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Sub-servicer Oversight

Going on auto-pilot with your sub-servicer can be very risky. Here's how to monitor them and red-flags to watch for.

Initial Due Diligence on Sub-Servicers

Before entering into a contractual arrangement with a third-party servicer or sub-servicer, you should perform an appropriate review for third parties, including:

1. Obtaining investor (including private investor) "seller/servicer" reports, as well as the servicer's internal audit reports and QC reports on servicing functions.

2. Confirming the servicer's approval and check for any recent adverse audit findings or suspensions by HUD, Fannie Mae, Freddie Mac, Ginnie Mae, and all PMI companies. Obtain ratings from these entities for the servicer's default and investor reporting and remitting functions.

3. Obtaining financial and historical background information, such as Dun and Bradstreet reports, audited financial statements and SAS 115, "Communicating Internal Control Related Matters Identified in an Audit," reports, attestations on servicing from external auditors, such as Regulation AB or Uniform Single Attestation Program (USAP) reports, servicer ratings from ratings agencies.

4. Performing an on-site due diligence visit and determining the adequacy of the servicer's internal audit function.

5. Checking the adequacy of the servicer's errors and omissions (E&O) insurance and surety bond coverage.

6. Require the sub-servicer to comply with all applicable laws, regulations, and other applicable requirements.

7. Clearly specify the servicing policies and procedures the servicer is to use for all common or anticipated servicing situations.

8. Permit on-site audits of the servicer at any normal business time by the lender or its agents.

9. Require the use of separate deposit accounts at approved financial lenders for both principal and interest and escrow payments. The deposit account statement should be transmitted directly to you, the lender.

10. Request that companies providing the PMI make all claim checks payable to the lender or notify the lender of payments to the servicer.

11. Allow the lender to have direct access to the MIS service bureau or servicer's MIS department for audit purposes.

12. Specify the dates and frequencies for remittance of principal and interest and payoff funds to the lender.

13. State the servicing fees and the manner of payment to the servicer, including identifying the recipient of ancillary income and float revenue.

14. Permit termination of the servicing agreement for cause and outline the transfer of the mortgage servicing files, records, insurance policies, computer records, and other related documents to the designee of the lender. The definition of "for cause" should be clearly defined to include fraud, embezzlement, diversion of mortgage payments or payoffs, failure to follow any provision of the servicing agreement, and continued careless servicing after the lender has sent a formal written warning to the servicer.

15. Permit the transfer of the same servicing records at any time without cause by payment of a stipulated termination fee to the servicer.

16. Require direct notification to the lender for cancellation or nonrenewal of E&O insurance, and/or surety bond.

Ongoing Monitoring of Servicer Performance

You should implement the following monitoring and audit procedures to minimize the risk of loss from a servicer:

1. Perform quarterly comparisons of the servicer's delinquency, foreclosure, real estate owned, and prepayment rates to the national averages from the MBA delinquency survey and perform any other trend and peer analysis.

2. Review and reconcile lender statements monthly against borrowers' payments and remittances from the servicer and escrows held by the servicer.

3. Perform annual desk reviews and on-site reviews of the servicer, and have tracking reports on the status of corrective actions related to these reviews.

4. Review monthly remittance reports and other computer reports from the servicers to detect discrepancies and errors.

5. Verify, on an annual basis, mortgage loans, property owners, and loan balances by direct mail.

6. Conduct annual reviews of the servicer's (1) external audit reports and attestations and (2) financial reports.

7. Review, on an annual basis, the servicer's internal audit and QC reports on servicing.

8. Check the servicer's E&O insurance and surety bond coverage annually.

9. Verify, through annual reviews, continued approval of the servicer by PMI companies, HUD, Fannie Mae, Freddie Mac, and Ginnie Mae. Obtain ratings by these entities on the servicer's default management and investor reporting and remitting functions.

10. Obtain, on an annual basis, investor "seller/servicer" reports.

11. Perform annual review of servicer ratings from rating agencies.

12. Review results of servicer disaster recovery plan.

13. Review the servicer's compliance self-assessments. When a lender uncovers problems, it should take immediate action. If the lender detects fraud or diversion of funds, it should move immediately to transfer servicing payments and lender accounts to its name or that of another servicer. Lenders, however, should not hesitate to transfer servicing for cause if the servicer does not follow any of the provisions of the servicing agreement or does not promptly correct problems after notice.

14. Be notified of any CFPB audits and have access to the Report of Exam.

Red flags and early warning signs of problems

1. Excessive delay in the servicer's remittance of mortgage loan payments or prepayments so the servicer can earn additional float income.

2. Diversion of escrow payments intended for payment of taxes or insurance to the servicer's use.

3. Retention of funds on full prepayments while representing to the lender that the borrower continues to make monthly payments.

4. Missing, lost, damaged, or out-of-date records.

5. Sending nonsufficient funds checks to the lender.

6. Canceling insurance or bond coverage to save money.

7. Misrepresenting the level of delinquencies and foreclosures.

8. Poor management of delinquencies, tax and insurance payments, PMI claims, or ARM adjustments. You should be aware that some state laws view the servicer as an agent of the owner of the mortgage loans and thereby hold the owner liable for the actions of the servicer. While some states regulate servicers, the regulations usually focus on consumer protection rather than safety and soundness. A lender should perform due diligence and ongoing monitoring with any new third-party servicer to minimize the risk of problems and losses.