Appendix

BASELINE Prudential Standards

CAPITAL

The Baseline Standards for capital require the following:

Net Worth: Total Equity Capital as determined by Generally Accepted Accounting Principles (GAAP), minus goodwill and other intangible assets (excluding mortgage servicing rights); and minus receivables from related parties and pledged assets net of associated liabilities.

Minimum Net Worth

- The higher of $2.5 million net worth plus 25 basis points of owned unpaid principal balance (UPB) for total 1 – 4-unit residential mortgage loans serviced[1], or
- FHFA Eligibility Requirements for Enterprise Single- Family Seller/Servicers[2] (as modified from time to time).
- Clarification: For Subservicers Only that are not originators and do not own mortgage servicing rights (MSRs) or whole loans: Minimum net worth requirement is $2.5 million net worth with no additional add on for UPB.

Minimum Capital Ratio

- The higher of Net Worth / Total Assets >= 6%, or
- FHFA Eligibility Requirements for Enterprise Single- Family Seller/Servicers (as modified from time to time).

LIQUIDITY

- Servicing Liquidity: The financial resources necessary to manage liquidity risk for MSRs and loans owned by the servicer arising from servicing functions required in acquiring and financing MSRs, margin calls associated with financing facilities, and advances or costs of advance financing for principal, interest, taxes, insurance and any other servicing related advances.
- Operating Liquidity: The funds necessary to perform normal business operations, such as payment of rent, salaries, interest expense and other typical expenses associated

[1] State regulators intend to seek comments on whether this term should include whole loans.
[2] “Proposed Minimum Financial Requirements for Enterprise Seller/Servicers.” Federal Housing Finance Agency, January 2015 including Updated Eligibility Requirements FAQ published 1/31/2020 available at: https://www.fhfa.gov/Media/PublicAffairs/Documents/Servicer-Eligibility-FAQs-1302020.pdf

with operating the entity. Consideration of such liquidity includes an understanding of increases in operating needs due to changing economic climate or other stresses impacting servicer operations.

State regulators limit the assets that may be used to satisfy liquidity requirements to high quality asset classes.

- Allowable Assets for Liquidity: Assets that may be used to satisfy these liquidity requirements include unrestricted cash and cash equivalents and unencumbered investment grade assets held for sale or trade (agency MBS, obligations of GSEs, US Treasury obligations). Allowable assets do not include unused/available portions of committed servicing advance lines of credit or other unused/available portions of credit lines such as normal operating business lines.

Minimum Servicing Liquidity

State regulators intend to rely on the eligibility requirement calculations established by FHFA but apply these calculations to the entire owned servicing portfolio, including whole loans.

Requirement:

- Base Servicing Liquidity:
    - The higher of 3.5 basis points of agency servicing[3] UPB plus non-agency servicing UPB, or
    - FHFA Eligibility Requirements for Enterprise Single- Family Seller/Servicers applied to both agency and non-agency servicing (as modified from time to time).

Servicing loans in forbearance, delinquency or foreclosure imposes additional costs on servicers and thus requires additional financial resources to cover these costs. Accordingly, the Baseline Standards include an incremental non-performing loan (NPL) charge to enhance the sensitivity of liquidity requirements to portfolio performance. Due to the incremental nature of the charge, as the volume of NPLs increase, so too do the servicer’s liquidity requirements.

Requirement:

- Incremental Non-Performing Loan (NPL) Charge
    - The higher of an incremental 200 basis points charge on NPLs for the portion of agency and non-agency NPLs greater than 6.0% of total servicing, or
    - FHFA Eligibility Requirements for Enterprise Single- Family Seller/Servicers applied to both agency and non-agency NPLs (as modified from time to time).

Note: This proposal does not require minimum Servicing Liquidity for the subserviced portion of a portfolio.

[3] Agency servicing includes mortgage loans purchased or securitized by Fannie Mae or Freddie Mac and loans made, insured, or guaranteed by the Department of Housing and Urban Development, Department of Veterans Affairs, or Department of Agriculture.

Requirements for Maintaining Appropriate Levels of Operating Liquidity

While the above standard addresses the funds needed for servicing functions, Operating Liquidity is not directly addressed. The Operating Liquidity requirement for state-licensed mortgage servicers (below) takes into consideration this gap in existing standards.

Requirement:

All servicers must maintain sufficient Allowable Assets for Liquidity in addition to the amounts required for minimum Servicing Liquidity to cover normal or non-servicing related operating expenses and general business risk (as described under Operating Liquidity above).

In general, all servicers, regardless of size and complexity must have in place sound cash management and business operating plans that match the size and sophistication of the institution. Management is expected to develop, establish and implement plans, policies and procedures for maintaining Operating Liquidity sufficient for the ongoing needs of the institution.

State regulators acknowledge that some servicers may maintain Allowable Assets for Liquidity in excess of the financial resources needed to cover the costs of servicing. State regulators believe this excess should be considered available for Operating Liquidity needs. In other words, if a servicer maintains the required 3.5 basis points of liquidity for its entire portfolio, but on average, its cost coverage for servicing is less than this amount, then the excess funds should be considered available to cover Operating Liquidity.

Requirement:

In addition to policies and procedures implementing the minimum Servicing Liquidity requirements above, management is required to have a sustainable written methodology for determining and maintaining, at all times, sufficient Operating Liquidity to ensure normal business operations, as well as recovery or orderly wind-down of critical operations and services. This methodology should account for the following factors:

- Servicer business model
- Composition of portfolio
- Allowable assets for liquidity
- Average monthly operating expense need
- Excess funds after coverage of monthly servicing expenses available to cover operating expenses

RISK MANAGEMENT

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

Requirement: All organizations must establish a risk management program under the oversight of the board of directors. The risk management program must 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 must be scaled to the complexity of the organization, but be sufficiently robust to manage risks in several areas, including, but not limited to:

- Credit risk
- Liquidity risk
- Operational risk
- Market risk
- Compliance risk
- Reputation risk

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

DATA STANDARDS

Federal regulation 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 Act (Regulation X)[4] and Mortgage Servicing rules under the Truth in Lending Act (Regulation Z)[5], collectively referred to as the "Mortgage Servicing Rules." The 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 the servicer's systems; and
- Copies of information provided by the borrowers to the servicer.

Requirement: Baseline Standards will require the Mortgage Servicing Rules standards to apply to all nonbank mortgage servicers and 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 of serviced loans.

[4] "Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X)." https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1024/

[5] "Mortgage Servicing Rules under the Truth in Lending Act (Regulation Z)." Available at: https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/mortgage-servicing-final-rules-mortgage-servicing-rules-under-truth-lending-act-regulation-z/

DATA PROTECTION

For the nonbank mortgage servicing industry, significant operations are data dependent. Information security is a critical component in protecting customer information and 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 (IT), information technology security risk assessment strategy and routine information technology testing and monitoring.

Requirement:
Governance over IT must 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.

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 include:

- Monitoring threats,
- Evaluating emerging threats
- Monitoring for external vulnerabilities and developing mitigation strategies,
- Performing periodic self-assessments,
- Adopting timely corrective action of significant deficiencies,
- Consideration of business continuity and disaster recovery,

- Assessing the scope impact and urgency of new threat vulnerabilities; and
- Reassessing the security environment and enhancing, as necessary.

CORPORATE GOVERNANCE

Requirement:

The board of directors of a nonbank mortgage servicer must establish a sound corporate governance framework to protect the financial, reputational, cultural and strategic interests of the firm and the firm's stakeholders and set minimum standards of acceptable behavior for employees. The board of directors must 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 compliance with prudential standards, evaluate emerging risks and file an accurate Mortgage Call Report.[6]

Internal audit requirements must be appropriate for the size and complexity and risk profile of the firm. Ginnie Mae reporting standards will be used as the Baseline Standard.[7] The requirements include audited financial statements and audit reports conducted by an independent public accountant (IPA) including:

- 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*.[8] The bulletin sets forth guidance addressing not only the data mapping problems so often experienced during a large transfer of loans, but also

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

[7] "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.

[8] "Bulletin 2014-01. Compliance Bulletin and Policy Guidance: Mortgage Servicing Transfers." Consumer Financial Protection Bureau, August 2014. Available at: https://www.consumerfinance.gov/policy-compliance/guidance/supervisory-guidance/bulletin-mortgage-servicing-transfers/

the compatibility of the data. Additionally, FHFA *Advisory Bulletin 2014-06: Mortgage Servicing Transfers* provides guidance required for participation in their programs.[9]

Requirement:
The Baseline Standards 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 OWNERSHIP AND CONTROL REQUIREMENTS

Requirement:
All nonbank mortgage servicers must provide 30 business days prior notification of a change in ownership of 10% or more of a mortgage servicer.

Such notice is intended to permit regulators to initially evaluate the proposed change in ownership and determine whether additional information about the new owners is needed to permit regulators to thoroughly evaluate the new owner's financial capacity and management expertise to effectively operate the nonbank mortgage servicer. If such a determination is made, regulators will notify the applicant and seek additional information about the owners' financial capacity and management experience.

Enhanced Prudential Standards

CAPITAL

Capital standards applicable to Complex Servicers should be commensurate with the risk within the entire firm.

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[9] "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

Requirement:
The firm's management and board of directors is expected to develop a methodology to determine and monitor the entire firm's capital needs. This methodology must 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 servicer based on:

- Size of each portfolio segment owned (proprietary, private label, Ginnie Mae, GSE);
- Size of portfolio serviced for others; and
- Advancing requirements across each portfolio segment.

Risks from Particular Loan Types
Different loan types present different levels of financial and operational risk to servicers. Each of the following loan types have significantly different risk characteristics dictating varying levels of capital need based upon the inherent risk:

- Prime
- Non-prime
- Jumbo
- Agency (GSE and Ginnie Mae)
- Non-QM

The Complex Servicer's management and board of directors is responsible for developing a methodology for supporting the capital adequacy of the firm and the capital planning process. The methodology must appropriately incorporate unique risks from these loan types, as well as other idiosyncratic risks and must be validated by an independent third party.

LIQUIDITY

Liquidity management is integral to a comprehensive prudential regime. Adequate liquidity levels held by Complex Servicers will minimize the likelihood that financial downturns have an adverse effect on these entities and provide regulators more options if severe problems require regulatory remedies.

Requirement:
Liquidity risk management must include a framework that encompasses cash flow projection analysis, a diversified funding strategy, stress testing and sound contingency funding plans.

The Complex Servicer's management and board of directors is expected to develop and routinely utilize a methodology to measure and monitor the liquidity needs of the enterprise. The methodology must quantify the amount of necessary on-balance sheet liquidity to ensure normal operations during a moderate stress environment. Complex servicers must maintain on-balance sheet liquidity consisting of Allowable Assets for Liquidity described under the Baseline Standards. The methodology must quantify the use of any off-balance sheet liquidity such as use of special purpose entities, parent company or affiliate support, unfunded or uncommitted lines of credit or other sources. Any forms of off-balance sheet liquidity must be tested and will be subject to regulatory review and approval.

Minimum Operating Liquidity

In addition to the Baseline Standards for Operating Liquidity for all servicers, for Complex Servicers, minimum Operating Liquidity amounts will be determined on an individual company basis. Management is expected to develop, establish and implement plans, policies and procedures for complying with liquidity requirements imposed by state regulators.

State regulators will evaluate the Complex Servicer's liquidity methodology and implementation of the methodology and require additional operating liquidity where deemed necessary. In conducting servicer reviews, examiners will consider institution and market risks including:

1. Asset concentration in MSRs.
2. Examination ratings for operational compliance.
3. Risk and delinquency profile of servicing book of business.
4. Servicer advancing obligation for each counterparty and availability of custodial funds to support advancing obligations.
5. Cost and availability of financing for servicing operations and advancing obligations.
6. Hedging strategy.
7. Corporate credit ratings.
8. Corporate family considerations, including affiliate or parent company support or exposure.
9. Stability and oversight of third-party sub-servicer, if applicable.
10. Planned or recent growth of portfolio or business.

Complex servicers that do not hedge their MSR portfolio may be directed by state regulators to carry additional liquidity or document why they do not hedge and the evaluation process they utilized in deciding this strategy.

STRESS TESTING

Stress testing is an analysis or simulation used on asset and liability portfolios to determine the impact caused by different financial and economic hypothetical situations or scenarios. Complex servicers will 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.

Independent third-party assessment and validation is considered an important part of the stress testing regime. A third-party vendor with expertise in developing and validating risk modeling assumptions provides state regulators with confirmation 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 nonbank 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 Complex 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 and corporate family,
- Description of principal business lines,
- Description of foreign operations,
- Identity of vendors key to the firm’s operations,
- Identity of principal officers,
- Identity of key creditors and credit terms,
- 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.

Requirement:
Complex Servicers are expected to develop and maintain a living will and recovery resolution plan, subject to state regulator review and approval.