Consumer Finance Group News Alert

Superstorm Sandy

Consumer finance industry perspectives

Most estimates place the damage from Superstorm Sandy at over $50 billion[1], which, if confirmed, would make it the second-costliest Atlantic storm in history, behind only Hurricane Katrina. The expansive nature of the damage from Sandy affecting at least 24 states from Florida to New England was unprecedented and is expected to see a broad, immediate, and unique response from the consumer finance industry.

Widespread and severe property, business and vehicle damage has prompted many banks, consumer finance asset servicers and investors to take action in the face of an expected increase in consumers who may be unable to make payments on their credit products as well as a significant increase in the number of insurance claims related to damaged assets. Many institutions and investors have already released plans to grant forbearance, waive late fees and other penalties, and expand credit limits on card products to help consumers deal with the aftermath of the storm.

The industry will likely be under an increased level of scrutiny to make sure that the response to Sandy is efficient, effective, and executed with compassion in consideration of the loss experienced by many.

To date Fannie Mae, Freddie Mac, FHA and the CFPB have already issued announcements related to residential lending and servicing and other regulatory agencies are expected to continue to issue guidance applicable to consumer finance in the coming days and weeks.

[1] CNNMoney – Sandy's cost to economy: Up to $50 billion (http://money.cnn.com/2012/11/02/news/economy/sandy-economic-impact/index.html)

This News Alert summarizes the guidance issued to date and identifies some operational and financial reporting considerations for industry participants. Specifically, the document addresses general considerations applicable across consumer finance assets as well as some that are specific to various asset classes: mortgage, credit cards, and auto finance.

Industry wide considerations

Sandy clearly has already had and will likely continue to have a tremendous impact on the affected geographic regions. While various products have specific areas of focus, the items listed below represent an overview of considerations that are generally applicable across consumer finance assets:

Customer outreach: Customers affected by the storm may be unreachable via standard telephone and letter campaigns. For those customers that have active email information on file, electronic messaging and / or creating a dedicated section on the company's website may be the most effective communication method. In addition, companies that have branch networks within impacted areas should consider offering walk up services for local customers to have the ability discuss their situation with servicing representatives and explore potential options. As applicable, Single Point of Contact agents should attempt to reach out to their designated customers in affected areas to gather as much information as possible on the severity of damage. This can also facilitate the amendment of standard operational processes for forbearance activities.

Customer service contacts: Companies should prepare for increased call volumes for items such as requesting copies of contractual documentation due to the loss of personal records resulting from the storm, claim information requests, payment waivers, etc. Consideration should be given to establishing dedicated call lines and hiring temporary resources to handle the increase in requests from impacted customers. Companies should also consider leveraging self service internet portals to allow customers to securely request copies of documentation. In addition to documentation requests, servicers should expect and prepare for an increase in requests related to hardship relief programs making it important that adequate information is prepared and available for call center agents or through self service channels.

Solicitations and collections: Demonstrating empathy for impacted customers can go a long way towards delivering a memorable customer experience in the face of this crisis. Pre-empting customers within the impacted areas from normal operational routines such as marketing solicitations or auto-dialer collection campaigns demonstrates that the organization has a level of sensitivity to the crisis and to those that have been directly impacted. A proactive approach can be to initiate targeted outreach campaigns to those customers that may be impacted, to confirm/qualify their situations and to proactively offer potential relief programs for their consideration.

Fee moratoriums: From both a regulatory and customer experience perspective, initiating a fee moratorium for customers within the impacted areas may warrant consideration and has the potential to be well received. In addition, taking a blanket approach for waivers versus a complex approval process can prevent subjecting the affected customers to qualification and documentation submission requirements.

Credit bureau reporting: Activating holds on standard credit reporting processes for customers that fall within the impacted areas may also provide relief to affected customers. Consideration should be given to a blanket approach versus a case by case qualification process that will increase operational complexity and potentially drive customer dissatisfaction if guidelines are too stringent. Adjustments can be made to reporting at a later date as necessary but there will likely be little sympathy for inappropriate negative reporting activity which serves to further inconvenience and challenge customers.

Fraud awareness: The CFPB's release on October 30, 2012[2] identified that frauds and scams are all too common in the aftermath of a natural disaster. As such, servicers should confirm that that their agents are enforcing customer identification criteria and use customer impact footprints that are zip code driven and cross referenced with government disaster information (such as FEMA data) in order to prequalify/prescreen impacted customers and avoid unnecessary qualification processes that can deteriorate the overall customer experience.

Disaster recovery/BCP: Disaster recovery and business continuity plans were put to the test during Sandy and, as experienced with previous large scale natural disasters, it is anticipated there will be some clear weaknesses identified in the aftermath of the superstorm. To prepare for future disasters, consumer finance firms should evaluate the effectiveness of their disaster recovery and business continuity plans, with a view to making enhancements to account for extended period of power loss, fuel shortage, public transportation stoppage, and other infrastructure damages. Vendor dependencies should also be considered as part of the disaster recovery and business continuity plans.

Mortgage banking implications

Potential actions for mortgage banking institutions include ordering re-appraisals, rescheduling closing dates, and extending rate locks on loans in the fulfillment pipeline as well as executing forbearance solicitation campaigns, suspending/adjusting certain collection call campaigns, and waiving late fees in certain circumstances. Organizations should perform a capacity analysis and

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[2] CFPB – Avoiding loan scams after a natural disaster (http://www.consumerfinance.gov/blog/avoiding-loan-scams-after-a-natural-disaster/)

possibly contract to meet additional short-term staffing needs quickly to avoid any inability to respond to customer needs.

Operational considerations

Considerations should be given to the following areas in order to help manage the overall customer experience and mitigate risks associated with damaged properties.

In process transactions: Special attention should be placed on "in process" transactions throughout the loan origination and servicing lifecycle. Transactions in the affected areas that were dependent on valuation data such as appraisals, broker price opinions, and property inspections will likely all require updates based on the potential for material change to the underlying collateral as a result of the storm. Some examples of in process transactions are listed below:

- Originations – Loan applications with appraisals in process or completed within the past 90 days will require revaluation with incremental valuation costs potentially having to be absorbed by the originators. Extensions of interest rate locks for impacted customers will also need to be considered, potentially resulting in further originator costs and adjustments to short-term hedging coverage/strategies.
- Modifications – Identifying pending extensions, deferrals, and forbearance actions that may need to be re-evaluated. It is important for servicers to clearly identify and document the population of pending modification cases impacted by Sandy and assess what levels of timeline extension may be required and to work with investors to obtain approvals for extended delays/forbearance where required.
- Short sales – Identifying pending short sale transactions, and developing strategies to manage both potential buyer cancellation and delay of pending transactions due to protracted closings, re-solicitation of investor approvals, and required revaluation of the underlying collateral.
- Foreclosures – Ensuring that in process foreclosure activity is suspended in accordance with existing GSE moratoriums. In addition, servicers should evaluate contractual servicing agreements (PSAs) to determine applicability of GSE actions on private investors and establish a policy for their bank-owned portfolio.
- Home equity line management – Identification of open/available HELOC's or HE loans that may require closure due to material change provisions.

Escrow processing: Companies should assess the capacity and ability of their escrow departments to deal with what is expected to be a significant increase in insurance claims and subsequent restricted escrow processing. These departments will have to coordinate closely with escrow vendors as well as insurance companies to oversee claims processes as well as disbursements related to the repair and rebuilding of homes.

REO inventory assessment: Servicers should identify affected REO properties, review recent valuations and inspections for the impacted properties, and mobilize inspection resources to complete updated inspections as well as coordinate with insurance adjusters to initiate claims. Asset managers and external agents should also be sufficiently educated on the claims process to drive and optimize recovery.

Mortgage investors/insurers: Coordinating disaster related payment deferral programs, interest moratoriums, and foreclosure moratoriums with private investors and mortgage insurers is important in facilitating a quick and responsive process free of unnecessary delay.

Equity analysis: Many mortgage servicers rely upon an equity analysis to support the decision to pursue foreclosure and stop advancing (for non-Agency servicing) at a specific delinquency status. Given potential changes in home values as a result of Sandy, consideration should be given to re-evaluating equity status for loans evaluated before Sandy.

Vendor dependencies: Mortgage firms should consider conducting an immediate assessment of their critical vendors, such as banks, warehouse lenders, technology vendors, attorneys, property preservation firms and closing agents, to assess whether or not critical services will continue or resume within an acceptable period of time and whether or not current vendors have the capacity to meet their operational needs within a controlled environment.

GSE disaster directives

Understanding and adhering to the disaster directives issued by the GSE's should be the initial starting point for establishing an overall handling strategy. Leveraging the various GSE directives to arrive at a common approach that satisfies all agency requirements may also be used for non-agency servicing to help keep consistency across products, as well as keep things simple for operators who are faced with the challenging task of counseling customers through this difficult time.

***Freddie Mac guidance*:** Freddie Mac issued guidance to homeowners and servicers on October 30, 2012 regarding relief policies for homeowners impacted by Sandy.[3] To be eligible for relief, the homeowner's home:

- Must have been damaged or destroyed by Sandy
- Must be located in a jurisdiction declared a disaster area by the President and where the President has made federal Individual Assistance programs available

Servicers have the ability to grant forbearance on mortgage payments for up to one year for impacted homeowners. Other relief options include the waiving of assessments of penalties and late fees and not reporting forbearance or delinquencies caused by Sandy to the credit bureaus.

***Fannie Mae guidance*:** In a statement released on October 31, 2012, Fannie Mae reminded servicers and borrowers of the options available to homeowners affected by Sandy.[4] Fannie Mae's existing guidelines, updated in 2009, give servicers the ability to grant forbearance to any borrower the servicer believes has been affected by a natural disaster such as Sandy. Servicers are expected to establish contact with affected homeowners within 90 days and determine if additional assistance is necessary.

Fannie Mae's disaster relief guidelines grant servicers the ability to temporarily suspend or reduce a homeowner's mortgage payments for up to ninety days if the servicer believes a natural disaster has adversely affected the value or habitability of the property. Payments can also be suspended if the natural disaster has temporarily impacted the homeowner's ability to make payments on their mortgage.

Fannie Mae is also encouraging impacted borrowers to reach out to their servicers or the Mortgage Help Centers for assistance.

***HUD/Ginnie Mae guidance*:** Between October 30 and 31, 2012, the office of Housing and Urban Development (HUD) announced foreclosure protection for Sandy victims in various New Jersey, New York and Connecticut communities.[5] HUD is speeding disaster assistance to these areas and providing support for affected homeowner and low-income renters. This support includes:

- Ability for impacted communities to reallocate existing federal resources towards disaster relief to assist in expediting repair and replacement of damaged homes
- A 90-day moratorium on foreclosures on Federal Housing Administration (FHA)-insured home mortgages
- Providing mortgage insurance to disaster victims who have lost their homes under HUD's Section 203(h) program
- Making insurance available for mortgage and home rehabilitation through HUD's Section 203(k) loan program which allows homeowners who have lost their

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3 Freddie Mac Extends Mortgage Relief To Borrowers Affected By Hurricane Sandy (http://freddiemac.mediaroom.com/index.php?s=12329&item=135028&intcmp=fm20121103FME)

4 Servicing Notice – Assistance in Disasters: Hurricane Sandy (https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2012/ntce103112.pdf)

5 HUD Hurricane Sandy Portal (http://portal.hud.gov/hudportal/HUD?src=/sandy)

home to finance the purchase or repurchase of a house, along with the repairs, through a single mortgage

- Providing Section 108 loan guarantee assistance to state and local governments for housing rehabilitation, economic development and repairs of public infrastructures

Flood insurance coverage considerations

It is important for servicers and organizations that employ sub-servicers or vendors to follow through and monitor the performance of claim processes due to the high anticipated volume of claims from Sandy. It is also important to consider and oversee vendor performance (inspectors, insurance companies, etc.) during the Sandy claims processes as part of third party monitoring activities, which are now a regulatory requirement and recognized area of focus for many mortgage servicers. The following represent key considerations related to Flood Insurance resulting from Sandy:

REO properties: Servicers rely on the property inspection process to determine damage to REO properties (as the property is typically unoccupied). In this case it is important to give clear and timely notification to inspectors to coordinate with the servicer on the filing of an insurance claim.

The inspection process may be bypassed and a claim be directly filed with the insurance company if the servicer is certain of damage to the property. As an interim step, insurers may give authorization for preservation actions that prevent further property damage.

Once insurable damage is determined, and a claim is filed, the insurance company will notify an insurance adjustor to visit the property to determine the extent of damage and approve the claim. The adjuster will provide a 'Proof of Loss' form to document the official claim for damages. This document substantiates the insurance claim and is required before the National Flood Insurance Program (NFIP) or insurance company can make payment. There is a requirement to file the claim within 60 days of the loss. This potentially creates a workflow issue with the servicer due the volume of claims expected to result from the storm.

Additionally, the servicer's insurance department (or outsourced insurance provider) must coordinate the claim with any homeowner insurance claims to determine the applicability of coverage once the cause of the claim is ultimately determined.

Other claims: The servicer also has a responsibility to oversee the successful adjustment of the claim. This process ensures the investor's collateral is intact. In many cases, the lien on the property is the mechanism to assure payment is made to the mortgage servicer. This helps the servicer to satisfy the debt (in the event of a total claim) and oversee the quality of the property's insurance repair.

Claim type qualification: There has been quick action from the governors of Connecticut, New Jersey, and New York to clarify that Sandy did not make landfall as a hurricane.[6] The implication of this is that regular deductibles, typically a fixed dollar amount of $500 or $1,000, would apply as opposed to hurricane deductibles which are expressed as a percentage of property value, typically 1% to 5%. It will be important for insurance entities and servicers to ensure the deductibles being assessed are consistent with the nature of the storm at the time damage was inflicted.

Credit card implications

Because of the unexpected and devastating impact Sandy had on the Northeast, card issuers recognize the need to modify their typical operations to offer a more customer focused approach and one that serves to enhance the customer experience of impacted cardholders. Understanding the elevated levels at which unexpected emergency spending may take place, issuers should consider liberalizing some of the more restrictive and punitive policies so not to impose additional financial and inconvenience hardships on their cardholders who are already impacted by this natural disaster. Consistent with high volumes of

[6] CNN Money: Governors say no to hurricane deductibles (http://money.cnn.com/2012/11/01/real_estate/sandy-hurricane-deductible/index.html)

inbound calls to customer service centers in the wake of previous disasters, card issuers (regardless of asset size) have made significant temporary modifications to standard operational procedures to accommodate the range of anticipated requests. Some of those actions include:

- Instituting liberal policies and credit criteria for the approval of cardholder requests for temporary credit limit increases in consideration of the increased frequency and volume of card transactions for emergency living provisions. Increasing limits due to expected higher and long term expenses for cardholders displaced in the Northeast within an acceptable risk management framework.
- Modifying their platforms to facilitate approving transaction authorizations for specific MCC (Merchant Classification Codes), as it relates to hotels, grocery stores, and any other items they feel support the recovery effort. These decisions are being made regardless of cardholders exceeding the established credit limit or early stage delinquency status.
- Expecting a significant increase in spend volumes during the next 30 days to include card activity, which will drive the staffing and operational center capacity models.
- Understanding that an increased level of risk exposure may exist from both a credit and fraud perspective and taking additional steps to enhance fraud operations, detection tools and investigative focus on transactions that appear suspicious in nature.

Auto finance implications

Effects on dealerships: Sandy has forced several automobile dealerships to close because of storm damage and power failures. An opportunity for the automotive finance industry lies in assisting the dealers in their efforts to rebuild. It is very likely that they will need additional financing for repairs not covered fully by insurance or for bridge loans, until the insurance claims are settled. Another opportunity to provide long-term financing may also exist for older dealerships affected by Sandy to update their facilities.

The supply of new vehicles, particularly from European automakers, may also be disrupted following the temporary closure of some Northeastern ports of entry by the Port Authority of New York and New Jersey. The supply of used vehicles will be affected until such time as the increased demand can be satisfied by relocating vehicles from other areas. Maintaining the dealer relationship during these times is essential. Consumer underwriting increases to such items as loan-to-value and after-market product limits may be considered, as needed.

However, the balance between the dealer relationship and the borrower relationship is critical. Controls must be in place to ensure consistent decision making in strict accordance with federal and local lending guidelines is maintained.

Effects on auto customers: Automotive finance companies should be diligent in their efforts to contact account holders in the affected areas. “Extensions” should be considered for borrowers whose employment was not disrupted but who may have unforeseen expenses that have to be managed. Longer term modification solutions may have to be considered for borrowers whose employment and/or income stream has been disrupted. In any case, communication sooner rather than later will help mitigate portfolio-wide delinquency and loss issues.

Developing a strategy to quickly assist performing borrowers either repair or finance a replacement vehicle should be considered where vehicles were damaged or destroyed by the storm. Acquiring and training underutilized resources from other departments to quickly address this transition may help keep borrowers in performing loans, manage the lender’s expectations of the insurance companies and maintain customer loyalty by providing an advocate to facilitate insurance settlements.

Finally, automotive lenders financing pre-owned vehicles from dealers must remain vigilant about flood damaged vehicles. Internal controls such as title searches or periodic collateral inspections should be considered to ensure storm damaged vehicles with "branded titles" are not inadvertently financed. This vigilance is not only required in the geographic areas affected by Sandy, but throughout the United States.

Financial reporting considerations

The impact of Sandy is expected to affect the financial reporting processes of many consumer finance institutions with exposure to assets held in the affected areas. Firms will need to assess Sandy's potential impact on their interest rate lock commitments (IRLCs), loans, leases, real estate owned (REO), servicing assets, deposits, and other financial holdings.

Institutions experiencing a loss/charge to earnings due to Sandy's impact may receive significant focus from investors and analysts during the fourth quarter earnings cycle. However, organizations should also be considering the potential need for subsequent disclosure in third quarter filings either under ASC 855 *Subsequent Events* or within the Management Discussion and Analysis (MD&A) section. Institutions may also consider disclosure of the impacts of business disruption to their operations and to financial forecasts or economic expectations.

In general, companies should be attempting to isolate the populations of assets which were potentially exposed to loss utilizing tools such as FEMA flood maps, satellite technology and zip code indicators of geographic regions declared disaster areas. In performing this analysis, companies should be considering multiple factors in the loss assessment including:

- What is the extent of insurance coverage on the property?
- Was flood insurance in place on properties that required it?
- Is the home uninhabitable or can it be repaired?
- Where loss forecast models are based on delinquency statistics, how will targeted forbearance programs artificially influence model results in the short term?
- Will targeted forbearance programs and/or other government assistance impact the loss emergence period for loans in the affected areas?
- Are processes in place to monitor and record foreclosure moratoria and other operational implications relevant to financial reporting?
- What adjustments should be made to IRLC valuation estimates to reflect the probable lower level of closings due to disruptions in the storm hit areas?
- What impact will the storm have on macroeconomic expectations due to potential job losses, corresponding unemployment increases and a general business downturn in the hardest hit areas?
- What other key assumptions utilized in deriving financial reporting estimates will be impacted (e.g. foreclosure sale and REO liquidation timelines, average property preservation cost for REO assets) by the storm and related responses?

Given the uncertainty surrounding many of the above issues, many companies may be inclined to estimate a range of potential loss exposure as it will take time to make a full and granular assessment of expected loss. Companies should keep in mind that ASC 450-20 *Loss Contingencies* (formerly SFAS 5) requires management to adequately support its best estimate of probable loss within the range or default to the low end of the range if no best estimate is identified. Any reasonably possible range of loss amount above the probable amount recorded must be disclosed as well (with the exception of loss contingencies arising from the recurring estimation of allowance for credit losses).

For loans impaired or acquired with deteriorated credit quality under ASC 310, *Receivables*, (formerly SFAS 114), management may estimate ranges for timing and amount of possible cash flows, and can evaluate the likelihood of the outcomes, but must select a best estimate. Additionally, any forbearance provided should be evaluated for whether it represents an other than insignificant delay in cash flows for loan impairment purposes.

In addition to the loan loss analysis, companies will need to evaluate the impact on related asset classes, many of which may require a "life of loan" approach to valuing the underlying cash flows. Assets that may be impacted include mortgage servicing rights (impacted by higher delinquencies, defaults and involuntary prepayments); retained interest and first loss cash flows (impacted by losses and involuntary prepayments); service fee accruals; late fee accruals; and other such cash flows that are likely to be disrupted by property losses, forbearance and heightened early stage delinquency reporting.

As companies grapple with financial reporting and disclosure decisions and issues they should look to existing guidance which was leveraged in circumstances of previous disasters such as September 11th and Hurricane Katrina. AICPA Technical Practice Aid 5400.05, *Accounting and Disclosure Guidance for Losses from Natural Disasters – Nongovernmental entities*, provides an overview of the authoritative FASB guidance for natural disasters.

Each company should also have discussions with its external auditors and regulators as needed. Further guidance may be issued, so attention should be paid to updated and new announcements and guidance from various governing and advising authorities.

In conclusion

In the wake of this disaster the implications and required response from consumer finance organizations are broad and extensive. While some of the considerations are driven by the basics of customer care, many are more complex driven by guidance set forth by investors, regulatory bodies, and other third parties organizations.

Given the extent, scope, and complexity of the required response, a project management discipline is necessary. Organizations should develop clear accountability and transparent reporting on the status of their Sandy response to determine that challenging areas are identified and prioritized in a timely manner and that execution is consistent with guidance and general customer care principles.

In its response to Sandy, the industry has an opportunity to demonstrate how it is customer centric, and many eyes will likely be focused on it to evaluate its response.

Additional information

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