third parties. However, while measuring performance is important, it is equally important to ensure measurements are easy to understand, consistently communicated, fit the corporate culture are aligned with compensation programs and establish accountability for success…and failure within the organization.

While other activities, including risk assessments and S.W.O.T. analyses may add value, understanding a company's challenges in meeting its corporate objectives within the framework described above is also important in establishing and executing the strategy. However, assessing the success of that plan will only be as effective as the tools implemented to monitor the company's results against the identified strategic objectives. As such, establishing accountability for financial and operational results, while developing procedures to monitor the company's accomplishments, is a critical function of maintaining focus on strategic objectives.

In short, companies must develop a strategic planning and monitoring infrastructure designed to identify market trends, reconcile those trends to the corporate strategy and determine if adjustments are necessary to the strategy to meet expected performance measurements.

Examples of current strategic trends

As companies continue to re–assess their approach to maintaining market share and meeting other strategic objectives (whether formally or informally), several trends appear to be emerging within the industry:

- Increased emphasis on leveraging existing franchise value in an effort to grow the business in a contracting market (e.g., leverage of retail branch banking infrastructure)
- Increased focus on extracting additional value from the mortgage loan value chain through the integration of cross sell strategies for title services, hazard insurance, operational outsourcing, product expansion and other personal banking products
- International and domestic financial service companies increasing their focus on the U.S. residential real estate lending market
- Pricing strategies based on the better of economic and investor proxies of value
- Integration of mortgage and home equity platforms to supplement reductions in first lien production and access outstanding residential property equity
- Advanced focus on product development and innovation
- Cost management strategies designed to reduce costs as an offset to revenue declines resulting from contractions in industry production
- Development of communication plans to communicate strategic success to internal and external constituents

An effective strategic planning process is a requirement for success in the consumer finance industry. Establishing or further developing a strategic planning process will lead to a better understanding of how a company creates, manages and increases its value.

For more information on strategic trends and the implementation of a strategic planning infrastructure, please contact Peter Pollini at 207–450–9036 or at peter.c.pollini@us.pwc.com.

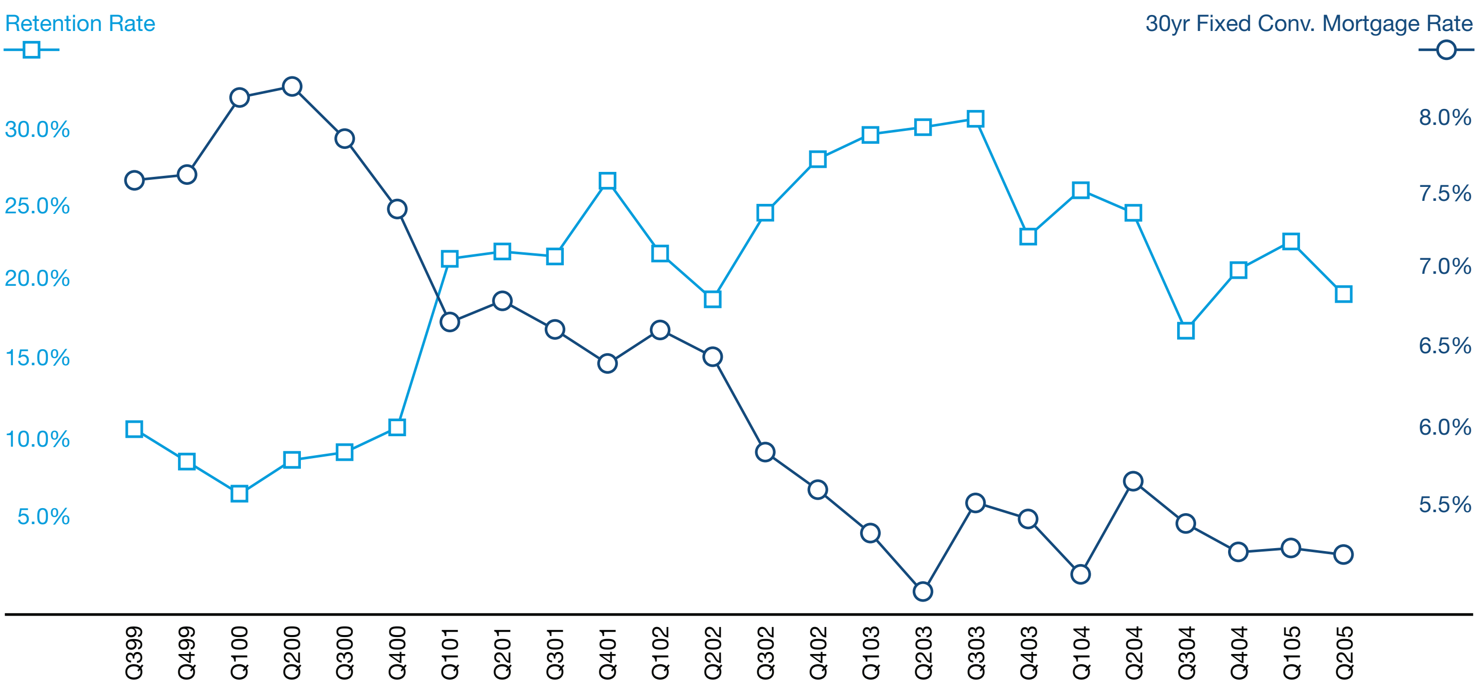
Taking advantage of retention initiatives

With interest rates rising and production volumes decreasing, there is a renewed focus on mortgage servicing and customer retention as significant drivers of profitability. When interest rates were declining, refinance activity and origination volumes reached unprecedented levels. As a result, there was less incentive for lenders to focus on improving their customer retention strategies as profitability was being driven by the production channels. However, with the refinancing boom winding down, lenders are looking for ways to capitalize on the rate increases that can help to offset foregon loan origination income and increase the value and profitability of their servicing assets.

PricewaterhouseCoopers has been trending the customer retention statistics of several top 20 servicers over the past five years. Based on the information captured, overall retention performance has been driven primarily by the refinance market (see chart below).

During the past several years, we observed that high portfolio run–off and low recapture (retention) rates contributed to impairment losses during the past record–breaking refinance wave. Structural changes have also continued to erode customer retention because margins on new loans have been under increasing pressure through the last rate cycle and the price sensitivity of customers continues to increase. In addition, service–related issues continue to remain important. An MBA Mortgage Channel Demographics Survey noted that an average of 35% of mortgage customers across the industry were satisfied with their mortgage experience and 60% of first–time mortgage borrowers were “very satisfied” with their lenders, but less than one third would “definitely” use that provider again. The primary reason influencing customers’ satisfaction is driven by the relationships the companies develop (or fail to develop) with their customers, and numerous lenders rarely interact with borrowers after the loan closes.

Average overall retention rate
Q3 1999 to Q1 2005



Note: Average rate shown here has NOT been restated for changes in peer group across quarters
Definition of overall retention rate: The number of loans retained in the period as a percentage of the total number of loans that ran off in the period.

Source: PwC Quarterly Customer Retention Survey

Consistently, the channel with the highest retention is the retail channel where borrowers are able to develop these relationships with their lenders, typically through a loan officer. Companies continue to make strides in meeting their customers' needs by providing more training to these loan officers, increasing the use of streamlined refinance products and more opportunities for interaction with a larger number of branches. Loan officer retention is also very important.

There has been a steady upward rise in purchase money lending in all rate environments. During periods of high refinance activity, attention tends to be diverted to refinance retention tactics at the expense of efforts to retain purchase money customers. Purchase retention is important because these loans have higher value and are an opportunity for continued retention value in the future. Therefore, if lenders could retain more purchase money customers while capturing the refinance activity, their servicing portfolios would also retain more value. However, purchase money retention rates have remained in the single digits. A strong purchase money retention strategy is a key component in improving overall retention performance.

Valuing retention

Economically, there is a fundamental difference between retention and replenishment that lies in the difference in origination cost and profit margins:

- Retention = maintaining existing customers via lower cost origination strategy
- Replenishment = maintaining or growing the servicing portfolio through higher originations than run off

Each channel has different economics. Retaining customers through traditional channels/methods often minimizes the benefit while retaining customers through the lowest cost, highest margin channel is clearly the objective, i.e., retail channels typically have higher costs and lower margins, whereas the direct channels have lower costs and higher margins. Being able to evaluate the relative economic benefits of retention is critical to implementing retention strategies that add value to the organization. However, few market participants are able to measure the full economic value of a retained loan.

A framework for pursuing retention initiatives

With the change in the mortgage rate environment and the end of large scale refinance activity, there is an opportunity for companies to revisit retention strategies and evaluate their performance. Key indicators of success are related to a company's ability to react to the current market conditions, availability and interpretability of retention data, and a company's ability to successfully use models to target "at risk" customers.

Retention performance reflects the level of resources in the organization focused on retaining customers. Successful approaches include a clear knowledge base, a strong customer strategy and well executed tactics.

How to drive better retention results

The table below outlines the attributes of each component: knowledge base, customer strategy and tactics, at the various sophistication levels.

Level one: Basic retention tactics

Most mortgage companies are here. They need to strengthen this foundation to move forward with a clear knowledge of retention economics and organizational focus. For companies in this category more advanced financial analysis can help drive future retention benefits.

Level two: Multi–channel approach

At this level, there is significant opportunity to improve results. Most mortgage companies have call centers and a website that do not realize their full impact. Measuring and analyzing the economics of retention (i.e., which types of customers are profitable and which customers are "at risk") can help drive the organization to the right strategy and tactics to retain customers. Other examples of understanding retention metrics include understanding which investor programs or correspondents/ brokers are more supportive of retention efforts.

Level three: Fully integrated loyalty initiative

At present, a few telecom and financial services companies are here. CRM systems are underutilized because basic knowledge and business processes are not in place.

	Level One: Basic Retention	**Level Two: Multi–Channel**	**Level Three: Fully Integrated Loyalty**
Knowledge Base	• Loan level economic value • Segments of at–risk refi loans • Loan level database • Analysis of service channel	• Sophisticated refi modeling • Segments of at–risk purchase money loans • Customer database • Customer contact analysis • Impact of website on retention and costs	• Household level profiling and targeting • Proforma allocation of resources to predicted
Customer Strategy	• Implementation plan • Change management issues addressed • Clear ownership • Aggressive pilots	• Integrated online value proposition • Clear website content priorities • Targeted customer metrics	• Segmentation capabilities • Clear customer migration
Tactics	• Credit reporting inquiries • Offering unique streamlined products • Modification programs • Outbound calls • Refi capture opportunities in servicing	• Customer service as a means to build loyalty • Segmented service levels • Actions to increase website usage • Web enabled call center • Security and privacy promoted	• Sophisticated cross selling initiatives • Real time offer optimization • Highly segmented retention

Summary observations

- Retention remains a significant opportunity for improving profits and is at the heart of a customer relationship focused strategy.
- Retention rates have been largely dictated by the refinance market in recent years and as a result, purchase retention has in large part been overlooked.
- Purchase retention rates are significantly worse than refinance retention rates within the industry.
- Companies should continue to focus on tailoring their interaction with borrowers to capture leads. An example would be to send neighborhood price comparisons to homeowners to entice interaction.
- Retention rates vary significantly by channel. Retail and direct channels exhibit the most success at retaining customers as there are more touch point opportunities where relationships are developed.
- While most businesses have implemented retention tactics, few have a comprehensive strategy and plan.
- Swings in the refinancing marketplace have driven an on–again, off–again approach to retention that leaves a lot of money on the table.

While the industry has begun to move away from viewing loans as a transaction and focusing more on customer relationships, there remains significant opportunity for improvement. There has been an increasing number of players entering the mortgage industry, including real estate companies, builders, credit card issuers and securities firms. Along with the increase in the number of players, there has been an increase in the product mix available to customers as well as the sophistication of the borrowers. A company's ability to measure and understand retention data is critical to their success in the long term.

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Implementing a customer service strategy

The 2005 J.D. Power and Associates' Home Mortgage study found that only 18% of mortgage servicing customers reported being "delighted" with their lender and just 16% said they were "delighted" with their mortgage originator. These results place mortgage companies in close proximity to other industries such as airlines and automakers, both of whom have been experiencing profitability challenges in recent years. This article proposes a framework that might help industry executives drive the implementation process of a profitable and successful customer service strategy.

Background

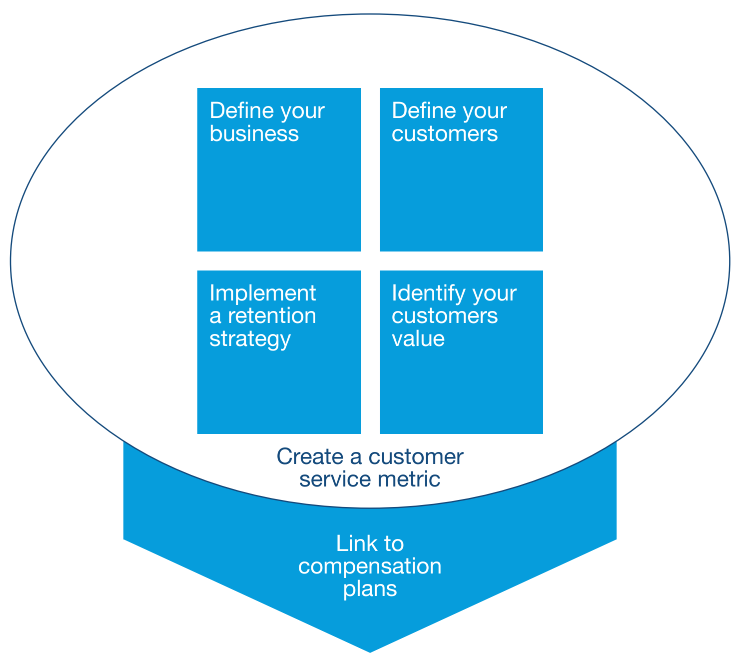
Historically, many companies have taken the approach of treating mortgages as a commodity where price is the only differentiating factor. As a result, they invest a significant amount of their resources on customer acquisition while spending significantly less on the customer experience. This commoditization and continued focus on cost reduction has resulted in reduced brand loyalty, inconsistent service and a general level of dissatisfaction from customers who try to avoid unnecessary contact with their mortgage service providers. The result of this is low retention levels.

To date, retention efforts have been typically limited to offering a reduced rate to existing customers. Although this business practice might be profitable, it only targets a small portion of the value that a comprehensive customer retention effort might bring. For example, its effectiveness might be limited when trying to attract current customers interested in second home or investment properties.

A framework for a successful customer service strategy

For a company to break free of the customer commoditization cycle, it is necessary to implement a framework that is communicated to all the levels of the organization. This framework includes six phases:

1. Define which business the company is in.
2. Clearly define who the target customers are.
3. Implement a "customer centric" retention strategy.
4. Understand customers' lifetime value.
5. Create a customer service metric specific to the company.
6. Link the customer service metric to compensation plans.



Define which business the company is in

It is critical for executives to clearly identify where they want to take their business in the future. Having a limited or short–sighted business definition will certainly make the organization think that the only way to be successful is to reduce costs in order to be able to offer the lowest possible price. That is the case of companies that believe they are just in the business of selling mortgages. But the reality is that the mortgage is just the instrument that people use to have access to what probably is the most valuable asset that they will possess – their home. Similar to other life decisions that require the purchase of a product and service (e.g., choosing a college), companies in the mortgage banking industry need to understand the value they can provide is much broader than just selling the instrument. Customers need information, advice and education when purchasing a home.

The continuous evolution of the mortgage banking industry might present two groups of mortgage companies in the future:

- Mortgage companies that not only offer mortgages, but that also offer credit cards, auto loans and deposit accounts, just as larger banking institutions with mortgage businesses do today
- "Home ownership" companies that offer mortgages, home equity loans, flood insurance, home improvement services and have marketing alliances or joint ventures with builders and Realtors

Clearly define who the target customers are

As part of the commoditization process that the industry has gone through, several companies are of the mindset that "any loan is a good loan" without really understanding which customers are the ones they can better serve. When defining their customer segments, executives need to ask themselves the following questions:

- What are the customer segments that the company can serve profitably given its competencies?
- Does the company have the right products and services for the customer segments it wants to serve?

The customer service offering will be very different depending on the customer segments that the company decides to target. For example, customers interested in a mortgage for a vacation property will demand a different level of customer service and service intensity than an emerging markets customer who is interested in a first mortgage.

Implement a "customer centric" retention strategy

For a more detailed discussion on retention strategy, see page 14.

A customer retention strategy should encompass more than just offering a refinance deal to customers or sending client information to other parts of the business. According to Peppers and Rogers, marketing consultants, "The best practices in retention could be classified into three categories: differentiated offers aimed at particular types of customers, additional service offerings that deepen a customer's relationship and self–service options that tend to entangle the customer with the firm". How do these three categories apply to mortgage banks?

Differentiated offers aimed at particular types of customers

This includes the classic refinance business but in a way that addresses the needs of the particular customer segments. Lenders should analyze if a refinance decision is generated solely by a desire for a lower rate or if the client is doing it as a way to obtain access to the accumulated equity in the property to do a variety of things, such as pay college tuition for a family member, take a long vacation, buy a car, etc. Understanding the client's motives allows offering differentiated products as some groups tend to be more rate–sensitive than others.

Additional service offerings

As customers progress in their lifetime value cycle, they will demand additional products and services from mortgage banks. These include:

- Mortgages for more expensive properties
- Mortgages for vacation homes or other properties as investments
- Additional financial products such as credit cards and auto loans
- Reverse mortgages

Self–service options

The implementation of an effective self–service strategy can increase retention since customers might feel that they have more ownership over the whole process and might not be willing to switch brands to avoid becoming familiar with a different online platform.

Understand customers' lifetime value

Although measuring lifetime value is a well known concept in other industries, it is still relatively new in the mortgage banking industry. In large part, customers are still viewed as one–time transactions and most companies do not take into consideration the profitability potential that the customer might bring to the organization in the future. Companies should have a process in place to calculate customer lifetime value and to analyze the changes in lifetime value from one period to the other. This will help the company understand the profile of its most valuable customers and should also enable it to refine their customer acquisition efforts.

The value generated by a customer is not only going to come from the loan that is being originated today. This customer will keep generating value as long as they keep doing business with the organization. The value will come from added servicing revenue generated by a lower level of prepayments, additional products and services, and referrals.

Whenever a company is going to make changes to its products, pricing or cost structures, it should take into consideration the impact of its decision on customer lifetime value. For example, a decision to increase certain fees to generate incremental revenue might bring additional profits in the short term but this benefit will be more than offset by the revenue lost due to unsatisfied customers leaving the company.

Create a customer service metric

Companies need to be able to quantify what is the customer's reaction to the service being provided and what is the progress that they are making towards becoming an organization with a customer service focus. Companies may elect to participate in a third–party study, conduct a telephone or online survey, or use retention as a way to measure customer satisfaction. This metric should fit the organization's culture and receive the same attention that financial metrics (e.g., ROE, net income, etc.) receive. This metric should not be seen as a "marketing objective" but as something that the whole organization works on. The "customer service culture" needs to be presented by the CEO and not by the Marketing or Servicing Departments.

Link the customer service metric to compensation plans

Once a company has identified the value of customer service, it is necessary to link the customer service metric to compensation plans. This will ensure that all employees see the customer service effort as something core to the company's success and as something from which they can all benefit. The company may decide to include a variable compensation component that is based on the change in the customer service metric plus the individual's effort in meeting his/her customer service objectives for the year.

Conclusion

Mortgage companies can generate additional value by improving their overall level of customer satisfaction. Customer service investments should be part of a process that involves all of the different business areas and should clearly identify and assess the impact that these decisions have on the bottom line.

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Tracking loss exposure and controlling foreclosure losses

Though certain foreclosure losses are uncontrollable, there are some losses that can be mitigated or prevented through the implementation of sound controls and processes. The key to mitigating and preventing losses is to ensure that the organization is continuously examining the root causes of losses, with the end goal being to minimize losses through process, system or control enhancements. Equally important is having strong performance metric reporting in order to identify any troublesome or irregular trends. Foreclosure reserving and reserve analysis are also crucial elements of default servicing that must be reviewed on a regular basis.

Recent trends in expanding the availability of credit through alternative lending products and the escalating prices of the housing market have placed a greater burden in controlling losses. As a result, historical losses may no longer be an adequate predictor of future losses. New products, such as Alt A and optional payment mortgages, may not perform as expected, resulting in unanticipated losses. Given the lack of history associated with these new products, the importance of credit risk and exposure modeling is paramount. In addition, the new bankruptcy legislation (see article entitled, Bankruptcy Abuse Prevention, Consumer Protection Act 2005 on page 58) will impact how servicers approach loss mitigation as well as alternatives to the expected reduction in bankruptcy cases.

More sophisticated investors are demanding the recovery of losses that are a result of operational defects in the loan origination and/or servicing processes. They are expecting a higher level of performance in loss mitigation efforts in order to reduce foreclosure losses and also are demanding the actions be processed within tighter timeframes. Also, as HUD increases the lending limit for their loan products, the amount of FHA losses will continue to increase as interest losses rise as a result of higher unpaid principal balances.

Along with these trends, there is the possibility of servicers getting caught short on resources due to the inevitable aged book of business migrating to defaulted status as a by–product of recent record high refinancing volumes. In the end, default areas may struggle to keep up with volumes, leading to missed timelines.

The above certainly will challenge servicers in the coming year, however, there are some preventative actions that servicers take now in order to better control and forecast foreclosure losses:

Systems

- Ensure that the servicing and default processing systems link activity between business units so as to minimize handoff risks. Loss mitigation tracking needs to be linked to claims and foreclosures to ensure timely action. Many investors require dual processing of a loan between loss mitigation and foreclosure. Activities between bankruptcies and foreclosures should also be linked to minimize the risk of foreclosure delays. Loss analysis should report loss root causes to business units in a timely manner in order to facilitate process improvements.
- Incorporate loan indicators within the servicing system to track loans that may be subject to large losses due to investor repurchase demands, origination fraud and uninsurability.
- Because nearly all loans are subjected to a loss mitigation review, determine if loss mitigation extensions can be codified within the servicing system so that loss exposure can be tracked.

Reporting

- Identify loans that require default staff to track and process work approaching key timeframes that, if missed, will create a financial loss.
- Develop aging reports to track activity within each key default category.
- Implement exception reports to identify illogical tracking conditions, for example, loans with a foreclosure sale completion date that are currently in an active bankruptcy status. This will enhance data integrity in the data warehouse of default processing activity.
- Provide a more effective tracking of foreclosure activity from a financial perspective. Most servicing systems focus on missed action dates of individual transactions. Servicers should translate these missed actions into financial exposure summaries.
- Develop detailed compliance metrics to track first legal actions, timely initiation of foreclosures, delays from third party vendors (attorneys, property preservation) and allowable delays in foreclosures (contested foreclosures, court delays, bankruptcies, loss mitigation).
- Develop timely scorekeeping to track root causes to losses incurred. Recommend preventative process improvements to mitigate losses.

Loss Mitigation

- Upon completion of developing a set of financial exposure reports, develop opportunities to mitigate losses. If a loan ultimately is foreclosed, the liquidation of the underlying collateral often only recovers 60 to 70 percent of the original investment. Loss mitigation actions can significantly reduce this loss.

Reserving

- Segregate the reserve tracking function from the default business units so as to eliminate conflict of interest. The tracking function is often more appropriately a responsibility of corporate accounting.
- Develop more detailed reserve estimates.
- Develop loss projections and compare actual results against these projections to assess differences for amount reserved, as well as populations requiring a reserve.
- Revalidate key assumptions in the calculation at least quarterly.
- Assess adequacy of reserves monthly.
- Develop migration analysis of defaulted activities predicting the expected severity of losses. Refine estimates of expected cure rates associated with defaulted loans.

Servicers can take several actions to implement preventive actions to control their level of foreclosure losses. Servicers can inventory data available to analyze and report key trends to management. Systems can be evaluated to determine if handoff risk between operating areas can be minimized for transition activities between bankruptcies, foreclosures and loss mitigation. Servicers can determine how they can expand their loss mitigation practices to minimize loss severity for owned assets. Risk models and reserving models that are required to be developed outside the capabilities of the standard mortgage servicing package and relevant default processing software packages can be assessed.

For more information on developing foreclosure related exposure metrics or an effective risk management practices associated with managing the foreclosure process, please contact:

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A glimpse into the mortgage product profitability crystal ball

The traditional paradigm of product profitability and pricing is changing as the competition between mortgage lenders continues to increase and borrowers become more sophisticated. Not long ago the 30 and 15 year fixed and CMT Hybrid ARMs were the extent of the mortgage product line. In addition, pricing was very generic, usually representing a boxy one price fits all strategy. Now products such as Alt–A, Interest Only, LIBOR ARMs, and Option ARMs are easily recognized by many borrowers. In addition, pricing has become much more sophisticated, generally requiring a FICO score before a price can be determined. Not only that, but doc type, LTV, prepayment penalty, geography, index, amortization term and loan type are all factors that can impact the price. The developing trend is for greater customization and granularity on individual loan characteristics and on a customer level.

Imagine a world in which the mortgage is designed specifically for the customer instead of specifying which customers will best fit into specific products. Also imagine pricing so modular that it is a near exact match to the expected profitability of each loan allowing a lender to offer the most competitive price while ensuring that its desired level of profitability is achieved. Imagine deciding maximum loan amounts per borrower by the amount of their potential income and not their current situation and designing products accordingly. In order for lenders to be successful in this new arena, there are some necessary components and techniques that must be developed. These include: creating a structured new product development process and enhanced product profitability reporting and measurement capabilities. In addition, it is critical that Finance or Capital Markets play a key role in the monitoring and the development of new products, in cooperation with Sales.

One of the critical success factors to ensure the expected profit margins are met is to make sure the company is organized to enable equal cooperation between Sales and Finance. What we have seen work well is a neutral group, generally housed in Capital Markets, who receives feedback from both the Sales and Finance teams and has specific objectives from each. First and foremost, a pricing strategy policy must be developed, where the objectives and guidelines are agreed upon by all parties including senior management. Without having formal documentation on the pricing and product policy, the potential for an imbalance between Sales and Finance is high, resulting in missed financial expectations and/or heightened tensions between the two groups.

Pricing and product profitability cannot exist in a silo. The Pricing Department should receive constant feedback on the competitive market and product features that work well and those that do not. Sales must feel like their voice is being heard, while Finance needs to make sure that profitability is looked at not only from a profit per loan perspective but also factors in anticipated volume based on the price to ensure overall profit targets are met. Clear and constructive communication between the two groups and a predefined pricing strategy helps ease tensions and foster effective product and pricing behavior. It is also important to offer a comprehensive product line to fit the needs of targeted borrowers, while not offering so many products that the cost of maintaining them exceeds their potential revenue. In addition, with each rollout of a new product, the impact of the new product on the existing product and pricing line should be examined to ensure the product will not cannibalize an existing product, thereby impacting profitability.

Loan programs are now being introduced that are focused on specific consumer segments. While this concept is not entirely new, the prevalence of these types of programs is becoming increasingly popular. For example, Fannie Mae has just revamped their Community HomeChoice program that enables low to moderate income disabled borrowers to qualify for a home loan. The program requires only $500 from the borrower's own funds and offers up to 100% LTV. Some other lenders have developed loans that are specific to doctors who have just graduated from medical school or are in their residency. The programs usually require little or no down payment and generally do not require mortgage insurance with acceptable credit.

In developing these types of segment specific programs, lenders are conducting analyses to determine profitability by customer but they are also discovering that the drivers of customer value vary from borrower to borrower. In addition, they are starting to price to the perceived value of the product and not just based on a spread to the competition. However, before deciding which mortgage programs to roll out, it is important to have a comprehensive process for product development.

Although new product development frameworks have been in place for decades, it is advisable that companies perform a review of their current process and determine if they are effectively using the company's competitive advantage in addressing customer needs in a profitable way.

The diagram below presents a simple framework of the steps that should be taken into consideration to ensure successful product development.

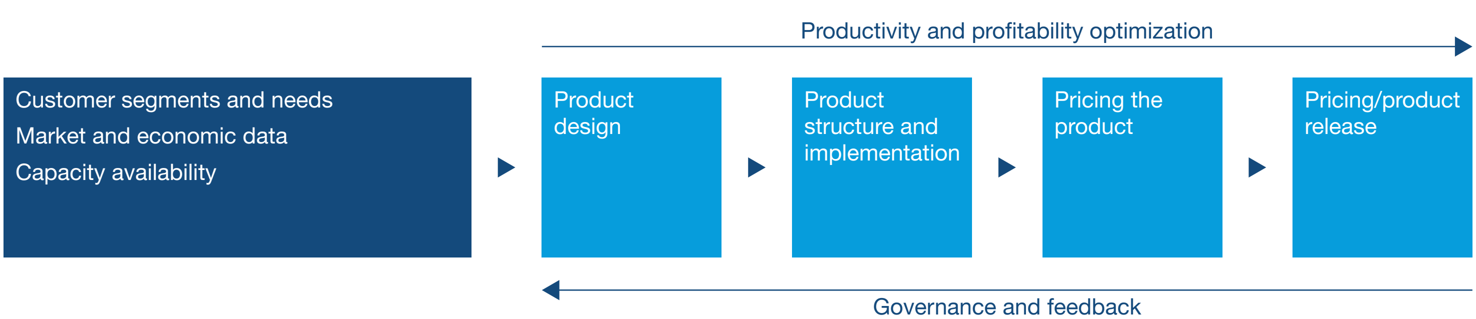
The product development process should start with an analysis of the internal and external factors that will drive the process. This includes an assessment of current as well as future expected customer needs, the prevailing macroeconomic conditions and the current capacity of the organization. These three factors are analyzed together and not in isolation. There are many examples of companies that have developed a great product; however, it has not been successful because the product launched at the wrong time or with inadequate resources.

Once the company has completed analysis on these three factors, the formal product design process starts. This step should never be done in isolation and should consider the impact the new product can have on the bottom line as well as on the expected revenues coming from existing products. It is advisable to create a New Product Committee that has representatives from not only Marketing and Sales, but that also includes Servicing, Secondary Marketing, Operations and Finance. This will help to answer the questions: can we do it?, when should we do it?, how should we do it?, and why are we doing it?

Once an optimal product design has been identified, the company must review their existing processes and systems to assess implementation needs. This is a critical part of the process as the new product needs to have adequate support. As part of this phase, the new product development team should also work with other groups in the organization to design training programs for key personnel.

The next step is pricing the product, and in this process Finance and Capital Markets play a pivotal role, but also must enlist the help of Sales. First, analysis is conducted to determine the customer's perceived value of the new product. There are various methods to do this, including using the expertise of Sales and Finance executives, conducting a customer survey, conducting pricing experiments or using historical data to determine the price response curve. The best implementations generally use a combination of all four. Once the consumers' demand for the product is determined, profitability targets can be established and a marketing plan can be constructed.

Now that the target price has been identified, a strategy should be decided on how the new product is going to be launched both internally and externally. This includes the traditional marketing



campaign plus an internal effort that considers the potential reaction from the Sales force.

After the new product is released to the marketplace, it is necessary to step back and analyze the reasons for the new product's success or failure. There are many times when companies believe that a new product has been extremely successful but the reality is that the product itself was not the reason for success and the success was influenced by an intense promotion campaign or the additional incentives given to the Sales force for placing the new product.

The new product development process should not be a static process. The New Product Committee should receive continuous feedback and ask the Development Team to go back to the drawing board every time that is considered appropriate. It is better to have a good product that takes longer to reach the consumer than being the first in the market with a bad product idea.

An important factor in managing product profitability is understanding the impact of price changes on volume. For example, what effect does a 10bps change in a company's pricing model margin have on a company's production volume? This process, otherwise known as price elasticity, is likely the most difficult task of the process because it involves complicated financial measurements and statistical analysis. Many organizations estimate what impact price changes will have on volume and then look back to see whether they estimated correctly. However, the difficulty is that the price change that was made was probably not the only change that happened in the market. For example, rates overall may have increased or decreased contributing to higher or lower volume, or competitors may have adjusted their prices impacting volume, or various marketing campaigns impacted the results, as a few examples. However, lenders are now realizing the importance of measuring elasticity and are now working with vendors or building internal models to support the analysis. This is critical since the price elasticity of a product can determine whether the price increase or decrease will increase profitability.

For example, if price elasticity on a product is less than one, meaning the price to volume relation is inelastic, a price decrease should not be implemented since the increase in volume will not offset the loss in revenue from the price cut. The opposite is true for a price increase: if elasticity is less than one, a price increase can be immediately implemented since the volume drop will be smaller than the percentage increase in price. Not only does this provide insight into pricing recommendations, but this type of analysis can also indicate the impact of a price change on other products.

The concept of cross–elasticity measures the impact of demand on one product when the price of another product changes. Therefore, it is important to understand when products are substitutes for one another. Quantitative information is gathered and product analysis must be conducted to determine when and which products are substitutes for each other. For example, let's say that at Company A, analysis has shown that the 5/1 Interest Only and the Payment Option ARM are substitutes for each other when the fully–indexed rate on the Payment Option ARM comes within 50 bps of the Initial Start Rate on the 5/1 Interest Only. Company A management is considering cutting price on the 5/1 Interest Only in order to compete with a competitor's aggressive pricing. Upon analysis, the price drop on the 5/1 Interest Only will be within 25 bps of the fully–indexed rate on a Payment Option ARM. Borrowers will most likely snap up the 5/1 Interest Only to lock into the interest rate stability over the five year initial term versus the unpredictable monthly interest rate adjustments of the Payment Option ARM. The impact to profitability could be substantial, if the price cut on the 5/1 Interest Only made the product only marginally profitable and took away volume from the more profitable Payment Option ARM.

Lastly, add–ons should be factored into the analysis. Add–ons should accurately reflect the costs associated with them as well as the elasticity of demand for the feature. Take for example low–doc loans: it may just be a convenient feature to have for some borrowers and if there were little or no cost for the feature most would take the option, but for self–employed borrowers, low–doc may be required. Therefore, in order to optimize product profitability, it is important to understand the target audience for each product and feature.

While the new paradigm for product and pricing is very exciting, getting there is going to take hard work and discipline, but by building the fundamentals and proper structure for product profitability the groundwork will be laid for this next generation.

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What's new in home equity?

Fueled in part by customer demand to access equity in their homes, low transaction costs and increased liquidity in the marketplace, home equity lending continues to evolve as a strategy for lenders to maintain revenues and for consumers to access capital at a low cost. However, this growth has also led to an emerging concern by regulators and analysts as to the industry's ability to manage risk on innovative product lines that have grown at such a pace. This growth is also leading to unexpected opportunities and challenges for lenders.

Opportunities and influences

Market opportunity

The potential home equity market in the United States is tremendous. With analyst estimates as high as $8 trillion[3] in available residential home equity value outstanding, the market continues to be an attractive target for traditional lenders (e.g., banks, mortgage companies) and non–traditional lenders (e.g., credit card companies, foreign banks). In addition, as customers have traditionally looked to refinance existing first mortgage liens when a need arose to access home equity, many customers who locked into historically low interest rates between 2001 and 2003 are continuing to utilize home equity loans to access additional equity without jeopardizing their low fixed rate mortgages. This combination of rate increases, home price appreciation and customer education of the relative value offered by accessing equity continues to fuel growth in home equity production levels.

Line utilization

Companies continue to develop their strategies to target customers in their various markets and channels. However, established lenders with existing home equity portfolios have an advantage in the marketplace when targeting expanded line utilization of their existing customers. As such, many of these companies are focusing on new production as well as strategies designed to solicit customers to further utilize their existing home equity accounts for debt consolidation, home improvement and other large scale investments. In this fashion, home equity lenders are not only attempting to increase their outstanding loan balances, but they are also further establishing their relationship with the customer by offering more, and better, products.

Other lender benefits

Although competition remains steady, lenders continue to benefit from consumer demand for home equity loans and lines of credit. In many cases, this is a direct result of ongoing consumer needs to access equity. In other cases, it is a result of targeted campaigns to leverage existing mortgage banking distribution channels (e.g., customer retention programs) or to cross sell home equity loans to existing clients. While traditional opportunities exist in retaining customer relationships established with the origination or acquisition of loans in the mortgage portfolio, companies are also exploring the available benefits of developing or leveraging existing affinity relationships with third parties to gain direct access to previously inaccessible customers.

[3] Morgan Stanley: Industry Overview—Home Equity Hegemony, Nov. 2004

Market liquidity

Traditionally offered as bank portfolio products, home equity loans have not regularly been offered by non–depository institutions. While some non–depositories have experienced limited origination success through sales of whole loan correspondent or wholesale transactions to traditional depositories, increased liquidity and demand in the asset backed securities market has amplified capital market access to non–traditional home equity originators and fueled continued growth in home equity originations (home equity issuances comprised 65% of 2004 ABS securitizations).[4] Further, while expanding demand for home equity originations in the ABS market has increased opportunities to fund home equity originations for non–depository lenders, it has also provided a viable balance sheet strategy for depository institutions that believe their concentration in home equity loans is too high or that need additional capital to fund unexpected increases in utilization rates among active customers.

Challenges and concerns

Housing bubbles

While expert opinions vary as to a possible housing bubble, the effects of a burst in any potential bubble are not entirely clear. Some experts do believe that a burst in a bubble would likely lead to, at a minimum, a decline in portfolio performance in the form of increased delinquency and charge–off activity. As a result, many firms are facilitating dynamic event planning initiatives to determine the key indicators of a potential bubble burst, assessing the impact of home price contraction and developing the required action plans to help guide the company in various scenarios. In some cases, this is a logical progression of existing event planning strategies while in others, it is a new concept to be considered for a new asset class in which the company has limited experience in managing risk.

Competition and customer value measurements

While there is consensus among industry participants that untapped home equity continues to be the primary opportunity in the marketplace, traditional utilization of home equity for debt consolidation purposes, safety in uncertain times, utilization for home improvement or education finance continue to remain the primary purposes for accessing home equity. Thus, as the potential of the home equity lending market is realized, the industry continues to experience increased penetration of traditional and non–traditional lenders into the marketplace. As a result, it should be expected that to maintain market share and customer relationships, lenders will continue to become innovative with their product offerings and/or attempt to increase production levels by reducing targeted returns. While this scenario may lead to further reductions in acquisition costs and a deeper perception of individual cash flow benefits to consumers, it will likely lead to margin compression across the industry as lenders continue to compete on price, thereby commoditizing home equity loans/lines similar to that of mortgage products. In this scenario, the investment in originating the customer, rather than the home equity product, becomes the commodity rather than the home equity product.

In some cases, the competition for home equity loans has driven the customer benefit of opening a home equity line to new highs with customer incentives including free maid service, teaser rates/zero percent APRs, and reward point programs similar to airline and credit card reward programs.[5] However, before developing defensive strategies to maintain market share through reductions in yield or offerings of other ancillary services, creating the tools to understand customer value and strategies to align pricing practices with expected return measurement is critical.

Portfolio management

While most traditional banks with experience in portfolio lending have infrastructures capable of servicing home equity loans and lines of credit, this product contains a significantly different risk profile than traditional mortgages. Specifically, the ability of borrowers to access available equity as needed has proven to be a challenge in ensuring funds are available to meet utilization needs while maximizing available balance sheet equity. In many cases, lenders are performing ongoing analysis of their portfolios to assess and mitigate developing risks to portfolio performance. Some of these strategies include:

- Post origination credit reviews
- Comparison of macro economic analysis to portfolio assumptions
- AVMs to assess property values and manage “bubble” fears
- Modification agreements to extend the term of interest only payments and line amounts
- Complex loss mitigation strategies on defaulted loans similar to that of first mortgage servicers
- Dynamic event modeling to assess the impact of key scenarios and varying rate environments

[4] Source: JP Morgan, MCM CorporateWatch and Bloomberg

[5] “Home Equity Loans Hit Record Levels—Lenders Use Incentives, Discounts to Entice Homeowners; Free Maid Service for Six Months” The Wall Street Journal, January 20, 2005.

While it is important to monitor and manage the credit performance of a home equity portfolio, ensuring sufficient access to capital exists to fund home equity line disbursements often proves more challenging. As such, depository and non–depository institutions have varying challenges in managing this liquidity risk. In funding the ongoing increases in home equity debt, depository institutions are now tasked with predicting not only line utilization, but also assessing the impact of that utilization on the capital requirements of the bank. While non–depository lenders may not have the same capital concerns, they are tasked with the challenge of aligning customer pricing strategies and utilization expectations with available financing options (home equity securitization vs. match funding of other debt issuances). As such, regardless of the lender's capital structure, managing risk on a home equity portfolio continues to remain challenging.

Loan fraud

Similar to other consumer products, instances of fraud on home equity originations continues to emerge as a primary concern. In some cases, this concern is raised as a result of actual fraud incurred while, in other cases, it is driven by a concern that controls implemented to detect and prevent the origination of fraudulent loans are not sufficient. However, with no secondary marketing agency to standardize credit, collateral and QC requirements, establishing cost effective controls to identify loan fraud continues to be a lender specific challenge but an emerging concern for home equity lenders in general. A recent fraud roundtable sponsored by PwC found the following to be the common concerns of risk managers when considering fraudulent originations:

- Fraud is a growing concern of many industry CEOs and is uniformly considered on their top ten issue list. This is a significant shift from the findings from the prior PwC Fraud Roundtable where few participants believed this was on the CEOs' top ten list;
- There is a need for a consistent measurement of fraud losses including standardized measurements of fraud frequency and severity;
- Focus on manual controls and training continues to be a primary detection tool;
- Law enforcement assistance is limited for fraud investigative and recovery efforts; and
- While participants agreed the frequency of fraud remains consistent, there is an increased concern related to reputation risk. This is a significant shift from prior roundtable results where this was not listed as a concern two years ago and may be a driver of CEO concerns given similar levels of fraudulent loans.

Operational efficiency

As volumes continue to remain at or above historical peak production levels and pressure on margins begins to build, home equity originators continue to shift their focus to process efficiency and cost containment strategies. Led in part by antiquated loan origination systems, more complex product offerings and manually intensive processes, many home equity lenders are expected to maintain focus on production while further assessing their fulfillment process in an effort to improve efficiency, scalability and control effectiveness. In short, some of the strategies being considered include:

- Shared service strategies between back office operations within a corporation (e.g., single closing department for home equity and first mortgage production)
- Consolidation of home equity and first mortgage platforms to improve scale and reduce internal competition among business units
- Offshoring and outsourcing domestically and abroad to reduce costs on non–consumer facing activities
- Process re–engineering to reduce cycle times and improve efficiencies
- Creation of transition strategies to a paperless environment as the reduced documentation required on many home equity products is expected to reduce processing complexity and improve the ROI of technology investments.

Regulatory scrutiny

Similar to those experiences of first mortgage lenders in the early part of this decade, home equity lenders are in many cases beginning to feel the effects of competition as concerns over margin compression, market share, production costs and product innovation continue to maintain the attention of industry participants and regulators. In response to these concerns and other perceived opportunities in the market, a joint regulatory advisory on home equity risk management practices was issued in May 2005 outlining regulator concerns in home equity lending.[6] In this bulletin, regulators identified the following items of concern related to the current home equity market:

- Interest–only features that require no amortization of principal for a protracted period;
- Limited or no documentation of a borrower's assets, employment and income (known as "low doc" or "no doc" lending);
- Higher loan–to–value (LTV) and debt–to–income (DTI) ratios;
- Lower credit risk scores for underwriting home equity loans;
- Greater use of automated valuation models (AVMs) and other collateral evaluation tools for the development of appraisals and evaluations; and
- An increase in the number of transactions generated through a loan broker or other third party.

Home equity lending continues to be a primary origination tool for many lenders. However, to maintain recent growth levels and achieve the potential of the market, originators must remain focused on innovation and their strategies to access customers while maintaining an appropriate infrastructure to monitor and manage interest rate, credit, liquidity and other associated risks.

If you have questions on home equity lending trends or related topics, please contact Peter Pollini at 207–450–9036 or at peter.c.pollini@us.pwc.com.

[6] The joint advisory—entitled "Credit Risk Management Guidance for Home Equity Lending"—was issued in May 2005 and sponsored by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision and the National Credit Union Administration.

Enterprise system implementations:

Five common pitfalls and strategies to avoid them

As today's residential mortgage market becomes more and more complex, from both a regulatory and competitive nature, originators and servicers have been forced to make large scale changes to the software systems that support their business model. In the past, loan origination systems (LOS) that required multiple levels of manual controls to ensure compliance with underwriting standards and systems that required manual input of third party data (credit bureaus, brokers, appraisers, etc.) were acceptable. In today's world of Sarbanes Oxley compliance, constantly evolving niche products, narrowing profit margins, and ever increasing regulatory oversight, these legacy systems are no longer acceptable. As a result, the past several years have seen virtually all large scale banks and mortgage companies either purchase or internally develop new software systems to facilitate the origination and/or servicing of loans.

While some enterprise wide installations have been successful, the majority are viewed by executive management teams as being on a scale ranging from marginally successful to "train–wrecks." Why is that? There are several key factors that consistently contribute to the success or failure of an enterprise level system installation in consumer financial services. We discuss five common issues:

1. Developing a realistic business case

Some companies begin the process of system replacement without performing any level setting assessment of what they are trying to achieve. In these cases, the need for a new system may be driven by any number of factors including a fundamental weakness identified in the existing system, the perceived inability to expand in either capacity or product, or simply that "newer is better."

Companies should evaluate, quantify and document exactly what they are hoping to gain from the implementation of a new software platform. Areas of known inefficiencies should be quantified and clear goals should be established for improvements in these areas.

The introduction of a new system into a process flow that is inherently inefficient will, in most cases, actually compound the problem as the end users will have the added burden of learning a new platform and then applying it to their roles.

All of the costs associated with a process that the new system will impact should be identified and documented to provide a baseline for overhead reductions that the new platform is expected to provide. When evaluating the expected gains from the implementation of a new system, all costs should be considered in the before and after scenarios. Many institutions have failed to adequately account for the ongoing maintenance, licensing, training, equipment and internal support costs associated with the new system. Failure to properly identify the current and expected cost components will lead to inaccurate cost vs. benefit analyses and could result in the implementation of a system that will actually increase operational expenses rather than provide gains.

Some situations arise where the need for the new system is being driven by requirements that supersede the cost component, such as the current technology platform is no longer supported or new regulatory requirements exist. In these situations, the implementation is still necessary, but the costs are going to increase. However, the business case should still be completed to accurately identify the new cost structure for executive management.

2. Owning the project

In some cases, project ownership and overall responsibility for the success/failure of the project is not clearly defined. The biggest pitfall in this area is viewing the system installation as purely an IT project. Line of Business (LOB) managers assume that since the project's primary objective is to deliver a software solution, all of the heavy–lifting work will be performed by the IT staff. In fact, today's advanced software systems require a tremendous amount of configuration to input the business parameters, products, pricing structures, etc. This knowledge is rarely housed within the IT area.

On the other side of the coin, business management may not adequately engage the IT team when evaluating the needs of the new platform. LOB personnel rarely have the IT expertise to evaluate the true feasibility of the modifications they want to see in the new system. This becomes particularly evident when the business wants to link multiple systems together that do not share common platforms, databases, languages, etc. This tends to result in poor setting of expectations if the LOB makes decisions about system configuration and integration without adequately consulting IT.

The best–run projects have an almost seamless integration between the IT and LOB teams where both areas share responsibilities for all aspects of the project, including key decisions. If these two groups do not work together, respect each other's skill sets and points of view, the project is at risk of failure.

Along with the ownership of the project comes the ultimate decision making authority for the project. This role, whether it is a single Executive Sponsor or an Executive Steering Committee, needs to be clearly defined at the onset of the project. Expectations for the timing of decisions should also be outlined at the project's initiation. Many failed projects can be directly attributed to the inability to make decisions timely and accurately. Most critical decisions are critical not only from a direction perspective, but also a timing perspective as they are required to move other aspects of the project forward. If the project leadership belabors every decision point and is consistently late to make and re–make final decisions late, it will be virtually impossible to meet deadlines for system delivery.

3. Letting the project requirements dictate the implementation date, not the other way around

This is probably the most common mistake made during large scale projects, whether they are directly related to system installations or not. All too many times the end date is carved into stone by management before any thorough GAP or needs analysis is performed. It is difficult to determine the end date for work when the work that needs to be performed is not yet defined.

Far too often the first action of executive management teams is to establish an unrealistic date for the completion of software installations and hold project teams, which are usually still forming, to these expectations. In such instance, the project is at risk of failure.

Project milestones should be established gradually and conservatively at the start of the engagement. For example, let's assume that Company X is going to install a new loan origination system that will support multiple origination channels that currently operate on separate systems. The first milestone of this project should be to perform a pilot GAP analysis on a specific functional area: Loan Origination/Sales, for example. Only after completing the first detailed GAP analysis and documenting the findings will it be possible to realistically estimate how long it will take to perform the GAP analysis for the other functional areas. At this point, the milestone should be established to complete the analysis phase. In similar fashion, the amount of time necessary to close the identified gaps can be accurately estimated only after completion of the development/customization for a pilot area. Once development and testing for some specific functional area(s) has been completed, it will be possible to extrapolate what has been learned at this point and more accurately establish milestones for the completion of the development for other areas. Establishing initial target dates in this fashion will provide more accurate insight into the overall timeline of the project.

The main point here is to establish achievable milestones, manage to those dates, and then establish the next set of dates. By doing so, this will:

1. Keep the project team focused;
2. Leverage the experience for future phases: and
3. Gain a clear understanding of the needs of a particular project.

4. Remaining objective and managing change

Beware of the “we’ve always done it that way” mentality when evaluating system options. When performing the needs evaluation or GAP analysis between the current system(s) that are in use today and the capabilities of the proposed replacement system, it is a mistake to take the approach that the new system needs to fit into unchanged operational procedures. This approach generally overlooks the features of the new system and the final installation can fail to capitalize on the inherent efficiencies that the new system is designed to provide.

LOB teams need to remain open to new ideas related to operational processing that surround the new application. This is very important when the current process is directly related to a lack of functionality in the existing platform. For example, many newer platforms for loan origination and servicing have integrated queuing capabilities that should be evaluated for use when the current process utilizes an external work management process, such as a spreadsheet or e–mail based solution.

The process of changing operational procedures brings potential stress to the employees who are being affected by the changes. This stress is significantly compounded if the employees’ comfort zones (i.e., legacy systems) are being changed at the same time. In many cases, companies will expect to implement the new system at 100% of its capabilities and that all of the operational gains will be realized starting from day one. This style of implementation most certainly would require major changes to both the business model and the operational structure of an organization as it relates to the processes impacted by the system change. An alternative approach would be that day one implementations are the base line system with as few customizations as possible. Plans should be in place to implement further customizations/enhancements over time. This approach will not only drive a faster implementation, it will also reduce the overall stress level of the employees, making them more accepting to the changes.

5. Dedicating the project team and clearly defining roles

The implementation team needs to contain representatives from all the areas that will be involved in the project including, but not limited to, LOB, IT, Finance, Audit, Legal and Compliance. Additionally, the team should be appropriately sized based upon the amount of work required. Many projects begin with what is intended to be a dedicated project team that only contains members from LOB and Audit. For success, the organization's leadership team should allow project team members to remain dedicated to the project and not require them to simultaneously maintain their normal day–to–day responsibilities.

In some cases the project team may be truly dedicated to the project, but the team is too small and members of the team are expected to perform more than one role. The most common mistake here is to expect the person defined as the Project Manager to also serve in other roles such as a LOB or IT Subject Matter Expert. Again, this will ultimately lead to delays and missed deadlines.

The staffing requirements for a large scale project should be a constantly evolving process and should be re–evaluated at each critical milestone in the project plan. When additional needs are identified they should be presented to Executive Management to allocate the appropriate personnel. Failure to evaluate and effectively respond to the ever changing resource needs will most certainly result in members of the team taking on more than one role/responsibility, leading to delays in the project and the overall frustration of the team.

As noted at the beginning of this article there are numerous reasons large scale system implementations succeed or fail. This article is only intended to point out a few of the more common missteps we have seen in recent years.

For more information on enterprise system implementations, please contact David Rice at 513–723–4762 or at david.rice@us.pwc.com.

Automated valuation models— How to manage your model risk

Part one: Back–testing

Residential real estate market growth has been driven by low interest rates and rising property values over the last four years. This has led to unprecedented numbers of new home purchases (both primary housing and investment properties), refinancing of debt on existing homes, and new home equity loan and line transactions. In addition, during this time period, mortgage originators have sought to increase the speed and lower the costs associated with real estate financing transactions. Furthermore, many institutions are using property valuation tools in risk management or internal control activities such as fraud detection and prevention, borrower default and prepayment modeling, and loss mitigation. The combination of these factors has resulted in an increased use of Automated Valuation Models ("AVMs") for determining or confirming the value of property securing real estate financing transactions.

AVMs are proprietary valuation models developed and licensed by vendors, or developed by mortgage secondary market participants. AVMs employ property–level information from databases and sophisticated modeling techniques to estimate the current fair market value of real estate collateral.

On May 16, 2005, the federal banking agencies[7] released interagency guidance applicable to all financial institutions engaged in home equity lending (both home equity lines of credit and closed–end home equity loans). The guidance outlines expectations for sound risk management practices for home equity lending programs. One particular element of the guidance[8] addresses collateral valuation management practices. Specifically, the guidance states that, for institutions to use AVMs to support property appraisals in a safe and sound manner, institutions must validate the AVMs periodically to "mitigate the potential valuation uncertainty" in the model, and to ensure that institutions utilize the most reliable and accurate AVM for underwriting and risk management purposes. Specifically, the guidance states that the AVM validation process must include "back–testing a representative sample of valuations against market data on actual sales."[9]

The following describes one approach to back–testing AVMs that institution can consider as part of their AVM risk management process.

[7] Collectively, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Association

[8] The guidance covers a variety of risk management elements including product development, marketing/sales activities, third party originations, collateral evaluation management, account management, portfolio management, operations/servicing/collections, secondary market activities, credit risk classifications, loan loss reserves and capital.

[9] Also, the guidance refers institutions to the model validation guidance outlined in the Office of the Comptroller of the Currency's ("OCC") Bulletin OCC B–2000–16, "Risk Modeling—Model Validation" that was issued May 30, 2000. Please see our Mortgage Banking Update, Winter 2003 for an article describing OCC 2000–16.

An approach to avm validations

Validating an AVM typically requires selecting a sample of properties from recent originations to be submitted to one or more AVM vendors in order to evaluate the accuracy of the AVM and the reliability of the vendor. After receiving the AVM estimates from a vendor, an institution must analyze the AVM's performance using a range of performance metrics, statistical analyses and tests. The results of these analyses must be formally documented and analyzed, with conclusions, and the basis for the conclusions must be fully supported and documented as well.

AVM property sample

According to the interagency guidance, the AVM sample must include properties that are "representative of the geographic area and property type" for which an AVM is used by the institution. The size of the sample will likely depend on a number of factors, but will be driven primarily by the size of the institution's lending footprint, the diversity of the institution's loan portfolio, and the number of properties a vendor will permit an institution to submit to it for evaluation purposes. This is an important consideration as an institution must be able to periodically submit a sample of properties to a vendor that is large enough to be representative of the institution's geographic area and property types, among other factors. Institutions should consider this validation requirement when negotiating a licensing agreement with an AVM vendor. Ideally, the property sample should be based on recent transactions in which the sales price or appraised value has not been publicly recorded, and therefore the property value has not reached the public databases used by AVM vendors.

AVM performance analysis

Analyzing the performance of an AVM is challenging because it can be evaluated across a number of different factors. Typically, however, institutions evaluate AVM performance in two main areas:

Coverage—The percentage of properties for which an AVM returns estimates for a given set of properties. All other things being equal, more coverage is better than less coverage.

Accuracy—The precision of the AVM estimate relative to a benchmark value, such as a property sales price or appraised value.

AVM coverage varies by AVM vendor. Some vendors offer AVMs that provide national coverage, while others offer regional coverage. AVM accuracy is typically measured at the property level using an error rate (i.e., AVM estimate minus sales price divided by sales price). Error rates for a group of properties in the sample can be summarized by key statistical measures: mean error rates, median error rates, or the distribution of error rates. Statistical tests, such as analysis of variance and t–tests, can be performed on the error rates in order to assess whether the differences in the error rates exist for geography (e.g., state level or county level), property type (e.g., single family detached or condominium) and property value ranges.

After completing the AVM performance analysis, the institution must document the assumptions, conclusions and recommendations for review and approval by management.

Role of risk management and credit policy in the process

An institution's Risk Management and Credit Policy groups are critical parties that must be involved in the oversight of the AVM validation process. From a model governance and risk policy perspective, Risk Management typically has a role in defining an institution's approach (broadly) to model validation, including defining roles and responsibilities that ensure independent, objective reviews, developing policies and procedures, and establishing documentation requirements. Any AVM validation program would typically be executed in conformance with corporate standards.

As it relates specifically to the design of an AVM validation program, Credit Policy and/or Risk Management typically have a role in defining criteria for what constitutes "acceptable" uses of an AVM, acceptable performance of an AVM (i.e., accuracy, reliability), and policies covering the initial due diligence and approval of AVM vendors based on their ability to provide AVMs that meet the defined performance criteria, and their willingness to permit ongoing validation of their services. Risk Management's/Credit Policy's involvement should be continuous, to ensure the initial design and ongoing performance of the program are reasonable and well controlled.

Conclusion

While AVMs can offer financial institutions faster loan origination cycle times, lower delivery and fulfillment costs, and automation of key risk management processes, improper use of AVM technology can expose an institution to increased credit losses and regulatory risk. In this article, we have discussed a methodology for back–testing AVMs that we believe is one method of performing analysis in a manner consistent with recently released regulatory guidance. Whatever the approach taken, a formal AVM validation program is necessary to meet regulatory expectations and will help an institution better measure and manage its AVM and vendor risks.

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Risk and control self–assessments

A critical component of mortgage enterprise risk management

Due to increasing scrutiny by regulators, rating agencies and the SEC, consumer finance companies have been forced to focus more on the assessment of the risks and controls within their organizations. Currently, most organizations have various levels of controls testing that are being performed throughout the year. Internal audit, external audit, risk management, compliance and quality control all are validating both operational controls and controls related to financial reporting for the organization. In addition, testing and management's assertion of Federal Deposit Insurance Corporation Improvement Act (FDICIA) Section 112, as well as the more recent Sarbanes–Oxley (SOX) Section 404 Act have placed increased demands on business units. Unfortunately, many consumer finance companies may be experiencing pains from overlapping risk management processes across these functions, as well as aggravated business units that feel as if they constantly sacrifice resources to comply with these important standards. One of the best ways to link all of these risk management processes is to develop a risk and controls self–assessment program that supports multiple control assessment needs.

Over the past 14 years, financial regulators and Congress have enacted legislation with the aim of protecting consumers and investors by requiring management to assess the strength of internal controls. Some examples include the FDICIA 112, and the more recent SOX 404, which concentrate on internal controls and management's role in the creation, maintenance and execution of those controls. FDICIA 112, a product of 1991 legislation, requires companies to document assertions for procedures followed and the effectiveness of these procedures. A review of these procedures is to be signed by management to ensure accuracy in financial reporting. In 2002, Sarbanes–Oxley strengthened these requirements.

SOX 404 required companies to include an assessment on the effectiveness of internal controls over financial reporting in their annual 10–K filings. These assessments must include management's responsibilities to establish and maintain internal controls and procedures for financial reporting. Based on the evaluation of the effectiveness of these controls, a conclusion by management must also be included in the assessment. External auditors later become users of these assessments in order to provide their opinion for inclusion in the 10–K.

Although not mandated by legislation, the complex nature of consumer lending and servicing also require management to understand levels of inherent risk and the strength of both financial and operational controls throughout the organization. Effectively identifying control weaknesses enables management to prioritize scarce IT and process engineering resources to address control weaknesses that may result in increased operational risk in critical processes such as underwriting, closing, funding, repurchases, default management, legal and compliance.

Risk and controls self–assessment program

A well–designed Risk and Controls Self–Assessment (RCSA) Program is a key risk management tool that can support the requirements of FDICIA 112, SOX 404, internal audit and other risk management processes. It can also help management assess operational risk levels and the adequacy of existing controls to mitigate inherent risks and provide them additional time to close gaps in advance of audits, regulatory reviews, and SOX 404 attestations. If properly executed, the RCSA Program will become a centralized process for assessing risks and controls that can be leveraged to comply with required reviews (i.e., SOX) and will help to eliminate the overlapping risk reviews/audits that business managers face on a regular basis. By helping to reduce the time spent by business unit managers documenting their risks and controls, they will have more time available to effectively run their units and manage their risks.

A RCSA Program typically requires management to identify, evaluate, and document key inherent risks and the design of controls for business processes. Inherent risks evaluated include not only financial and operational risks, but should also include fraud, strategic, reputational, regulatory and legal risks. Inherent risk levels can be assessed based on the potential impact to an organization if controls did not exist to mitigate the risk.

In our experience, the following critical success factors support the successful implementation of a RCSA Program:

- Executive management supports the RCSA Program—by stressing its importance to business unit managers and by allocating the appropriate level of resources to the program.
- A steering committee consisting of senior business line management representatives from key departments, as well as internal audit and compliance, oversees and administers the program, as well as reviews RCSA findings.
- A dedicated team of people is charged with the facilitation of the individual RSAs. These resources facilitate the review process and develop the documentation from the review, thus removing the burden of documentation from the individual business unit managers.
- Business unit managers realize that the self–assessment process is meant to be constructive and that an honest evaluation of risk level and control effectiveness is necessary.
- A process for identifying and evaluating inherent risks and controls maximizes consistency in evaluations across business processes.
- Documentation templates that support detailed documentation of risks and controls, as well as summarization of risk and control evaluations for the steering committee, are used.
- Business unit managers distinguish between controls that are designed to mitigate risks and business processes that have no control objectives, when evaluating and documenting the design of controls.
- Action plans for closing control gaps are identified during the self–assessment process. The successful completion of the action plan and closing of the control gap should be independently validated by the steering committee or an outside group such as internal audit during the next scheduled audit.

We have found that an RSA program enables risks and related controls/processes to be documented and monitored in a consistent fashion to meet multiple needs.

- The deliverables from a successful RCSA Program can be tailored to support FDICIA 112 risk and controls self–assessment reporting requirements.
- Internal audit can leverage the RCSA deliverables for audit planning purposes to prioritize upcoming audits, as well as focus audit procedures in high risk areas for specific business departments.
- Loan quality control and compliance programs can leverage findings from business unit self–assessments to better target quality control and compliance monitoring programs and resources.
- RCSA deliverables containing controls documentation can help refine existing SOX 404 test plans for internal controls related to financial reporting.

A RCSA Program is an effective way, with respect to both time and cost, for a financial institution to link many existing risk management processes. As regulators push financial institutions for more robust internal controls effectiveness measurement and management, the need for a robust risk and controls assessment process has never been greater.

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Notes on house price appreciation

It seems that every day we are bombarded with whitepapers, articles and media discussion related to rapid house appreciation and record loan origination and refinance volume. National house appreciation in July climbed to 14.1% growth year over year, according to data released by the National Association of Realtors. Areas such as California, New York, Nevada and Florida have experienced much more significant growth. Many factors effecting house prices are tied to local economics rather that national economics and therefore, the likelihood of localized bubbles is greater than a national bubble. As Alan Greenspan said, "It's pretty clear that it's an unsustainable underlying pattern." In this article, we will discuss the potential impact of slowing and/or decreasing property values, a rising interest rate environment and the trends in credit standards, all of which we are now begining to see.

Slowing and/or decreasing property values

A primary risk to both mortgage lenders and borrowers is associated with the potential decline in property values and therefore, the underlying collateral of the loan. If house prices decline, the collateral for mortgage products becomes less valuable. This, in turn, increases the potential for losses due to forced sale or foreclosure. With house price appreciation continuing to exceed record highs, the likelihood of a pricing plateau or pricing decline increases. This is especially true in localized markets such as the Northeastern and Southwestern coastlines. Slowing growth or decreasing values may have a variety of impacts on products such as I/O ("interest only") and option adjusted ARMs and HELOCs. In addition, borrowers that have purchased properties for investment purposes may be impacted.

The rapid increase in I/O and option adjusted ARM products may indicate borrowers are stretching their resources to obtain home ownership. These products are most popular in areas facing rapid house appreciation. The popularity of these products is derived from their ability to allow borrowers to acquire the maximum amount of house with the lowest initial payments. Option adjusted ARMs also allow the borrower to make minimal payments that are lower than the scheduled payment, introducing a negative amortization feature. Although many mortgage products are at risk in the event of a house price decline or plateau, the I/O and option adjusted ARMs face unique risks, since it is likely that these borrowers are already closer to their borrowing capacity. I/O products face risks when mortgage payments become fully amortizing and borrowers default due to their inability to make this higher payment. When a default occurs on an I/O at the time of reset, the unpaid principle balance is generally equal to the initial loan amount and could be greater than the house price in a declining market (depending on initial LTV). Similarly, option adjusted ARM products face similar risk in that they allow for a negative amortization. If borrowers default on these products, the unpaid principal balance for those borrowers optimizing the negative amortization feature of the product will exceed the unpaid principal balance and losses will unlikely be offset by house prices in the event of a plateau or decline.

Home equity lines of credit (HELOC) and Home equity loans (HEL) have also seen a rapid increase in popularity over the past few years due to increases in house prices, which create equity, and low interest rates, which creates attractive financing. In the case of a significant house price decline the home equity market could dry up and face significant losses if borrowers cannot maintain their payments on such loans during a rising rate environment.

HELOCs/HELs hold subordinate lien positions and can only recover their losses after the proprietary liens are satisfied. Therefore, the impact of declining house prices and defaults is likely greater for these products.

Another cause for concern in the housing market is growth in the investment sector. Investors' objectives and strategies are mixed but many believe they add speculation to the market. Some investors are purchasing homes for rental income purposes with the hopes to cash in on financial leveraging and rapid house appreciation. However, the group that causes greater concerns for lenders are investors who hold properties for a short–term investment hoping for rapid house appreciation and to sell the property at a gain. These investors often purchase homes with no expectation of rental income or with rental income not able to cover the minimum cost association with home ownership. If house prices start to fall or level off, many of these investors may default and simply walk away from these homes.

Increasing interest rate environment

In a rising interest rate environment, many borrowers may come under budgetary constraints to make higher mortgage payments associated with their adjustable rate mortgages and home equity lines of credit. If defaults occur as a consequence of interest rate increases, investors may experience higher than expected losses as they rely on the values of the property as collateral against losses. This interest rate driven default concern is increased by the ever popular discussion surrounding the housing bubble. If there is in fact a housing bubble, and it burst during a period of high default, losses could be dramatic.

Credit quality considerations

Credit quality is another concern for investors in mortgage products. Some lenders have recently started to tighten what were being suggested as relaxed credit standards. They have also begun to increase their positions in the subprime market. When credit standards are relaxed, the potential for default is generally increased and many historical measures of default may be inadequate to measure the additional credit risk assumed. Moreover, recent losses on mortgage products may have been disguised through increases in house prices.

Risk management strategies

Fast growing real estate markets, changing credit standards and increasing interest rates demand that mortgage lenders and investors continue to monitor and analyze their credit exposure.

The following methods will allow management to track and monitor its risk exposure:

- Utilization of loan level actual vs. modeled data warehousing solutions to analyze loan and borrower attributes such as geographic location, LTV, credit scores, etc. Use these to trend loan, borrower and market changes
- Development of trigger points and action plans to manage risk associated with these possible scenarios
- Automation of underwriting toolset and exception tracking software
- Risk Management Review Board
    - Companies looking at their models/assumptions at a localized perspective. Perhaps certain markets are too risky, too expensive, etc.
- Performance of stress tests on existing portfolios and measure the value at risk in multiple economic environments
- Modeling of the potential exposure to "payment shock" on adjustable rate products
- Review of risk and return exposure on new products
- Review of underwriting standards and controls in place to monitor compliance with those standards
- Establishment of a credit risk management team that has the ability to oversee production and reduce or eliminate production in markets where credit exposure outweighs returns
- A look at lending limits in markets viewed as "overheated"—i.e., only lend up to 90% LTV to build in some cushion in the event of price drop

Conclusion

As a result of the risk characteristics associated with new mortgage products discussed above, companies shoud continue to monitor, assess and respond to risks in a timely manner. Furthermore, companies need to determine their risk strategy and make business and risk management decisions in conjunction with that strategy. They should consider the utilization of loan level risk management tools to assist in identifying, quantifying and responding to risks.

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Accounting and financial reporting

Auto finance: credit risk and reserving

As in many sectors of consumer finance, automotive finance companies have reaped the benefits of reduced credit loss provisions. Lenders' efforts in recent years to reduce their exposure to credit losses from retained portfolios and loan/lease backed securitization paper have resulted in improving charge-off rates and modest releases of credit reserves. Improvements in the forecasting and management of credit risk have driven these reductions, which have naturally supplemented profit forecasts. Lenders have also benefited from a period of low interest rates, giving borrowers more latitude in meeting their monthly credit obligations.

In light of such positive news, the allowance for loan and lease loss (ALLL) estimate continues to receive a high degree of attention from regulators, most notably the Securities and Exchange Commission (SEC) and the Office of the Comptroller of the Currency (OCC). Though numerous publications have surfaced over recent years, authoritative guidance consistently states that financial institutions (including automotive lending institutions and automotive finance captives) must maintain a systematic, consistent and well-documented process for estimating their credit loss reserves. Such a reserving process necessitates a complete understanding by management of the credit risks faced throughout the automotive lending cycle. Identifying the risk drivers and their interaction among various lending facets, such as loss forecasting, loss mitigation and reserve modeling, will improve credit risk management and benefit this sector of consumer finance.

Background

Auto lenders recognize credit reserves to reflect the amount of losses incurred within an investment portfolio of loan or lease receivables. Losses are estimated from delinquencies that occur when a borrower fails to make a scheduled loan payment in accordance with contractual terms.

Per SEC Staff Accounting Bulletin 102,

> Generally accepted accounting principles (GAAP) for recognition of loan losses is provided by Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (SFAS No. 5) and No. 114, *Accounting by Creditors for Impairment of a Loan* (SFAS No. 114). An estimated loss from a loss contingency, such as the collectibility of receivables, should be recorded when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. SFAS No. 114 provides more specific guidance on measurement of loan impairment and related disclosures but does not change the fundamental recognition criteria for loan losses provided by SFAS No. 5. Additional guidance on the recognition, measurement, and disclosure of loan losses is provided by Emerging Issues Task Force (EITF) Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D-80), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FIN 14), and the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*.

Auto lenders will typically write-off loans that have become 120 days or more delinquent. Prior to default, servicers will attempt to cure the delinquency through some form of loss avoidance or mitigation. If mitigation is unsuccessful, the lender will assert its security interest in the vehicle to legally repossess and re-sell it at auction. Anticipated auction proceeds are compared to the unpaid principal balance and related operational expenses to estimate a loss. The estimated loss is then charged against any previously recorded credit loss reserve. Under the accrual basis of accounting, no specific income effect is realized at the time of the charge-off.

Evaluating loan and lease loss estimation criteria has been a high risk area for a company's senior management and independent auditors. Credit loss recognition timing is paramount, as an overstated ALLL will result in understated current earnings. The quality of current earnings for many auto lenders has been scrutinized by ratings agencies over recent periods. The SEC has repeatedly indicated that a creditor should not build the allowance in prosperous economic periods to provide for losses expected to occur in the future. This practice, whether deliberate or not, can be difficult to ascertain given the inherently subjective nature of judgments required in evaluating the wide array of factors underlying a credit loss reserve estimate.

With the implementation of the Sarbanes-Oxley Act of 2002, public auto lenders are now responsible for ensuring that controls are in place to consistently determine the ALLL in accordance with the company's stated policies and procedures, relevant regulatory guidance and GAAP. Specifically, lenders must maintain an ALLL at a level that is appropriate to absorb incurred credit losses inherent within their retained portfolios. This includes both observed losses (e.g., >120 day delinquencies), and unobserved losses arising from some loss event (e.g., job loss, divorce, etc.) that are expected to become observed over a supportable impairment window. Losses should not be recognized before it is probable that they have been incurred, even though losses may be probable based on past experience or expected future trends. These types of considerations require a high degree of management judgment that inevitably results in a range of estimated losses. Management is then responsible for choosing the best point estimate from this defined range, and must re-evaluate this estimate on a recurring and timely basis.

Credit loss forecasting

Auto lenders have better data and forecasting tools than ever before, and staffing devoted to risk management has increased. Many lenders have also improved their portfolio's credit quality by exiting riskier lending practices or selling higher risk loans into the secondary market. This practice has helped lenders manage risks and improve forecast precision.

Detailed loss forecasting begins during the underwriting process. Acceptable risk criteria can be extrapolated to a pool of similar loans to help predict losses. Borrowers with a higher risk profile are then generally assessed a higher interest rate to compensate for the increased risk. However, many auto lenders have been challenged by extremely competitive market conditions, where interest charged to the borrower is often impacted by market incentives, providing little benefit under high loss scenarios. Zero percent APR and other bargain financing alternatives, while generating higher origination volumes, have prevented lenders from simultaneously offsetting risk through higher rates. Auto captives have an enormous competitive advantage over other lenders in this regard, as they generally receive subvention payments from their parent automotive company to compensate for rate incentives that lure borrowers. These subvention payments allow auto captives to earn an appropriate risk-weighted rate of return while still offering below market rates to consumers.

Losses for prime transactions tend to occur early on, with limited defaults coming later in the loan/lease term. As the down payment or principal invested increases, defaults should decrease due to the reluctance of the borrower to forfeit equity in the vehicle. Non-prime borrowers may only qualify for loans with low payments, which are typically achieved by lengthening the contract term. This practice can be risky for auto lenders as public research suggests that charge-offs among extended term loans outweigh charge-offs from contracts with shorter terms. Principal will also amortize more slowly, thus increasing loss severity in the event of borrower default. Lenders must therefore consider the risks associated with extended term loans and leases, and build a reserving model capable of capturing embedded losses that may not become observed until later in the loan term.

In addition to heightened credit risk as average durations rise, vehicle values tend to depreciate much faster than loans amortize, causing loss severities as a percentage of unpaid principal balances to trend higher in the auto industry than many sectors of consumer finance. Unlike mortgage collateral that often appreciates, passenger vehicles tend to swiftly depreciate during the vehicles' first few years of service. This reduces the borrower's ability to refinance since the loan balance may be higher than the underlying collateral's worth. Interest incentives will also reduce the likelihood of loan prepayments and refinancing activity. By locking in borrowers at attractive rates, "low APR" loans may not generate sufficient interest income to offset potential credit losses incurred. These factors contribute to increased charge-offs as resale values are usually declining both before and after vehicles are repossessed in the event of default.

Lenders should also monitor the geographic makeup of their loan and lease portfolios and strive for geographic diversification to minimize exposure to regional economic downturns. Revised origination targets or other risk management measures should be utilized to maintain portfolio credit quality while exercising fair lending practices. Lenders should also be aware of the bankruptcy laws and repossession requirements of different states, as these factors can greatly influence the timing and severity of losses.

Loss mitigation

Once a loan is written, effective loss avoidance and mitigation begins with the servicing function. Loan servicing is one of the most critical aspects of loan performance, as an ineffective servicer will adversely affect loss rates. An interruption to, or transfer of the servicing function, is also likely to hinder credit performance. A servicer's consistency, financial health and ability to accommodate portfolio growth is therefore highly relevant when forecasting losses and setting reserves. Larger auto lenders will typically establish service centers in different geographic regions or high origination areas to ensure efficient collections and dispute resolutions.

The servicer plays a key role in tracking delinquencies and enforcing loss mitigation in addition to its payment collection obligations. A typical default can occur as early as three months after the initial delinquency has been observed, leaving the servicer a short window to establish contact with the borrower and take corrective action. Consistent and timely loss mitigation procedures should be employed to avoid vehicle repossession, which is usually the most costly collection alternative. Collections should be flexible enough to allow the borrower sufficient time to work around the event causing delinquency, yet should require that repossession proceedings occur quickly when nonpayment becomes inevitable. Bankruptcy laws can hinder the repossession process, as many states allow the filer to retain their vehicle for work transportation to help repay more senior debts. Small balance charge-offs, grace periods and other loan restructuring alternatives should be explored, but these practices should only be applied under specified circumstances. Exceptions should be explicitly authorized, but also reviewed to refine mitigation criteria as repayment patterns emerge.

Once authorized, repossession will occur to offset unpaid balances and other recovery costs. The lender may also realize additional recoveries through subsequent legal cases against the borrower. Regardless, it is imperative that the lender act quickly to repossess the vehicle, as efficient repossessions ensure the vehicle draws the highest possible resale proceeds. Repossession proceeds may be marginalized by declining residual values whether the vehicle remains with the borrower, remains vacant during pending litigation, or sits idle on a lender's auction lot. Establishing a positive relationship with the borrower can help reduce these losses, especially high dollar charge-offs associated with "skips" or vehicles that are hidden or abandoned by the borrower and cannot be located. Skips can greatly exaggerate average severities and highlight the need for consistent contact with the borrower throughout the collection process.

A properly governed and well controlled accounting infrastructure that provides accurate and timely payment and collection data will help facilitate the overall collection process. Event modeling accounting systems can also assist the servicer in identifying key portfolio attributes that alert management of potential slowdowns or busy periods so management can budget and staff accordingly.

Credit loss reserving

Numerous factors need to be considered when establishing and evaluating the adequacy of the ALLL. Historical charge-off rates and loss ratios (often used for evaluating impairment for loans collectively evaluated under FASB Statement No. 5) may be more or less predictive depending on any changes in economic conditions, any changes in a financial institution's lending behavior (higher quality borrowers, in particular, have led to improving average credit scores and better performance of more recent vintages.), and any changes in competitive pressures related to profit expectations or market share.

Lenders often assign loans into vintages that can be monitored for delinquency or charge-off "roll rates" that assist in extrapolating portfolio trends. Relying on historical static pool information to gauge future losses would only be sufficient if the past were a perfect predictor of the future. Static pools will only capture performance over a specific period and will have unique macroeconomic factors influencing their outcomes. It is therefore important to evaluate the economic conditions present as of the current financial statement date to capture the proper impairment period.

Lenders also utilize information derived from credit bureau reports during the underwriting process to set a baseline estimate for the general credit quality of their portfolio. Monitoring the credit tier build of a loan or lease portfolio is important for reserving purposes, as management's sales objectives (i.e., easing underwriting standards in order to boost volume) can cause deviations in reserving needs that may not be captured by historical indicators.

The majority of originators will then use some form of credit monitoring (i.e., analyzing delinquent loans to identify significant predictors of default) to assist in the subsequent loss forecasting and reserving process. Technical risk modeling groups often perform this function. Consistent validation and self-correcting mechanisms reviewed by the lender's accounting or finance team will ensure the model has met the objectives of management, is in accordance with GAAP, and is Sarbanes-Oxley compliant. Additional collateral and borrower attributes, including vehicle age, price, down payment, interest rate, depreciation, term, geographic trends and loan type should also be considered.

Conclusion

Public stakeholders and regulators continue to place emphasis on proper credit risk management and sound reserving practices by automotive lenders. Credit reserving for auto loans and leases can be very difficult when considering the high volume and short duration of auto backed products compared to other types of loans. Cyclical trends can have an immediate effect on auto collateral residuals, which highlights the need for a well governed and systematic reserving process that complies with GAAP. Event modeling systems can help managers capture historical loss indicators as well as changes in the current macroeconomic environment to properly measure impairment. This will help to ensure a properly valued portfolio, and also firm up profit forecasts as reserve accruals become more precise.

For more information on credit risk and reserving for auto finance, please contact Chris Abate at 415–498–7693 or at christopher.abate@us.pwc.com.

Basel II: Can you afford to tune out?

The Basel Committee on Banking Supervisors has released an international framework that updates the framework for measuring capital requirements first established in the 1988 Basel accord. This new framework, called Basel II, permits organizations to incorporate their unique risk profile associated with credit, market and operational risk into the computation of capital as opposed to basing capital on standardized allocation methods. Basel II is set to be implemented by 2008. Regulators announced in October 2005 that there will be a delay in full implementation. Compliance will still begin in 2008, but will run in parallel and be phased in over four years. Regulators have also just announced a new ANPR for the development of Basel 1A, targeted specifically at smaller US Banks and Thrifts.

Compliance

The new Basel II standards will have an impact on selected banks within the U.S. banking system. Banks with total assets of at least $250 billion or total on–balance sheet foreign exposure of $10 billion are required to comply with the new framework. Also, the scope of application has been broadened to encompass bank holding companies that are parents of internationally active banking groups. Additionally, “Tier 2” banks may also choose to opt into the advanced approach and therefore will be required to meet Basel standards. It is expected that between ten to twenty U.S. banks will be required to comply with Basel II.

Under Basel II, banks will be required to calculate their capital requirements based upon credit risk as well as operational risk. These computations will be driven by a bank’s individual historical loss experience associated with various asset classes and segmented into various risk components. Various computations surrounding the probability of default, the exposure of a credit at default, and the loss expected on defaulted credit will be required. The impact of operational risk on capital had not been a component of capital under the 1988 Basel Accord, but is under the new regulations. Compliance issues associated with the computation of risk are anticipated.

U.S. regulator actions

The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corp. and the Office of Thrift Supervision had intended to publish a notice of proposed rulemaking in the middle of 2005 regarding U.S. implementation, but have agreed to a delay to better assess the results of a recently completed quantitative impact study. The results of the study were initially inconclusive as responses to the study provided no uniformity of approach and larger than expected variances in final capital computations. The joint regulators were expecting to issue the final ruling in the first quarter 2006, but recently announced that they will issue a revised ANPR instead.

Potential consequences in the United States

The banking community is conflicted as to whether implementation of Basel II will create disparities in the U.S. marketplace for credit instruments. There will definitely be differences in the minimum capital standards observed by companies within the United States. For example, capital required for residential mortgages under Basel II may drop to one–half to one–quarter of the capital required under the 1988 Accord. On the other hand, capital required for operational risk may offset partially, or in full, this advantage. Losses due to fraud may be a significant factor in computing operational risk and may severely impact an organization's level of required capital.

A reduced level in required capital may provide Basel II compliant banks with a competitive advantage over Tier II non–compliant banks. Major regional banks are likely to be impacted the greatest by this. These banks may tend to opt out of certain lending practices or may decide to merge with compliant organizations, which would increase the trend of consolidation in the banking industry. However, representatives of the Federal Reserve have contended in recently prepared speeches that they do not expect this disparity to occur as the pricing of lending instruments, especially mortgages, will be driven by secondary marketing conditions, not by minimum regulatory capital requirements.

What banks need to do

Whether a bank decides to opt to comply with Basel II or not, there are steps that should be considered in addressing the decision to comply.

- Become familiar with the provisions of the Basel II accord and subsequent notices of proposed rulemaking.
- Assess the cost of gathering data for compliance with the provisions. The gathering of historical and prospective data most likely cannot be accomplished through existing corporate data warehouses and will require a cost–benefit analysis regarding going forward with implementation. Determine how long it will take to complete the process of gathering data and to change business practices and operating systems to gather data prospectively.
- Determine if the changes in capital requirements will affect the cost of doing business from a cost of capital perspective, or whether products will be priced based upon secondary marketing conditions.
- Examine modeling capabilities to convert data captured into required loss given default computations, including any present value computations.
- Determine whether U.S. agencies are expected to require a full implementation of Basel II or will recommend an approach that may be a hybrid of the two Basel standards.
- Develop a framework to quantify capital requirements associated with operational risk factors.

Banks may lose the opportunity to offer competitive pricing of their lending products against other financial institutions that achieve an advantage by reducing their cost of capital through Basel II compliance. Banks should begin today to assess the costs and benefits of Basel II compliance.

For more information regarding Basel II implementation and compliance considerations, please contact John Adams at 240–447–4071 or at john.m.adams@us.pwc.com.

Measuring and recording loan origination costs under FAS 91

A lender generally performs certain activities to process a borrower's request for credit. Those activities may include: evaluating the prospective borrower's financial condition; evaluating and recording guarantees; collateral and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction.[10] With the issuance of the Financial Accounting Standards Board Statement 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91), those fees and costs are required to be deferred and recognized over the life of the loan as an adjustment of the yield using an interest method. To comply with the Standard, lending institutions are required to develop a costing approach to help identify, capture and record the direct loan origination costs. In the following article, we outline the various methods used by different lending institutions to recognize or capture these origination costs as part of their financial reporting process.

FAS 91 was established in 1987 in response to an AICPA Issue Paper that indicated a diversity in practice in the accounting for nonrefundable fees and costs associated with lending activities. Prior to the Statement, lending institutions charged acquisition costs to expense and recognized all or a portion of origination and commitment fees at the time the loan was funded. These recognition methods were determined inappropriate because they did not match the entity's efforts (direct lending costs) with its accomplishments (loan interest income). To provide for a standardized recognition criteria that would allow a lending institution to recognize direct lending costs as a component of the loan yield, FASB issued the Statement. The provision of this Statement had an impact on all lenders including banks, thrift institutions, insurance companies, mortgage bankers, and other financial and nonfinancial institutions. In order to comply with FAS 91, lenders were challenged to develop costing methods that adequately captured all direct lending costs in an effective and efficient way. By 1989, all affected institutions had adopted and disclosed their application of FAS 91.

Fifteen years later, an increased focus on accuracy and transparency of financial reporting has again raised questions as to how lending institutions are complying with FAS 91 requirements. Many lenders have been required to review and assess their current practices and methods in estimating FAS 91 deferred fees and costs. In some cases, institutions have updated their legacy approaches with new and more effective methods of estimating direct origination costs. It is these approaches to capturing and measuring origination costs that will be discussed in the remainder of this article.

Evaluating cost methods and approaches

The first step when performing an assessment for compliance under FAS 91 is to review the entity's overall origination process. Origination costs that are covered by FAS 91 represent the costs associated with direct activities performed by a lender when processing a borrower's request for credit.[11] In general, those activities will occur from the time a lender is evaluating the borrower's initial credit application up until the credit request has been processed and closed. Lending activities[12] consider by FAS 91 to be directly related to the loan origination process are:

[10] FAS 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, par 36.

[11] FAS 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, par 6.

[12] Q&A 91—A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers, par 9—24.

- Loan counseling, such as discussing alternative borrowing arrangements with borrowers, and negotiating terms
- Application processing
- Appraisal
- Initial credit analysis and investigation
- Quality control review performed during the underwriting period
- Direct approval processing
- Loan evaluation and approval committees (all activities involved in origination decisions)
- Loan closing

Further, lenders may also incur direct costs that are not reimbursable by the borrower when processing a loan application. These costs are also deferrable under FAS 91. Examples of these costs may include:

- Any incremental direct costs of loan origination incurred in transactions with independent third parties during the loan origination process
- Travel expenses such as air travel and hotel accommodations incurred by personnel directing lending origination activities
- Application process fees, title search and appraisals

When reviewing the loan origination process, lenders must also consider different loan origination channels, processing centers and any credit efforts that may be undertaken to review and approve a loan application. Once an entity has determined their direct lending activities the next step is to assess their current approach to capturing all direct origination costs. It is important to determine at what level the cost development and analysis take place. For example, some lenders have performed cost studies based on loan products while others have viewed the most effective assessment based on size and frequency of origination activities.

In general, lending institutions should strive to apply the most effective cost approach when capturing FAS 91 costs and activities. There are various study approaches available to capture direct origination costs. The most commonly used are:

- Successful efforts approach
- Time and motion approach
- Walkthrough and interview approach

Successful effort approach

In this approach, all costs are specifically tracked in the entity's general ledger, i.e., actual expenses are tracked and recorded by loan type or activity, personnel expenses are tracked by activity and can be subsequently adjusted for idle time and time spent on non–origination activities. Lending institutions use this type of approach when all direct loan origination activities and costs can be clearly identified and tracked for reporting purposes. Once all activities have been captured, the appropriate FAS 91 costs are allocated based on overall successful origination efforts. The success rates applied should be based on the company's past records. In general, an entity tracks its successful loan origination rates for a period of time (3 to 12 months) to develop the overall success rate. This percentage is then applied to the actual expenses to arrive at the total FAS 91 costs for the period examined.

Time and motion study approach

This method is mainly used by entities that have retail branches as their main origination channel. For example, this approach has been found effective by lending institutions for loans that are originated in branches where the employees perform non–origination activities, such as taking deposits and helping customers set up checking, savings and investment accounts, in addition to performing loan origination activities, such as taking applications or closing loans. Applying this method allows entities to track and estimate what portion of the employee's time is spent on origination activities.

Walkthrough and interview approach

This approach involves gaining an understanding of the different steps involved in loan origination and interviewing the individuals who perform the steps in order to develop a reasonable estimate of the time and costs associated with loan origination. This approach is used by entities when the other two approaches described above are not reasonable given the nature of the loan type and/or channel. The approach would be appropriate in situations where new loans are not frequently originated (i.e., only four new loans are originated each quarter) or the loan origination process requires an extended period of time (i.e., it takes an average of six months from the time an application is submitted to the time the loan is closed). In these cases, it may not be practical or possible to track a sample of loans through the origination process.

Cost development

Lending institutions must carefully examine their loan origination activities when evaluating and determining the cost method for capturing direct origination activities. In the process of establishing the most effective method, lenders should consider loan products, loan channels, loan sizes and frequency of origination activities. A loan product originated by various channels using one cost approach may not be the most effective method of capturing all FAS 91 activities. In other instances direct lending activities for a specific loan product may be viewed as immaterial compared to other products and the entity may determine that analytics will be the most effective study approach. For example, entity A originates two products using one channel of origination. Product 1 is widely used and very popular among the entity's customers. Product 2 is rarely used and generates only 1% of the total origination volume. For purposes of capturing FAS 91 fees and costs, the entity may determine that analytics such as reviewing overall direct costs and allocating them proportionally to Product 2 will be the most efficient method given the size and materiality of the transactions.

After reviewing the loan origination process, identifying the direct lending activities and determining which cost method is most effective, the next step is the application of the cost study. Cost studies will require time and effort from various resources throughout the organization. Based on the size of the institution and overall origination process, many lenders have created an oversight committee to monitor the process. Institutions have found that a committee is able to monitor the execution of the cost study and ensure that agreed upon methodology is consistently applied for the various loan products identified by the institution. In addition, a committee will ascertain that the cost study is adequately performed and documented especially when documentation is a key element in a 404 control environment.

When the studies are completed, the institution must assess and review the results. When results substantially differ from previous estimates, management will have to address and evaluate the proper accounting treatment. It is very important for lending institutions to understand prior cost studies and how substantially different the overall approach and cost activities were compared to the new and refreshed study approach. Side by side analysis will provide management with more insight as to how results should be treated. Furthermore, lenders should also consider how this process will be evaluated and assessed for appropriateness and how it will be applied on a go forward basis.

Lenders must maintain a well documented and controlled process for determining direct loan origination costs. It is important that, regardless of which approach is selected, the end results are transparent and validated. It is also important that the overall methodology is assessed and reviewed on a regular basis to ensure appropriate application of the Standard. This is imperative where new products, channels and business lines are created. A well thought–out process will help lending institutions to continue to improve the quality and transparency of their financial reporting around FAS 91 deferred fees, including disclosures around critical accounting estimates.

For more information on FAS 91, please contact Jivka Batchvarova at 206–398–3632 or at jivka.i.batchvarova@us.pwc.com.

Implications of the proposed reduction in the minimum servicing fee

The mortgage banking industry is engaged in a debate regarding the minimum servicing fee rate currently paid by Fannie Mae and Freddie Mac for loans in their mortgage backed securities (MBS). The debate began when several lenders approached Fannie Mae and requested a reduction in the minimum service fee rate. Since then, Freddie Mac has also entered the discussion as a result of Fannie Mae bringing the subject to the Mortgage Bankers Association.

The minimum or normal servicing fee rate of 25 basis points for single family, fixed–rate loans was established by the Government Sponsored Entities (GSEs) during the mid 1980s. The rate was established at 25 basis points to ensure that servicers could cover the cost of servicing mortgages in MBS pools as well as to ensure that all costs associated with a transfer of servicing from one lender to another would be covered. While many industry participants currently retain servicing fees in excess of the minimum, referred to as excess servicing, certain industry players are now pushing the GSEs to reduce the minimum to as low as 12.5 basis points. Other companies, both large and small, are pushing back against the proposal.

Due to the competitive nature of the servicing market, the GSEs implemented the 25 basis point minimum to promote best practices in the hope that quality would not be traded for efficiency. In this article we explore the question: will lowering the minimum servicing fee uphold the original intent?

Arguments made by proponents

Those who are lobbying for the reduction in the minimum service fee rate put forth several arguments that are outlined below.

- **Greater alignment between servicing revenues and the cost of servicing.** Principal loan balances have increased significantly in the past 20 years, which has driven servicing fee revenue on a per loan basis to similar highs. In addition, credit quality has remained steady and servicing efficiencies have been realized largely due to improved technology. As a result, the disparity between servicing fee income and servicing costs has increased dramatically. According to one servicer, the cost to service a conventional conforming loan with an average balance is now only 3 basis points. If the GSEs' original intent of setting a minimum was to ensure servicers generated enough cash flow to cover the cost of servicing loans, a reduction of the minimum servicing fee would bring the two more in line without deteriorating servicing quality.
- **Greater flexibility in determining the amount of servicing rights to retain.** By lowering the minimum rate, companies would be given more latitude to manage their servicing portfolio from a risk management perspective. Those desiring to decrease their servicing asset investment would readily have that option available, while the option to retain servicing in excess of the minimum would still remain. For example:
  - Companies that wish to reduce the volatility of their earnings could do so by reducing their servicing asset investment by retaining a lower minimum servicing fee. The smaller servicing asset would reduce both the company's risk exposure and the potential for earnings volatility.
  - In addition, a reduced servicing asset investment would also give companies less of an asset to hedge and lower regulatory capital requirements. This flexibility may allow for companies with capital constraints to increase their growth potential.
- **Fewer barriers for small to mid–sized companies to enter the market.** The reduction in the minimum servicing fee has the potential to ease the entry of smaller scale servicers that may have hesitated previously due to the size of the

servicing asset. While it would still remain a very complex asset to manage from a risk and accounting perspective, the opportunity to reduce the asset balance may attract new servicers.

Arguments made by opponents

Those opposed to any reduction in the minimum service fee rate have also put forth several arguments that are presented below.

- **A misalignment of servicer and bondholder interests.** With potentially less future income at stake, servicers would have less of an incentive to minimize prepayments. As a result, there is a risk of adverse selection based on the level of servicing retained. The misalignment of interests could also negatively impact the liquidity of the To Be Announced (TBA) market by causing investors to remove their investment from the market.
- **Need for servicing fee to adequately cover the cost of transferring servicing from a distressed servicer.** Occurrences in the credit card asset–backed markets have provided instances where current levels of servicing fees sufficiently covered the cost of servicing, but were not able to compensate for the cost of transferring servicing during a distressed asset disposition.
- **Potential for the servicing asset to become a servicing liability.** Given the current interest rate environment, adjustable rate mortgages (ARMs) and refinancings into ARMs have become very popular. If interest rates were to rise to a point where it begins to significantly affect mortgage payments, and subsequently, default and delinquency rates, a significant degradation of credit quality could potentially result in the servicing asset being converted to a servicing liability.
- **Changes in GSE processes and requirements.** GSEs leverage the servicing asset by seizing it when servicers fail, perform inadequately or refuse to honor repurchase agreements. A smaller asset provides less protection for the GSEs, which could result in higher guarantee fees or more stringent collateral requirements.
- **Increased industry consolidation.** Increased consolidation in the industry could occur as a result of large servicers acquiring servicing market share more quickly as servicing becomes less expensive. Greater concentration could also result due to the relatively higher costs of operations incurred by smaller servicers.
- **Potential negative impact on the TBA market.** The change could cause the TBA market pricing to be segmented between MBS with higher servicing fees and MBS with lower servicing fees. This segmentation could impair the liquidity of the TBA market and affect pricing.

Tax considerations

In addition to operational impacts, there are also tax considerations that must be examined as part of this debate.

Since 1991, the IRS has allowed for a safe harbor from capitalization of normal servicing fees that is aligned with the GSE minimum (generally 25 basis points). This safe harbor permits companies to forego capitalizing the normal servicing fee asset for tax purposes, thus allocating more basis to the mortgage loans resulting in taxable income being less than GAAP income. When a servicer retains servicing fees above the safe harbor rate, referred to as excess servicing fees, capitalization of this excess servicing asset is required for tax purposes. All other factors being equal, lowering the minimum servicing fee to 12.5 basis points may cause the IRS to reduce the normal servicing fee safe harbor amount, thereby increasing the amount of excess servicing fee retained with a corresponding increase in the current income tax burden to the servicers. For certain industry participants, this could have a very significant effect. Reductions in the minimum servicing fee, if adopted, may also have other tax implications or opportunities for servicers that buy or sell servicing rights.

Ginnie Mae's minimum service fee reduction

During 2003, a minimum service fee rate reduction was made in the Ginnie Mae II MBS ("Ginnie II") program. The minimum servicing fee was dropped from 44 basis points to 19 basis points. With the adoption of the lower minimum, Ginnie Mae has seen an increase in the placement of mortgages into Ginnie IIs. According to Ginnie Mae executive vice president Michael Frenz, approximately one–third of single family, fixed–rate mortgages securitized through Ginnie Mae were previously placed in Ginnie IIs compared to the fifty percent that are now placed in Ginnie IIs.

The Mortgage Bankers Association (MBA) has noted that since the reduction, retained servicing fees (including normal and excess) associated with Ginnie IIs have remained in the 40 basis points range. There are no definitive answers as to the reasoning behind the retention of servicing in the 40 basis points range; however, it should be noted that differences exist between the programs offered by Ginnie Mae and the GSEs, including the fact that buy–ups and buy–downs are not offered by Ginnie Mae. In relation to the GSE environment, the MBA also referenced the fact that even with the 25 basis point minimum; many lenders choose to retain excess servicing, thereby increasing their MSR investment.

Reducing the minimum servicing fee is a topic that will continue to receive much attention in the industry. Though the specific repercussions of such a move will not be known unless the change is made, the impact has the potential to be pervasive. It is clear that more data needs to be analyzed, more results need to be studied, and industry participants must elevate their viewpoints and concerns to the forefront of the debate. As the movement to reduce minimum service fees progresses, companies should also begin to explore and evaluate alternative strategies for financing the increased excess servicing assets that may be created.

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Understanding Regulation AB

The registration, disclosure, and reporting requirements for publicly issued asset–backed securities (ABS) are governed by the Securities Act of 1933 and the Exchange Act of 1934.[13] The modern asset–backed securitization market did not exist at the time of the creation of these laws, and as a result, the process of asset–backed security registration has been revised several times by Congress and the Securities and Exchange Commission (SEC) to better reflect the needs of the ABS market.

On December 22, 2004, the SEC published final regulations, labeled "Regulation AB,"[14] that, among other things, consolidate and codify existing interpretative, primarily client–specific positions that clarify the Securities Act registration requirements for asset–backed securities offerings. We will highlight the three key changes required by this new regulation:

1. Changes to the required disclosures associated with the securities registration process
2. Changes to the Exchange Act reporting requirements for ABS
3. A new annual servicing assertion and accountant's attestation report

Transition timeline

Only those securitizations that meet the definition of "Asset–Backed Security" issued through the SEC registration process (S–1 and S–3) are covered by Regulation AB. Therefore, privately issued securitizations are not subject to the regulation.

All public asset–backed issuances commencing after December 31, 2005 will be subject to the new regulatory requirements. Those issuances commencing on or prior to December 31, 2005 will be grandfathered in their entirety. Nearly all issuers will need to file amendments to their outstanding registration statements, ensuring compliance for takedowns after December 31, 2005 under the new rules. In some cases, registrants will have a grace period extending through the first quarter of 2006.

Assuming ABS registrants file on a calendar year basis, the first 10–K filed under the new rules would be due no later than March 2007. However, master trusts not filing on a calendar year basis may be subject to the new rules as early as March 2006. The new monthly report, Form 10–D, will be required to be filed as early as January 2006.

[13] PricewaterhouseCoopers has prepared this article regarding Regulation AB in order to provide a framework for a general understanding to a user of such information. PricewaterhouseCoopers does not practice law, and is not in this article interpreting the requirements of the U.S. securities law and regulations or providing legal advice. Readers should seek advice from legal counsel with regard to any matters of law related to the preparation or understanding of information related to Regulation AB.

[14] ABS transaction fails to comply with Exchange Act reporting requirements. Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506] (the "ABS Adopting Release"), available on the Web at http://sec.gov/rules/final/33–8518fr.pdf

New disclosure regulations for ABS securities

The new Form S–3 instructions for ABS, as described in "Regulation AB,"[15] specify incremental information that must be reported in the registration documents. Issuers will need to determine which information is applicable and material for each offering.

Perhaps one of the most significant of the new requirements is the static pool analysis. The static pool information presents the performance for specific types of assets originated at different points in time. By comparing the performance of originations at similar points in the asset life cycle, investors can evaluate trends or patterns that may not be apparent from overall portfolio data.

The SEC believes that investors will benefit from static pool data regarding delinquency and loss history critical information in evaluating their investment in asset–backed securities. The new SEC regulations require disclosure of static pool data if material to the transaction.

In general, static pool data will be required with respect to the delinquency and loss experience of the sponsor's overall portfolio, or from prior securitized deals, for the past five years, or a shorter period when appropriate. The data should be presented in increments, monthly or quarterly, that are material or significant to the asset type being securitized.

Given the enormous amount of historical data for which disclosure may now be necessary, the SEC will provide issuers with the option of posting static pool data on a web site rather than including it in the prospectus. The process of finding, capturing, reviewing and reporting static pool data will be a challenge for even the largest of ABS sponsors.

Changes to the Exchange Act reporting requirements

Under the existing reporting system, periodic distribution and pool performance information is generally filed on Form 8–K in lieu of filing quarterly reports on Form 10–Q. However, investors are not able to easily distinguish these Form 8–K reports from other reporting on Form 8–K, such as the reporting of extraordinary events or the filing of transaction agreements.

The SEC is adopting a new Form 10–D, to act as the report for the periodic distribution and pool performance information. Every asset–backed issuer subject to Exchange Act reporting requirements will have to make such reports on Form 10–D and to file the report within 15 days after each required distribution date. A report will be necessary regardless of whether the required distribution was actually made or whether a distribution report was in fact prepared or delivered under the governing documents.

[15] Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506] (the "ABS Adopting Release"), available on the Web at http://sec.gov/rules/final/33–8518fr.pdf

With Form 10–D, issuers must provide information required by Item 1121 of Regulation AB and attach as an exhibit to Form 10–D the distribution report delivered to the trustee or security holders. The stated expectation is that all or most of the distribution and pool performance information required by Item 1121 will be included in the distribution report. If all of the required information is not in the distribution report, the missing information must be provided in the Form 10–D itself.

The final regulations add a separate general instruction to Form 10–K—Instruction J—to specify how the form is to be used with respect to ABS. Key changes include a specific Sarbanes–Oxley 302 certification and a statement of compliance with the applicable servicing criteria (defined in Regulation AB) from all parties participating in the servicing function.

The final regulations are specific and limiting with respect to who is permitted to sign ABS Exchange Act reports. For Forms 10–D and 8–K, the report must be signed by the depositor. “In the alternative,” however, the report may be signed on behalf of the issuing entity by a duly authorized representative of the servicer. With respect to Form 10–K, such annual reports must be signed either (i) on behalf of the depositor by the senior officer in charge of securitization of the depositor or (ii) on behalf of the issuing entity by the senior officer in charge of the servicing function of the servicer.

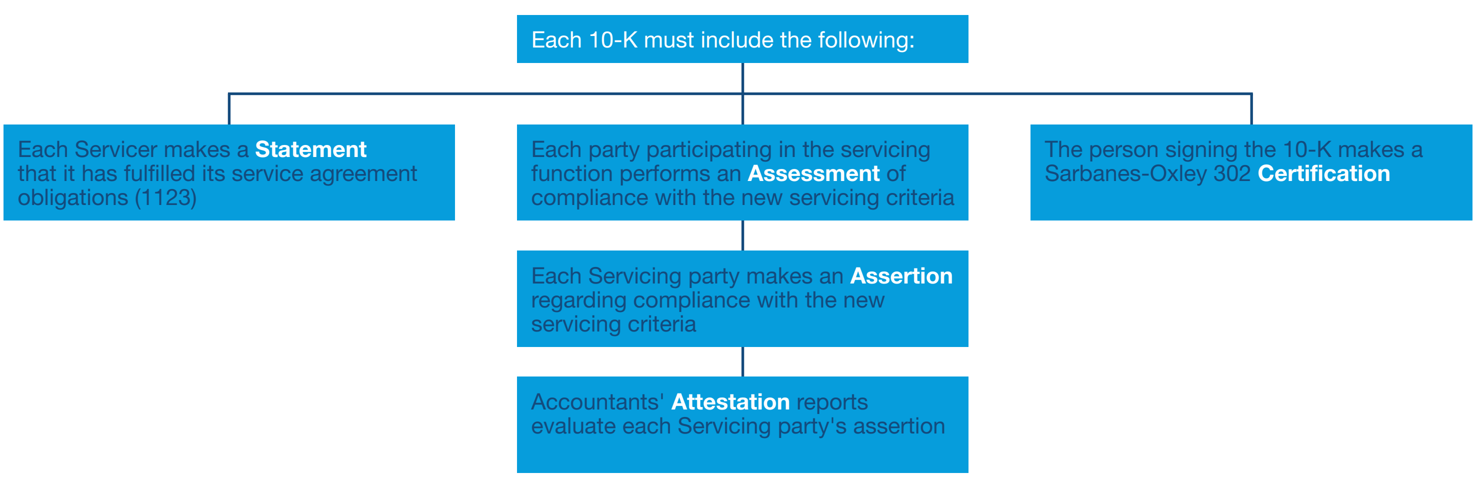
Servicers and depositors have already begun to analyze the additional information that will need to be reported on Forms 10–D and 10–K. The new forms will require changes to both information systems as well as the processes by which organizations gather and report the required information.

The annual servicing assertion and accountant’s attestation report

A servicer assessment report will be required from each party participating in the servicing function of an ABS, containing the following:

1. A statement of the party’s responsibility for assessing compliance with the servicing criteria applicable to it.
2. A statement that the party used the servicing criteria (as defined in 1122 of Regulation AB) to assess compliance with the applicable servicing criteria.
3. The party’s assessment of compliance with the applicable servicing criteria as of and for the period ending at the end of the fiscal year covered by the Form 10–K report. The report must include disclosure of any material instance of non–compliance identified by the party.
4. A statement that a registered public accounting firm has issued an attestation report on the party’s assessment of compliance with the applicable servicing criteria as of and for the period ending at the end of the fiscal year covered by the report on Form 10–K.

The report is to include an assessment of the servicing function as of the end of, and for a full fiscal period (or the applicable partial period in the case of the initial report), rather than at a single point in time. Also, servicing compliance is to be determined at a “platform” level, rather than at a transaction–specific level. This platform level reporting approach assumes that the asserting party will assess compliance with respect to all ABS transactions involving such party that is backed by assets of the type backing the ABS covered by the Form 10–K report.



A new “Attestation report on assessment of compliance with servicing criteria for asset–backed securities” in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning an asserting party’s assessment of compliance with servicing criteria, will be required under the Regulation and in accordance with standards on attestation engagements issued or adopted by the Public Company Accounting Oversight Board (AT § 601).

The report issued by the registered public accounting firm must be available for general use and not contain restricted use language. The SEC believes that the servicing criteria adopted as part of Item 1122 of Regulation AB are suitable criteria, as that term is defined in the SSAE No. 10, and are available to enable a registered public accounting firm to issue a report on a party’s assertion without restricted use language. These procedures will largely be incremental to procedures often performed today under the Mortgage Banker’s Association “Uniform Single Attestation Program.”

Material instances of non–compliance during the reporting period, even if such non–compliance was subsequently corrected during the reporting period, must be disclosed on Form 10–K.

Conclusion

PwC views the implementation of Regulation AB as a positive initiative for the U.S. structured finance markets in general. However, some issuers may be challenged initially as they attempt to grasp the breadth of the regulation’s requirements and the exact interpretation of certain sections.

With the deadline for compliance rapidly approaching, key considerations include ensuring enterprise–wide compliance with the regulation, development of contingency plans for possible non–compliance, monitoring the process and expense of implementation, and managing significant system/data changes that may be necessary to comply with the new reporting requirements. These issues, if not addressed properly, could cause timing delays in new issuances and restatement of noncompliant servicer reports, and while the SEC’s potential reaction to such issues is difficult to predict, it could lead to a sponsor’s loss of shelf registration eligibility if a sponsor of an ABS transaction fails to comply with Exchange Act reporting requirements. The compliance requirements extend beyond the issuing entities established by the depositor, and affects any issuing entity established directly or indirectly by any affiliate of the depositor with respect to the same asset class.

This article is a reprint from a white paper published by the PwC Consumer Finance Group.

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Bankruptcy abuse prevention, Consumer Protection Act 2005

The intent of modern bankruptcy law is to give debtors a fresh start and a new opportunity without the discouragement from previous debt. However, the bankruptcy system also provided some debtors a way to lawfully avoid full or partial payment of debt to the detriment of their creditors by using bankruptcy as a way to evade the repayment of debt. Previously, bankruptcy law was less concerned with the impact upon the creditor than the debtor.

In 1997, the National Bankruptcy Review Commission submitted suggested bankruptcy legislation changes to Congress. Over the past few years financial services companies and other creditors have increased lobbying efforts, resulting in new legislation.

Early this year the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("the Act") passed through Congress and was signed by the President on April 20, 2005. The Act is amending the United States Bankruptcy Code, 11 U.S.C. (the "Bankruptcy Code"). Parts of the new legislation took effect April 20, 2005, and the Act became effective on October 17, 2005. The impact of the new bill is something financial services companies should consider to determine the current and future effect on businesses.

Bankruptcy legislations

Filing for bankruptcy can be initiated either by an individual filing a petition to voluntarily file for bankruptcy or by the creditor requesting a court order to declare an individual bankrupt. Some of the most common causes for filing for bankruptcy are unemployment, large medical expenses, seriously overextended credit, marital problems and other large unexpected expenses. An individual may file for bankruptcy in accordance with the provisions of Chapter 7 or Chapter 13 of the Bankruptcy Code, depending on the individual circumstance.

Under Chapter 7 of the Bankruptcy Code, a debtor may wipe out all eligible debt and is able to retain certain "exempt" property. All non–exempt property is liquidated and the cash is distributed to the creditors. The specific rules regarding the exempt property are dependent on the state in which the debtor resides. However, for the majority of cases filed under Chapter 7, the debtor typically has no or very little non–exempt property to lose.

Chapter 13, on the other hand, is more applicable to debtors who are behind on debt payments (e.g., mortgage loans, car loans or credit card debt) and need help repaying their outstanding commitments. It allows debtors who have sufficient income in excess of their expenses to pay off their debt over an extended period of time, usually three to five years. It also allows debtors to protect any significant non–exempt property.

Highlights to changes in the Bankruptcy Code

Listed below are only a few examples of the changes to the Bankruptcy Code. Under the updated Code, it is generally more difficult for individuals to file for bankruptcy. The Act seeks to discourage abusive bankruptcy filings and bad faith repeat filings, mandates more severe penalties against debtors and debtors' attorneys, and places a higher burden of proof on the side of the debtor. A large portion of the Act is devoted to the discouraging of bankruptcy abuse.

- The Act adds a means test based on the median family income in a state that prevents employed debtors earning more than the maximum disposable income allowed from filing under Chapter 7. Instead, it forces them to file under Chapter 13, meaning that rather than having all of their eligible debt wiped out, they will have to repay at least part of their debt under a three to five year repayment plan. The Act also amends Chapter 13 by restricting monthly living allowances based on IRS standards applicable to all debtors, rather than based on individual circumstances, as is the current practice.
- The time period that needs to elapse between filings under Chapter 7 is increased from six years to eight years. Furthermore, under the new legislation, Chapter 13 cannot be filed if the debtor had obtained a discharge under Chapter 7 within the previous four years or had obtained a discharge under Chapter 13 within the previous two years. The Act also adds limitations to bad faith repeat filings.
- The new Act requires individuals willing to file for bankruptcy to complete an approved credit counseling course within the six months prior to filing.
- State exemptions may be claimed either for the state in which the individual resided for the two years prior to filing or, if they have resided in more than one state for the two year period, the state in which they resided for the majority of the 180 days prior to this two year period.
- The new Act amends the homestead exemptions, whereby the exemption for property acquired within the 1215 days preceding the filing date is limited to $125,000. This excludes any interest transferred from a debtor's previous principal residence (which was acquired prior to the beginning of the 1215 day period) into the debtor's current principal residence, if both are located in the same state. The $125,000 homestead cap applies, regardless of any higher state exemptions, if the court determines that the debtor has been convicted of a felony, the filing of the case was an abuse of the provision of the Bankruptcy Code or the debtor owes a debt arising from other violation of securities laws or other criminal activity.

- Where the bankruptcy filing was found to be fraudulent or there were multiple bankruptcy filings to avoid foreclosure, the court may grant relief from the automatic stay.
- If the value of the collateral is less than the total debt outstanding, the debtor now has to pay the higher amount to retain title of the property. Under existing legislation, debtors were able to chose the lower amount
- Where a motor vehicle was purchased within 910 days of the filing and a secured creditor has a lien, the creditor retains the lien until the entire debt has been paid.
- The Act adds student loans from non–government and profit–making organizations to the list of loans that cannot be erased by either a Chapter 7 or Chapter 13 filing, unless this would provide undue hardship on the debtor or his dependents. The Act also adds debts incurred on the basis of fraud, credit purchases of $500 or more for luxury goods or services made within 90 days of filing, and loans or cash advances of $750 or more taken within 70 days of filing to the list of debts that may be declared non–dischargeable.
- The court may reduce a claim by a creditor if the creditor unreasonably refused to negotiate a reasonable alternative repayment schedule proposed on behalf of the debtor by an approve credit counseling agency.

Expected impact on financial services companies and creditors

The new legislation makes filing for bankruptcy more difficult for individuals. Therefore, during the period leading up to October 17, 2005, there have been many advertisements geared towards individuals seeking bankruptcy advice suggesting individuals take advantage of the current legislation. During the months and particularly during the week prior to October 17, there were a record number of bankruptcy filings throughout the country, which in many areas were significantly higher than expected. This will have an affect on financial services companies that have credit risk exposure to those debtors. There is expected to be a significant increase in credit card losses during the fourth quarter of 2005 and there may also be an impact on delinquencies and foreclosures on other consumer loans.

Going forward, the provisions under the new Act may lead to an increase of one–on–one loss mitigation actions between the creditor and debtor to help resolve the delinquent credit. Creditors, knowing they will probably lose less under the new Act, may be willing to forgive some debt on a case by case basis to assist the debtor (i.e., extend due dates, forgiveness of interest and late fees, reset rates, conversion of debt from unsecured to secured, etc.).

There is an expectation that bankruptcy filings, especially under Chapter 7, will decrease once the surge of last minute filings under the old law has been through the courts, as the new legislation will make it harder and more expensive for individuals to file for bankruptcy. There are more severe penalties for fraudulent bankruptcy filings, not only for the debtors, but also for lawyers involved with the filing. In addition, the time between bankruptcy filings has increased under the new Act, making it harder on individuals who continuously spend in excess of their income to keep filing bankruptcy to get out of debt. As discussed above, the Act adds a number of provisions to prevent abusive and repeat filings and enhances protection of secured creditors, which, in the long run, are expected to reduce creditor's losses due to bankruptcies.

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An end to VA no bids?

Department of Veterans Affairs announces proposed rule changes to modernize its processes

In February 2005, the VA announced in 38 CFR 36 its proposed changes to regulations regarding the servicing and liquidating of guaranteed housing loans in default and submitting of guaranty claims by loan holders.

The announcement of these proposed changes is the culmination of a series of actions that began in 1995 with the consolidation of its processes into regional loan centers in an effort to streamline and modernize processes within loan guaranty operations.

This announcement is reflective of the VA's redesign and modernization goals that include the following:

- Improving services provided to veterans
- Reducing the paper burden associated with servicing VA loans by moving towards a paperless environment
- Promoting information exchange between the VA and the mortgage industry to be extent permitted within applicable privacy laws
- Providing easy access to timely and reliable reports and data from servicers that supports the VA's decision–making process and efficient use of resources
- Implementing standard processes that operate consistently across regional loan centers

Many of the specific changes announced resulted from recommendations received during a series of roundtable meetings held in 2002 with servicers, mortgage insurers, GSEs, attorneys and software developers, as well as key stakeholders within the VA. If the proposed changes are implemented, servicers will now be responsible for many of the activities currently performed by VA staff, but will also be compensated for their work in the form of incentive payments to complete permitted loss mitigation activities.

Key Changes

Some of the key changes in the proposed rule include the following:

- Servicers will be given more authority to implement loss mitigation options as an alternative to foreclosure. In order to accomplish this, servicers will be provided with a rules–based process that replaces VA consent with delegated authority for foreclosure action that is currently performed in VA regional loan centers. Servicers will be compensated for their work through a schedule of fee incentives paid to complete certain loss mitigation activities that will be weighted by an assessment of the servicer meeting defined performance standards.
- Servicers will be ranked into four tiers based on performance. The model that performs the rankings will follow the system used by FHLMC. The VA has requested input for developing criteria to be used in creating the rankings. In the first year, all servicers will be presumed to be tier two. Incentive payments will be driven by these tier ratings; tier one servicers will receive the highest level of incentive payments for completing permitted loss mitigation activities.
- Servicers will be required to report the status of all guaranteed loans in their portfolio, as well as reporting significant events in the servicing and termination of such loans. Holders will be required to report such information electronically through data file exchange, direct systems interface or directly through the internet. The VA is developing a website at www.VBAValeri.com to accomplish this data exchange. Currently, loan reporting from servicers is not required, which has limited the VA in analyzing key trends.
- Servicers will be responsible for calculating the net value of the security property for each loan terminated, replacing the current process of receiving bidding instructions from the VA.
- Servicers will be required to submit a guaranty claim electronically within one year of the completion of the liquidation sale. If servicers do not comply with this deadline, they risk not recovering proceeds from the VA on defaulted loans.
- Claims paid will be examined in a post–audit process on a sample basis to determine if the claim was completed properly. The sample size and frequency of audit will be driven by tier ranking.
- Title evidence for conveyance of a property will be standardized across jurisdictions, which will reduce the amount of documentation required.
- Caseloads will no longer be assigned to VA offices via geography. Caseloads are to be assigned across regions to distribute workload evenly. This should serve to eliminate operating nuances that currently exist between regional offices.

VA will be offering training to servicers to facilitate conversion to the amended processes. In addition, to further support this initiative, VA is working with Fidelity Systems to develop an automated loan servicing information system that will be linked to other servicer information systems to receive relevant loan data.

Servicers will have several challenges in complying with these proposed changes:

1. The reporting of key loan default events could be required daily. Tracking and reporting activities that have traditionally been reported monthly to insurers may be burdensome for some.
2. Servicers will have to ensure their software service providers are involved in the process with respect to exchanging data with the VA, especially if they do not link with the Fidelity system.
3. The post claims audit process must be managed, especially if VA uses examination processes similar to those used by HUD, which extrapolates its audit findings for purposes of calculating recoveries from servicers for claims discrepancies. Extrapolation can be costly to servicers.
4. It appears that VA no bids will be eliminated, but the servicer may still have to buy down loans based on their calculation of collateral value and net value.

The 60 day comment period has passed. Most comments were received from attorneys. It is anticipated that VA will move forward with these changes. In preparing for these changes, servicers should assess their readiness to implementing these change by reviewing their electronic data exchange capabilities, their loss mitigation practices, and their claims and post–claims processing processes.

For more information regarding proposed VA changes and implementation considerations, please contact John Adams at 240–447–4071 or at john.m.adams@us.pwc.com.

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