Proposed Regulatory Prudential Standards for Non-Bank Mortgage Servicers

Executive Summary

State regulators, through the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR), have evaluated establishing a set of prudential regulatory standards that would apply to non-bank mortgage servicing companies. Through the Mortgage Servicing Rights Task Force (Task Force), a group of state regulators from California, Illinois, Massachusetts, Minnesota, Pennsylvania, New York, South Dakota, Texas, and Washington, the states have developed baseline prudential standards and enhanced prudential standards for non-bank mortgage servicers. State regulators request public comment on all aspects of the proposed standards.

Given their credentialing and licensing authority over non-bank mortgage servicers, state regulators play a central role and have a responsibility to ensure these entities conduct servicing operations in a safe and sound manner and have strong consumer protections in place.

Companies that specialize in servicing mortgage loans, particularly troubled loans, provide an important service to the mortgage finance system. However, the recent and pronounced growth of non-bank mortgage servicing companies and their servicing portfolios have challenged the state system to ensure the regulatory framework keeps pace. A strong non-bank mortgage servicing sector will serve as a solid foundation as policymakers contemplate mortgage finance reform.

State regulators are well positioned, as the regulatory authorities of these institutions and as regulators with experience and responsibility for a diverse range of depository and non-depository financial services providers, to design and implement a comprehensive prudential regulatory framework for non-bank mortgage servicers. Prudential regulatory standards for non-bank mortgage servicing companies would help achieve the following goals:

- Provide better protection for borrowers, investors, and other stakeholders in the occurrence of a stress event;
- Enhance effective regulatory oversight and market discipline over these entities; and
- Improve transparency, accountability, risk management, and corporate governance standards.

Therefore, state regulators propose and seek public comment on a baseline set of prudential standards be applied to all non-bank mortgage servicers licensed by and operating in the states. The baseline prudential standards would cover eight areas, including capital, liquidity, risk management, data standards, data protection (including cyber risk), corporate governance, servicing transfer requirements, and change of control requirements (hereinafter, “Baseline Standards”). To the extent possible, the Baseline Standards will leverage off of existing standards or generally accepted business practices. Once adopted by state regulators, these standards will represent regulatory requirements for state-licensed non-bank mortgage servicing firms.

The non-bank mortgage servicing industry is diverse, ranging from small firms with straightforward operations to large complex firms with multiple business lines. By utilizing existing standards or generally accepted business practices, the Baseline Standards seek to minimize regulatory burden for small, less complex servicing firms.

Additionally, the Baseline Standards will also serve as a starting point for enhanced standards for entities that require increased regulatory oversight due to their size, complexity, and overall risk profile.

OVERVIEW OF THE NON-BANK MORTGAGE SERVICING INDUSTRY

Non-bank entities that specialize in loan servicing have grown dramatically in size, complexity, and importance in the post-crisis mortgage market. Non-bank mortgage servicers have acquired massive portfolios of mortgage servicing rights, many of which consist of delinquent loans that require a heightened level of service and support. Changes in the mortgage market and these entities' rapid growth have highlighted the critical services these firms provide to homeowners, investors, and other market participants. The goal of these standards is to ensure the regulatory approach keeps pace with the change in the market.

Non-Bank Mortgage Servicing Business Model

Mortgage loan servicing is a critical component of the broader housing finance system. Non-bank mortgage servicing companies specialize in the following servicing functions:

- Calculating, collecting, and transmitting a mortgage loan borrower's principal and interest payments;
- Managing mortgage escrow accounts;
- Collecting insurance claims;
- Distributing servicing advances;
- Managing delinquent mortgage loans;
- Assessing loans for modification and other loss mitigation activities;
- Overseeing foreclosure proceedings; and
- Managing and/or facilitating the sale of real estate owned (REO) following foreclosure.

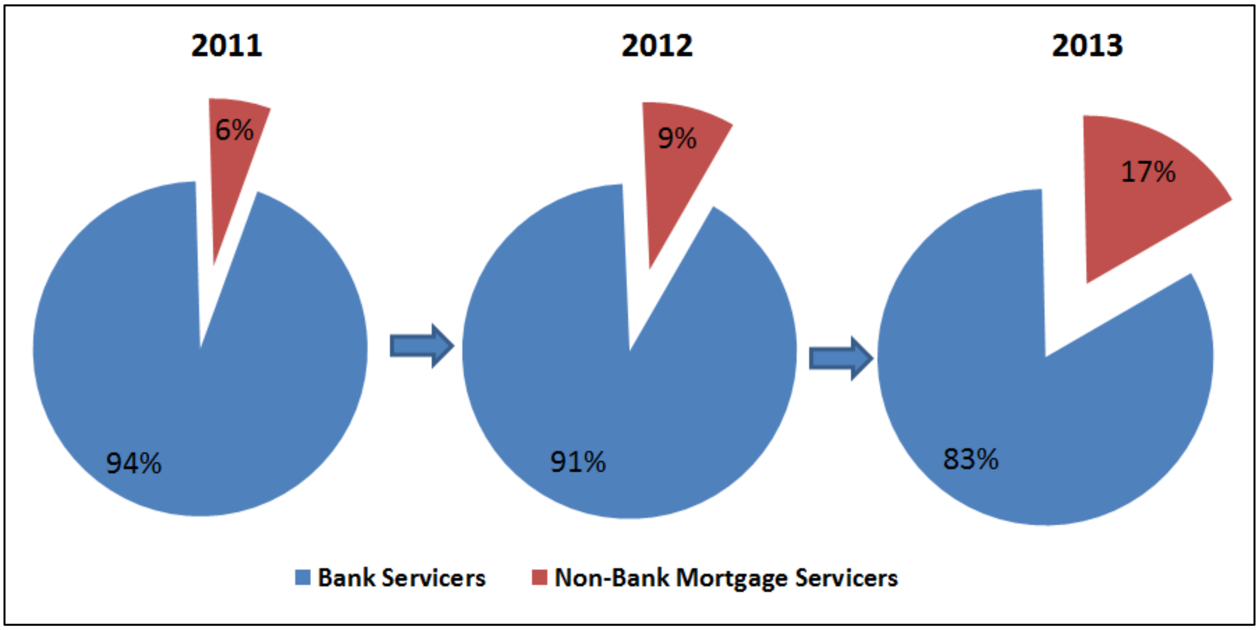
Non-bank mortgage servicing companies perform these functions on behalf of mortgage loan owners and guarantors, be they financial institutions, private investors, Ginnie Mae, or government sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac. Non-bank servicers earn contractually established fee income, typically based on the unpaid principal balance of the loans serviced. Non-bank mortgage servicers may also have additional business lines, such as loan origination and warehouse lending.

Non-Bank Mortgage Servicing Industry Trends

Over the past few years, a large and increasing share of mortgage servicing rights (MSRs) have shifted out of commercial banks and into non-bank mortgage servicing companies. When examining the 30 largest bank and non-bank mortgage servicers from 2011 through 2013, the Federal Housing Finance

Agency (FHFA) estimates that share of MSRs held by non-bank mortgage servicers increased from 6 percent to 17 percent over this period. The FHFA also estimates that of the nearly $10 trillion mortgage servicing market, non-bank mortgage servicers now hold around $1.4 trillion in MSRs.[1] Figure 1 shows the recent shift of MSRs out of commercial banks and into non-bank mortgage servicers from 2011 through 2013.

Figure 1. Recent Growth of Non-Bank Mortgage Servicers



Source: FHFA

There are a number of factors driving the large migration of MSRs out of banks and into non-bank servicers. First, the Basel III capital rules, which apply to banks but not non-bank mortgage servicers, have made MSRs more expensive to retain. While banks were previously allowed to apply the value of their MSRs to help meet Tier 1 capital requirements, the new capital rules limit the amount of MSRs that can apply to Common Equity Tier 1 (CET1) capital to 10 percent. MSRs that fall within this 10 percent threshold will be subject to a risk weight of 250 percent in 2018, while those that exceed this 10 percent threshold carry a dollar-for-dollar capital charge. Figure 2 illustrates the negative treatment MSRs receive under the Basel III capital rules.

[1] "FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages." Federal Housing Finance Agency, July 2014, pgs. 1-2. Available at: http://fhfaoig.gov/Content/Files/AUD-2014-014.pdf

Figure 2. Basel III Capital Treatment of MSRs

	Basel II	**Basel III**	
		If MSRs ≤ 10% of CET1	*If MSRs > 10% of CET1*
MSR Treatment for Tier 1 Calculation	100% Risk Weight	250% Risk Weight	No Risk Weight; Dollar-for-Dollar Charge
Example MSR Balance	$100	$100	$100
Risk-Weighted MSR Balance	$100 = $100 x 100%	$250 = $100 x 250%	N/A; Dollar-for-Dollar Charge
Capital Required for "Well-Capitalized" Classification at 8% Tier 1/RWA	$8 = $100 x 8%	$20 = $250 x 8%	$100 (Dollar-for-Dollar)
Percentage Increase Over Existing Capital Need	-	250%	1250%

The large spike in delinquent and defaulted loans following the housing downturn and financial crisis has also contributed heavily to the transfer of MSRs to non-bank servicers.[2] Indeed, a large share of the MSRs transferred from banks to non-bank servicers consists of portfolios of troubled loans. Servicing such loans is a high-touch and labor-intensive process, and commercial banks may view troubled loans as too challenging and costly to service.

Non-Bank Mortgage Servicers' Strengths

Non-bank mortgage servicing companies have a number of strengths relative to bank servicers, and their business model provides a number of unique benefits to the market. Since servicing troubled loans is such an intensive and demanding business, companies that specialize in and concentrate their operations around servicing these types of loans are often more efficient at the process. With more advanced servicing technology systems, non-bank servicers may also be better able to offer loss mitigation alternatives to troubled borrowers. They also benefit from lower servicing costs compared to their bank servicer peers who face more stringent regulatory and financial requirements.

Non-Bank Mortgage Servicers' Weaknesses

Non-bank mortgage servicers and the regulatory framework they operate under also have key weaknesses. Non-bank servicers may be more susceptible to economic downturns as they do not operate under a prescribed capital standard and therefore, may retain less capital. There are no comprehensive enterprise-wide liquidity requirements or standards to ensure sufficient reserves to continue servicing the MSRs in their portfolios in the event of material financial stress.

The current regulatory framework does not have clear enterprise-wide expectations for internal controls, compliance, and risk management systems. These entities' may not have mature policies and

[2] Ibid.

procedures in place to accommodate the rapid and aggressive growth of their MSR portfolios and the increased complexity of the organization.

Regulators and the industry have also recognized widespread data quality and integrity issues, especially in the context of transferring servicing rights. Non-bank mortgage servicers often struggle to integrate acquired loan portfolios, and to locate legal and collateral documents associated with the transferred loans. All of these issues are exacerbated if a servicer's operational capacity has not kept pace with its growth.

STATE REGULATORS AND PRUDENTIAL REGULATORY STANDARDS FOR NON-BANK MORTGAGE SERVICERS

State regulators, the Consumer Financial Protection Bureau (CFPB), Ginnie Mae, and FHFA (through Fannie Mae and Freddie Mac) have all established a variety of standards that apply to non-bank mortgage servicers. For example, state regulators have established bonding and licensing requirements, the CFPB has issued servicing standards related to consumer protections, and the FHFA and Ginnie Mae have imposed various capital and liquidity requirements. Still, these standards and requirements may not be consistent and do not always cover a servicer's entire book of business. Additionally, non-bank mortgage servicing companies are not subject to consistently comprehensive safety and soundness standards.

In its *2014 Annual Report*, the Financial Stability Oversight Council[3] (FSOC) identified the rapid growth in non-bank mortgage servicers as a market development that warranted heightened risk management and supervisory attention. FSOC recommended that state regulators work together to develop prudential and corporate governance standards for non-bank mortgage servicing companies, in collaboration with the CFPB and FHFA.[4] Following FSOC's recommendation, state regulators, through CSBS, launched an effort to evaluate options for prudential regulatory standards for non-bank mortgage servicers. This effort has included extensive research and engagement with a variety of industry and regulatory stakeholders.

FACTORS TO CONSIDER IN DEVELOPING PRUDENTIAL STANDARDS FOR NON-BANK MORTGAGE SERVICERS

In alignment with FSOC's recommendation, state regulators have considered a variety of prudential and corporate governance standards for non-bank mortgage servicing companies. When appropriate and

[3] The Financial Stability Oversight Council consists of the following members: Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, Comptroller of the Currency, Director of the Consumer Financial Protection Bureau, Chairman of the Securities and Exchange Commission, Chairperson of the Federal Deposit Insurance Corporation, Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, Chairman of the National Credit Union Administration, a presidentially-appointed independent member with insurance expertise, Director of the Office of Financial Research (non-voting), Director of the Federal Insurance Office (non-voting), a state insurance commissioner (non-voting), a state banking supervisor (non-voting), and a state securities commissioner (non-voting).

[4] "2014 Annual Report." Financial Stability Oversight Council, May 2014, pg. 10. Available at: http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf

available, state regulators sought to leverage existing requirements or generally accepted business practices.

State regulators closely evaluated the following 12 factors in designing comprehensive prudential standards appropriate for non-bank mortgage servicers:

1. Capital Requirements
2. Liquidity Requirements
3. Risk Management Standards
4. Data Integrity Standards
5. Data Protection, including Cyber Risk
6. Corporate Governance
7. Servicing Transfers Requirements
8. Change in Ownership of Mortgage Servicer Disclosure Requirements
9. Stress Testing
10. Living Wills and Recovery and Resolution Plans
11. Reserves and Valuation Methodology
12. Transactions with Affiliates.

The remainder of this report outlines state regulators' baseline prudential regulatory framework for non-bank mortgage servicers, and provides additional information and analysis regarding each of the prudential standards proposed by state regulators. Furthermore, state regulators believe that enhanced prudential standards may be appropriate for large, complex non-bank mortgage servicing companies. The proposed enhanced prudential standards build upon the Baseline Standards, and additional standards would be applied to firms according to factors such as the number or dollar amount of loans serviced, the composition of the servicing portfolio, and the entity's primary business (e.g., subservicing, master servicer). State regulators welcome public comment on all aspects of the proposed standards, and specifically request comments on the questions that conclude this report. State regulators will review comments received during the comment period.

BASELINE PRUDENTIAL STANDARDS

As state regulators explored prudential standards for non-bank mortgage servicers, the states expressed strongly that the standards should be scaled to minimize the burden on less complex firms. Accordingly, this set of standards will be relied upon by the regulators for all firms, regardless of complexity. Enhanced requirements will be applied to more complex servicers with a higher risk profile.

During the review of potential areas for prudential standards, state regulators centered on eight areas that should apply to all servicers through Baseline Standards. These categories include:

1. Capital
2. Liquidity
3. Risk Management
4. Data Standards
5. Data Protection, including Cyber Risk
6. Corporate Governance
7. Servicing Transfer Requirements
8. Change of Control Requirements.

For each of these areas, state regulators propose to leverage existing standards or generally accepted business practices. This should allow for an easier transition as the industry should be familiar with the existing standards. In areas where there are not current standards applicable to non-bank mortgage servicers, relying on generally accepted business practices will ensure widely available resources for implementation.

By establishing Baseline Standards, state regulators can focus on the firms that require enhanced standards due to their complexity and overall risk profile. State regulators believe the Baseline Standards should be sufficient for most servicers.

CAPITAL

The Baseline Standards will require a base net worth of $2.5 million with an escalator of .25 percent of the unpaid principal balance of the serviced portfolio. The standard will apply to the corporate entity with the escalator applicable to all serviced loans. Any change to the escalator by a GSE will be applied to all serviced loans. This is the same standard currently proposed by the FHFA for Fannie Mae and Freddie Mac servicers.[5]

LIQUIDITY

The GSEs have proposed a liquidity standard of 3.5 basis points of the agency servicing portfolio if agency non-performing loans is less than or equal to 6 percent. There is an additional incremental

[5] "Proposed Minimum Financial Requirements for Enterprise Seller/Servicers." Federal Housing Finance Agency, January 2015. Available at: http://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Proposed-Minimum-Financial-Requirements-for-Enterprise-Seller-Servicers.aspx.

charge of 200 basis points for non-performing loans if non-performing loans exceeds 6 percent of the portfolio.[6]

The Baseline Standard will adopt the GSEs' standard of 3.5 basis points but apply it to all serviced loans. The Baseline Standard will not apply the additional incremental charge based on non-performing loans due to differences in the advance requirements for private label securities.

Since this standard will only provide liquidity for the servicing portfolio, the Baseline Standard will include a provision for management to have a methodology to determine the liquidity needs for other activities. State regulators will have the ability to challenge the methodology and require additional liquidity if deemed necessary.

RISK MANAGEMENT

Non-bank mortgage servicers face multiple risks which need to be appropriately managed through a variety of market and economic cycles. The ability of non-bank mortgage servicers to internally measure, monitor, and mitigate risks inherent to servicing will help increase the financial strength of non-bank servicers and is a prudent business practice.

All organizations should establish a risk management program under the oversight of the board of directors. The risk management program should have appropriate processes and models in place to measure, monitor, and mitigate financial risks and changes to the risk profile of the firm and assets being serviced. The risk management program should be scaled to the complexity of the organization, but be sufficiently robust to manage risks in a number of areas, including, but not limited to:

- Credit risk
- Reputation risk
- Transaction risk
- Operational risk
- Compliance risk
- Financial risk
- Affiliate/Related Party risk
- Vendor (sub-servicer) risk.

A risk management assessment should be independently conducted on an annual basis concluding with a formal report to the board of directors. Evidence of risk management activities throughout the year should be maintained, including findings of issues and the response to address those findings.

DATA STANDARDS

The CFPB requires data and documentation standards for all entities that service more than 5,000 loans through the *Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X)*[7]

[6] Ibid.

and *Mortgage Servicing Rules under the Truth in Lending Act (Regulation Z)*,[8] collectively referred to as the "Mortgage Servicing Rules." The CFPB's Mortgage Servicing Rules require that within five days of a request by the borrower the servicer must be able to retrieve the following documents and data on each mortgage loan serviced:

- Transactions credited or debited to the loan account, including escrow and suspense;
- Security instrument;
- Notes created by servicing personnel;
- Data fields created by servicers systems; and
- Copies of information provided by the borrowers to the servicer.

Baseline Standards will require the CFPB's Mortgage Servicing Rules standard to apply to all non-bank mortgage servicers and ensure they apply to all serviced loans. As part of effective risk management, all firms will be required to have a documented process for onboarding, maintenance, and internal audit.

DATA PROTECTION

For the non-bank mortgage servicing industry, significant operations are data dependent. Information security is a critical component for institutions to preserve in order to protect customer information, as well as maintain compliance with laws and regulations regarding customer privacy. In addition, strong controls over the protection of customer data mitigate the likelihood of a cyber-threat, security breach, or identify theft.

Data protection in the Baseline Standard is covered in three sections: governance over the information technology, information technology security risk assessment strategy, and routine information technology testing and monitoring.

Governance over IT should include:

- An effective management structure that encompasses proper responsibilities and authorities;
- Documented accountability that provides clear reporting lines, clear expectations, and the use of authority to achieve compliance with policies and standards;
- Strong oversight by the board of directors;
- Documented board approval of written IT policies;
- Senior Management having appropriate responsibility to ensure integration of controls; and
- Security Officers having appropriate authority to respond to security events that occur.

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[7] "Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X)." Consumer Financial Protection Bureau, Docket No. CFPB-2012-0034. Available at: http://files.consumerfinance.gov/f/201301_cfpb_final-rule_servicing-respa.pdf.

[8] "Mortgage Servicing Rules under the Truth in Lending Act (Regulation Z)." Consumer Financial Protection Bureau, Docket No. CFPB-2012-0033. Available at: http://files.consumerfinance.gov/f/201301_cfpb_final-rule_servicing-tila.pdf.

IT Security Risk Assessment encompasses:

- Identifying the data that needs protecting;
- Identifying the entity's outsourcing strategy;
- Classifying and ranking sensitive data;
- Assessing threats and vulnerabilities;
- Evaluating control effectiveness;
- Prioritizing risks;
- Assessing the probability of an event occurring, and the impact the event will have; and
- Identifying gaps in internal controls.

IT Security Testing and Monitoring should:

- Monitor Threats;
- Evaluate emerging threats;
- Monitor for external vulnerabilities and develop mitigation strategies;
- Perform periodic self-assessments;
- Adopt timely corrective action of significant deficiencies;
- Consider business continuity and disaster recovery;
- Assess the scope impact and urgency of new threat vulnerabilities; and
- Reassess the security environment and enhance as necessary.

CORPORATE GOVERNANCE

The board of directors of a non-bank mortgage servicer should establish a sound corporate governance framework to protect the financial interests of the firm's stakeholders and set minimum standards of acceptable behavior for employees in the business. The board of directors should also establish an appropriate set of internal controls, as well as a method for independently validating the accuracy and reliability of the financial and servicing information of the firm. Accurate and reliable information is necessary to monitor the compliance with prudential standards, evaluate emerging risks, and file an accurate Mortgage Call Report.[9] Internal audit requirements should be appropriate for the size and complexity of the firm.

[9] The Mortgage Call Report (MCR) is a quarterly report of residential real estate loan origination, servicing, and financial information completed by companies employing state licensed mortgage loan originators (MLOs). For more information, visit the NMLS Resource Center, available at: http://mortgage.nationwidelicensingsystem.org/slr/common/mcr/Pages/default.aspx.

Ginnie Mae reporting standards will be used as the Baseline Standard.[10] The requirements include audited financial statements and audit reports conducted by an independent public accountant (IPA). The audit reports include:

- Assessment of the internal control structure;
- Computation of adjusted net worth;
- Validation of valuation reserve methodology;
- Verification of adequate fidelity and errors and omissions (E&O) insurance;
- Compliance testing over servicing, pooling and reporting activities; and
- Testing of controls around risk management activities, including stress testing and compliance.

SERVICING TRANSFER REQUIREMENTS

The Baseline Standards for servicing transfers will align with the CFPB's *Compliance Bulletin and Policy Guidance: Mortgage Servicing Transfers*.[11] The bulletin sets forth guidance addressing not only the data mapping problems so often experienced during a large transfer, but also the compatibility of the data. Additionally, FHFA *Advisory Bulletin 2014-06: Mortgage Servicing Transfers* provides guidance required for participation in their programs.[12] Baseline Standards will incorporate both sets of guidance, including these general principles:

- Maintain policies and procedures that are reasonably designed to achieve the objective of facilitating the transfer of information during mortgage servicing transfers;
- Implement a post-transfer process for validating data to ensure it is transferred correctly and is functional, as well as develop procedures for identifying and *addressing* data errors for inbound loans;
- Organize and label incoming information, as well as ensure that the transferee servicer uses any transferred information before seeking information from borrowers; and
- Conduct regularly scheduled calls with transferor servicers to identify any loan level issues and to research and resolve those issues within a few days of them being raised.

CHANGE OF CONTROL REQUIREMENTS

State regulators will require prior notification of a change in ownership of a mortgage servicer to evaluate whether the new owners have the financial capacity and management expertise to effectively

[10] "MBS Guide. Chapter 3: Eligibility Requirements – Maintaining Ginnie Mae Issuer Status." Ginnie Mae, October 2014. Available at: http://www.ginniemae.gov/doing_business_with_ginniemae/issuer_resources/MBSGuideLib/Chapter_03.pdf.

[11] "Bulletin 2014-01. Compliance Bulletin and Policy Guidance: Mortgage Servicing Transfers." Consumer Financial Protection Bureau, August 2014. Available at: http://files.consumerfinance.gov/f/201408_cfpb_bulletin_mortgage-servicing-transfer.pdf

[12] "Advisory Bulletin 2014-06. Mortgage Servicing Transfers." Federal Housing Finance Agency, June 2014. Available at: http://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2014%20AB-06%20Mortgage%20Servicing%20Transfers%20Advisory%20Bulletin.pdf

operate the non-bank mortgage servicer. A change in control is defined as a change of 10 percent or more in ownership of a company, or the ability of a person or group acting in concert to elect a majority of the directors of the corporation. Additionally, if the change results in a group that can effect a change in policy of the corporation, regardless of ownership percentage, the event would also trigger the notice requirement.

ENHANCED PRUDENTIAL STANDARDS

Beyond the Baseline Standards proposed for all firms, certain firms should be subject to enhanced prudential standards based on their other lines of business, size, and overall complexity. State regulators see a need for such firms to have in place advanced risk management and management information systems to mitigate risk. Specifically, these more complex entities should deploy enhanced planning, modeling, metrics, and audit in the following four areas:

1. Capital
2. Liquidity
3. Stress Testing
4. Living Will and Recovery and Resolution Plans.

The firm's management and board of directors would be expected to develop methodologies to determine and monitor appropriate measures for the firm in each of these areas. The methodologies would need to quantify the appropriate level of support and risk tolerance. The approaches would need to account for balance sheet and off-balance sheet activity and exposures. Capital and liquidity should ensure ongoing operations and accommodate a moderate stress environment.

Independent third party assessment will be considered an important part of the enhanced prudential standards. The third party vendor, having expertise in validating modeling assumptions, will provide confirmation to the regulators that the model is appropriate, the assumptions are valid, and the outcomes realistic.

CAPITAL

Capital standards applicable to more complex non-bank mortgage servicers should be commensurate with the risk within the entire firm.

The firm's management and board of directors would be expected to develop a methodology to determine and monitor the whole firm's capital needs. This methodology should incorporate the risk characteristics, described below, that influence the overall risk profile of the entity.

Risks from a Particular Servicing Class

The composition of a servicing portfolio can vary, and include differing levels of risk to the organization based on:

- Size of proprietary portfolio;
- Size of portfolio serviced for others with advance requirements;
- Size of portfolio serviced for others absent advance requirements; and
- Size of portfolio subserviced for a master sub-servicer.

Risks from Particular Loan Types

Different loan types present different levels of financial and operational risk to a non-bank mortgage loan servicer. Each of the following loan types have significantly different risk characteristics and, for companies subject to these enhanced standards, would require varying levels of capital based upon the risk inherent in the following loan types:

- Prime
- Subprime
- Jumbo
- Agency.

The firm's management and board of directors would be responsible for developing a methodology for supporting the capital adequacy of the firm and the capital planning process. The methodology should appropriately incorporate these risk types, as well as other idiosyncratic risks. The methodology would be subject to regulatory approval and would need to be validated by an independent third party.

LIQUIDITY

Liquidity management is integral to a comprehensive prudential regime. Adequate liquidity levels held by large and complex servicers will minimize the likelihood that financial downturns have an adverse effect on these entities, and provide regulators more options in the event that severe problems necessitate regulatory remedies. Liquidity risk management should include a framework that encompasses cash flow projection analysis, a diversified funding strategy, stress testing, and sound contingency funding plans.

The firm's management and board of directors should develop a methodology to measure and monitor the liquidity needs of the enterprise. The methodology should quantify the amount of necessary on-balance sheet liquidity to ensure normal operations during a moderate stress environment. Firms should maintain on-balance sheet liquidity consisting of high quality liquid assets.[13] The methodology would also need to quantify off-balance sheet liquidity in the form of unfunded lines of credit or other sources. Any forms of off-balance sheet liquidity will need to be tested and will be subject to regulatory review.

STRESS TESTING

Stress testing is an analysis or simulation used on asset and liability portfolios to determine their reactions to different financial and economic hypothetical situations. Firms subject to the enhanced standards would be required to maintain a robust, forward-looking capital and liquidity planning process that considers the servicer's unique markets and risks. The process should inform the firm's ability to maintain sufficient capital and liquidity throughout times of economic and financial stress.

[13] High quality liquid assets as defined by the "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards." Office of the Comptroller of the Currency, Federal Reserve Board, and Federal Deposit Insurance Corporation, October 2014. Available at: http://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf.

Independent third party assessment will be considered an important part of the stress testing regime. The third party vendor, having expertise in validating modeling assumptions, will provide confirmation to the regulators that the model is appropriate, the assumptions are valid, and the outcomes realistic.

LIVING WILL AND RECOVERY RESOLUTION PLANS

Although FSOC has not designated any non-bank mortgage servicers as systemically important financial institutions, these firms play a critical role in the housing market. During periods of material financial stress, living wills provide a roadmap that clearly illustrates the ownership and operational structure of the organization, and outlines a possible path to recovery should certain events pose significant hardship for a large servicer.

The roadmap also outlines the necessary steps for management or the regulators to execute an efficient and orderly resolution should failure become inevitable. Typical resolution plans include:

- Consolidated financial information;
- Description of the corporate entity;
- Description of principal business lines;
- Description of foreign operations;
- Identity of vendors key to the firm's operations;
- Identity of principal officers;
- Description of material management information systems; and
- Outline of a recommended plan, with descriptions of potential purchasers of either servicing rights, bulk transfers, or the company outright.

The plan will be subject to regulatory review.

QUESTIONS FOR PUBLIC COMMENT

State regulators request public comment on "Proposed Regulatory Prudential Standards for Non-Bank Mortgage Servicers" and seek feedback on specific questions that will help inform state regulators as we continue to develop a regulatory structure for non-bank servicers. All comments will be made available at www.csbs.org.

1. Should all non-bank mortgage servicers be required to have a full financial statement audit conducted by an independent certified public accountant?
2. Should there be a 6 percent net worth requirement in addition to the minimum capital requirement plus add-on?
3. Is the Fannie Mae and Freddie Mac proposal to require more liquidity when delinquencies rates rise reflective of increased risk? What operational challenges does the standard create?
4. How should state regulators approach formulating a prudential standard for liquidity, considering a firm's potential cash outlays for both private label and GSE backed paper?
5. What is a reasonable ownership percentage threshold to trigger a change in control event?
6. Which criteria should be used to determine the firms that are subject to enhanced prudential standards?
7. Do any of the Baseline Standards threaten the viability of a servicer?
8. What is a reasonable transition period to implement the Baseline Standards? Are there specific standards that would require additional time to implement?
9. What timeframes would be appropriate to implement each of the enhanced standards?
10. What effect will the enhanced standards have on the warehouse and advance facility borrowing contracts/capacity of large servicers?
11. Is a prescribed risk-weighted capital adequacy measure more appropriate than a company established capital adequacy methodology for complex firms subject to enhanced prudential standards?