Financial and Compliance Auditing Update

AHACPA

Common Engagement Deficiencies

Professional Standards

AHACPA

- Failure to appropriately document planning procedures, including:
  - Risk assessment (and linkage of risks to procedures performed)
  - Planning analytics
  - Understanding of IT environment
  - Internal control testing

FASB Codification

AHACPA

- Failure to disclose the date through which subsequent events were evaluated
- Failure to correctly classify cash flows, present gross amounts instead of net, and identify non-cash transactions on the cash flow statements
- Failure to appropriately disclose related-party transactions, debt maturation schedules and significant estimates
- Failure to appropriately disclose fair value hierarchy of investments, description of the levels, description of the assumption methods used and tabular presentation of amounts
- Failure to perform sufficient procedures or sufficiently document the procedures to obtain assurance of the fair value measurements

Yellow Book Independence Deficiencies (Peer Review Guidance)

AHACPA

If there is a failure to document **one or more** of the elements of the independence evaluation required by the 2011 Yellow Book, ordinarily the engagement should be considered as not performed in conformity with applicable professional standards in all material respects. If there is marginal documentation of a particular element required by professional standards, the peer reviewer should use judgment to determine the degree of noncompliance on the conclusion of the engagement.

Single Audit Peer Review Deficiencies

AHACPA

Examples of the issues that arise that cause the team captain to consider whether a firm should perform additional audit procedures and reissue the prior year single audit reporting include the following:

1. Missed major program due to using preliminary expenditures when final numbers were higher.
2. Improper clustering of programs resulting in a missed major program
3. Failure to include and audit all programs with same catalog for domestic federal assistance (CFDA) number when determining major programs
4. Failure to properly perform Type A & B program risk assessments
5. Failure to properly compute the program type A/B threshold determination resulting in a missed major program or incorrect program selection
6. Improperly classifying an entity as a low-risk auditee resulting in missed major programs due to percentage of coverage audited as major (watch the 30 day rule)

Single Audit Peer Review Deficiencies, continued

AHACPA

7. Inadequate testing of internal over compliance (for example, not testing to support a low assessed level of control risk, not testing controls relating to some direct and material compliance requirements, or inappropriate sample sizes or related documentation) or compliance (for example, failure to test compliance for all direct and material compliance requirements or inappropriate sample sizes or related documentation) to support the major program opinion
8. Failure to document an understanding of internal control over compliance of federal awards sufficient to plan the audit to support low assessed level of control risk for major programs, including consideration of risk of material noncompliance (materiality) related to each applicable compliance requirement and major program
9. Failure to document the adequacy of the planned sample size for test of controls over compliance to achieve a low level of control risk
10. Failure to document the testing of controls and compliance for the relevant assertions related to each applicable compliance requirement with a direct and material effect for the major program, including insufficient documentation and usage of dual-purpose testing.
11. Failure to document internal controls over the preparation of the Schedule of Federal Awards (SEFA).

Peer Reviewer Focus – Inherent Risk

AHACPA

- ***Guidance***
  - In large, major accounts and audit areas, the inherent risk is rarely low. Low risk may come from a relatively small balance or it may be low on a specific assertion (for example, currency valuation risk when only one currency is involved). Note: Unless controls are tested and determined to be effective, the risk of material misstatement is, essentially, equivalent to inherent risk, even though they may be assessed as required in AU-C sec. 315.
- ***Question***
  - *Revision for 2016*: Where RMM for any relevant assertions or significant accounts is indicative of an IR assessment set at less than high, is there a reasonable basis for that assessment? [AU-C sec. 315.03 and AAG-ARR sec.3.23 and 5.70] Consider: discussions amount the engagement team, key elements of their understanding obtained regarding each aspect of the entity and its environment, and any significant decisions reached or a separately documented IR assessment, if applicable.

Peer Reviewer Focus – Control Risk

AHACPA

Guidance

An assessment of control design and implementation is required on every audit, whether or not controls are tested and relied on. Specifics regarding the account being reviewed should consider the inherent risks and whether specific controls exist to address the inherent risk by assertion.

Question

Consider the relevant assertions and risks related to the account or audit area. Did the auditor evaluate the design and implementation of relevant controls in this area? [AU -C sec. 315] Consider the following:

- Documentation includes actual controls and **not just process descriptions**
- In addition, are all the following present in the documentation:
  - Who performed the procedure and when
  - Who in the client organization was interviewed
  - What evidence regarding the control was examined during the procedure

Peer Reviewer Focus – Control Risk, continued

AHACPA

Question

If control risk is assessed at less than high, has evidence been obtained to support the level of reliance planned, as follows:

- If the auditor is relying on a service auditor's report, did the auditor substantively meet professional requirements regarding internal control, including those detailed at AI35 of this checklist? [AU-C sec. 402)
- For controls where sampling is planned, is the level of testing sufficient to support the level of planned reliance (considering the parameters of risk, tolerable rate, expected rate, and population size) [AU-C sec. 330.07-.10] [AAGARR sec. 5.69]
- For controls not involving sampling (for example, governance assessments) has sufficient evidence been gathered to support the level of planned reliance? [AUC sec. 330.07-.10, AAG-ARR sec. 5.70]

AU-C 315 Paragraph 13

AHACPA

The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit

Q & A on Paragraph 13

AHACPA

- Does the understanding of internal control relevant to the audit encompass more than control activities?
  - All components
  - AU-C is Framework neutral (however, there is only 1 framework – COSO) So it is mandatory to use something, but nothing is mentioned
  - AU-C 315 does identify as requirements all 5 components of COSO

AU-C 315 Paragraph 14

AHACPA

When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.

Q & A on Paragraph 14

AHACPA

Does an understanding of controls relevant to the audit require an assessment of design and confirmation of implementation for all relevant controls every year?

- Yes
- Combination of inquiries and other corroborating procedures
- Flexibility in what is performed each year

AU-C 315 Paragraph 19

AHACPA

- The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:
  a. The classes of transactions in the entity's operations that are significant to the financial statements.
  b. The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
  c. The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.

AU-C 315 Paragraph 19, continued

AHACPA

- The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:
  d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
  e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
  f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

Q & A on Paragraph 19

AHACPA

- Does the auditor have to obtain an understanding of business processes relevant to financial reporting and communication in every engagement?
  - Yes!
  - Processes versus controls

AU-C 315 Paragraph 21

AHACPA

- *Control activities relevant to the audit*. The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

Q&A on Paragraph 21

AHACPA

- What are control activities relevant to the audit (CARA)?
  - Judgment
    - Factors to consider include, among others, materiality, risk and complexity of systems
    - Auditor's knowledge
    - Management's review controls
    - Controls around data and information produced by the entity
  - Requirement
    - Controls that address significant risks of material misstatement
    - Controls that address risks of material misstatement for which substantive procedures alone are not sufficient
    - Controls on which the auditor plans to rely to design substantive procedures
    - Controls over journal entries

AU-C 315 Paragraph 26

AHACPA

- To determine the further audit procedures the auditor should identify the risks of material misstatement at:
  - The financial statement level and,
  - The relevant assertion level for classes of:
    - Transactions
    - Account balances
    - Disclosures

AU-C 315 Paragraph 27

AHACPA

- For the risk assessment the auditor should:
  - Identify risk throughout understanding of the entity and its environment, including controls by considering classes of transactions, account balances and disclosures in the AFS
  - Assess the identified risks and evaluate whether they relate more pervasively to the AFS as a whole and potentially many assertions
  - Relate the risks to what can go wrong at the relevant assertion level
  - Consider the likelihood of material misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in material misstatement

AU-C 315 Paragraph 28

AHACPA

- As part of the risk assessment described in paragraph .26, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk.

AU-C 315 Paragraph 29

AHACPA

- In exercising professional judgment about which risks are significant risks, the auditor should consider at least:
  - Whether there is a risk of fraud
  - Whether the risk is related to recent significant economic, accounting or other developments
  - Complex transactions
  - Involves significant related party transactions
  - Degree of subjectivity in the measurement of financial information related to the risk, especially those related to uncertainties
  - Significant transaction outside the normal course of business

Testing Controls

AHACPA

- Five elements of COSO
  - Evaluate design
  - Test effectiveness of key control attributes (not processes)
    - Inspection and re-performance
    - Procedures consistently performed, by the right person, in accordance to policy, and prevents management override
    - Must test throughout the period
    - Deviations must be defined and documented in advance of the test
    - Determine if expansion of the sample with provide evidence of containment of the error

Sample Sizes

AHACPA

- Size of population has little impact on sample sizes, except for smaller populations
- Controls Testing
  - Identify characteristics indicating performance of control
  - Deviation is a departure from the expected performance of the control (departure from Federal rules or contract conditions
  - Defined for each audit objective
- Compliance Testing
  - Determine whether deviations constitute a finding and its effect on compliance opinion

Dual Purpose Sampling

AHACPA

- Covers both testing of effectiveness of internal control over compliance and whether auditee complied with relevant compliance requirements
- Same sampling unit
- Size will generally be the larger of the two required samples
- Failure of a control may not lead to noncompliance
- Findings evaluated separately
- Documentation clearly distinguishes between controls and compliance testing

Combining Compliance and AFS Samples (paragraph 21.56)

AHACPA

21.56

Another example of using a sample for multiple purposes is when auditors wish to use a single sample for testing for both Uniform Guidance compliance audit objectives and financial statement audit objectives. Such an approach may present additional complexities to consider because often there are different characteristics, and even different appropriate populations, for single audit and financial statement audit tests. Although many auditees record federal award transactions within their general ledgers, populations used for financial statement purposes often do not align well with sampling populations for testing in a Uniform Guidance compliance audit. The same principles described previously for a dual purpose sample apply when a single sample is used to achieve both Uniform Guidance compliance audit and financial statement audit objectives.

Combining Compliance and AFS Samples (paragraph 21.56), continued

AHACPA

21.57

Although it is challenging to select samples that achieve both Uniform Guidance compliance audit and financial statement objectives, they do occur. An example of a sample that achieves both Uniform Guidance compliance audit and financial statement audit objectives is a sample of transactions inspected to determine the following:

- Indications of compliance with relevant federal statutes, regulations, and compliance requirements over allowable costs and cost principles
- Indications of performance of internal controls over both allowable costs and cost principles and appropriateness of the expense for financial reporting
- Evidence that the recorded amount, account, and period are correct for financial reporting

Controls Sample Size

AHACPA

- Planned to a low assess level of risk
- Accordingly, a 90-95% confidence level
- High level of assurance
- Appropriate for populations of greater > 250

Significance of Control and Inherent Risk of Compliance Requirement 0 deviations expected	*Minimum Sample Size*
Very significant and higher inherent risk	60
Very significant and limited inherent risk or Moderately significant and higher inherent risk	40
Moderately significant and limited inherent risk	25

Significance of Control Being Tested

AHACPA

- Amount of evidence may vary based on the significance of the control
  - Example – Loan File QC is the only control over the production of loans. Therefor the significance of the control is great due to the magnitude of risk of noncompliance
- May consider the subsequent information from other procedures that may limit the severity of the impact of noncompliance

Inherent Risk of Noncompliance

AHACPA

- Key Risk factors for Compliance
  - New Program / place in the life cycle
  - Complexity in of program
  - Complex processing
  - Involvement of third parties
  - Previous significant deficiencies and mater weaknesses
  - High employee turnover
  - High volume of activity
  - Substantial change in policies, processes
  - Significant changes in federal statutes, regulations

Reporting To The Board – A New World of Governance

CFPB requires a CMS

AHACPA

- The Owner or the Board of the Company Must:
  - Establish the company's compliance responsibilities
  - Communicates those responsibilities to employees
  - Ensures legal requirements are included in all business processes
  - Reviews operations to ensure responsibilities and legal requirements are met
  - Takes corrective action; updates tools, systems, and materials, as necessary
- HOW ARE THESE RESPONSIBILITES ACCOMPLISHED?

The New World of Governance

AHACPA

- OCC/FDIC Banks have always had Structured Governance
- Governance:
  - Establish Policy for Regulatory Compliance
  - Establish Operating Policy
  - Establish Operating Objectives
  - Approve Budget
  - Create Compensation Standards
  - Select and Supervise CEO
  - Measure Results Monthly

8 Fundamental Areas of Risk

AHACPA

- Credit Risk – Repurchase Tracking & Loss Reserve
- Interest Rate Risk – BE vs Hedging, Lock Policy
- Liquidity Risk – Cash Flow Forecast
- Price Risk – Gain on Sale Baseline and Reconciliation
- Operational Risk – Poor Training, U/W Quits, Branch Quits
- Compliance Risk – forgot about TRID
- Strategic Risk – Growth Exceeds Warehouse Funding Support
- Reputation Risk – Negative Events

The Board Report Content

AHACPA

- Cash Flow Results and Projections
- Revenue – Gain on Sale, Origination Income
- Expenses – COGS, Operating, Unusual Items
- Budget Variance
- Internal Audit Results
- Reporting
  - GAAP reporting with MTM of IRLC
  - Management reporting Excludes IRLC
- KPIs
- Dashboards

What the Board Really Wants to Know

AHACPA

- What happened during the last quarter?
- How do the results compare to what was expected?
- Why was there a difference?
- How do the results compare to last year?
- Why was there a difference from last year?
- How do the results compare to the future?
- What are you doing today to make things different tomorrow?

Use of Key Performance Indicators (KPIs)

- Mortgage Pull-through Rate
- Average Mortgage Loan Value
- Mortgage Application Approval Rate
- Percentage of Loans Abandoned
- Average Applicant Income
- Percentage of Loans Declined
- Percentage of Applications Closed for Incompleteness
- Amount Collected per Collections Employee
- Mortgage Loans Closed per Originator
- Mortgage Production Mix - Purchases
- Applications per Underwriter
- Unit Cost per Loan Serviced
- Unit Cost – Loans Originated
- Loans 90+ Days Past Due
- Total Volume Originated
- Loans Serviced Per Employee
- Loan Production Revenue per Loan
- Production Labor Expense per Loan Originated
- Average Loan Balance
- Loan Cycle Time (origination)
- Apps per Processor
- Closing per year
- Closings per FICO Score Category

CFPB Mandated Controls and Compliance

Ability-To-Repay

AHACPA

- Under the Ability-To-Repay (ATR) rule, a creditor must make a reasonable, good-faith determination that the consumer has a reasonable ability to repay the loan.
- What is a **reasonable, good-faith determination**? Courts would likely consider:
  - Underwriting standards
  - Consumer payment history
  - Inconsistency in applying underwriting standards

Ability-To-Repay, continued

AHACPA

A creditor must consider 8 specific underwriting factors:

1. Currently or reasonably expected income or assets other than the value of the dwelling that secures the loan;
2. Current employment status if employment income is relied on in determining repayment ability;
3. Monthly payment on the covered transaction;
4. Monthly payment on any simultaneous loan;
5. Monthly payment for mortgage-related obligations;
6. Current debt obligations, alimony, and child support;
7. Monthly debt-to-income ratio or residual income; and
8. Credit history.

Qualified Mortgages (QM)

	Types of QM Mortgages			
	General	Temporary	Small Creditor	Balloon Payments
Points and Fees < 3%	X	X	X	X
No Interest only loans or negative amort.	X	X	X	X
Loan terms not < 30 year	X	X	X	X
Higher-priced (APR > APOR by 1.5 points) for first lien and 3.5 popints for second-lien	X	X		
Higher-priced (APR > APOR by 3.5 points) for both first and secondary lien loans			X	X
Rural/Underserved				X
Term of at least 5 years				X
Debt to Income Ratio	43%	Meet GSE Requirements	Not specified	Not specified

Small creditor - originates fewer than 500 first-mortgage per year and less than $2 billion in assets

Loan Originator Compensation

AHACPA

On January 20, 2013 the CFPB issued a final rule on LO Comp under TILA, as amended by Dodd-Frank. Revised the Federal Reserve Board's LO Comp Rule.

- LO defined as: "a person who takes an application, offers, arranges, a assists a consumer in obtaining or applying to obtain, negotiates, or otherwise obtains or makes an extension of consumer credit for another person."
  - Excludes persons who perform administrative or clerical tasks
  - Teller/Receptionist: not an LO as long as this person does not discuss credit terms that may be available to that person selected based on the person's financial characteristics and does not refer the consumer, based on the LO's assessment of the consumer's financial characteristics, to a particular LO

Loan Originator Compensation, continued

AHACPA

The rules prohibit:

- Compensating a LO based on a term of a transaction or a "proxy" for a term of a transaction
  - Proxy for a term: (i) consistently varies with a factor or term over a significant number of transactions, and (ii) the LO has the ability to manipulate the factor.
  - Examples from the final rule on what a proxy is
- Dual Compensation: a LO receives compensation from the consumer and an additional party
- "Steering," or directing a consumer to execute a transaction based on the fact that doing so will result in higher compensation for the LO from the creditor

Loan Originator Compensation, continued

AHACPA

Exception to term of transaction prohibition

- Compensation under a non-deferred profits-based compensation plan is permitted IF:
  - The compensation paid does not exceed 10% of the LO's total compensation, or
  - The LO served in that role for ten or fewer transactions during the 12-month period preceding the date of compensation determination.

Loan Originator Qualifications

AHACPA

- LOs must comply with licensing, registration and other provisions of the Secure and Fair Enforcement of Mortgage Licensing Act (SAFE Act).
- Pursuant to Dodd-Frank, for employees not covered by the SAFE Act or state implementing laws, loan originator organizations must:
  - Obtain a state and national criminal background check
  - Obtain a credit report
  - Obtain information from the National Mortgage Licensing System and Registry
- The rule establishes standards for determining employee qualification that are mostly consistent with those in the SAFE Act

Consumer Protections

AHACPA

Pursuant to Dodd-Frank, it is unlawful for any provider of consumer financial products or services or a service provider to engage in any unfair, deceptive or abusive act or practice(UDAAP).

- Examples of UDAAPs:
  - Collecting fees not expressly authorized by the agreement creating the debt or permitted by law
  - Falsely representing the character, amount, or legal status of the debt
  - Misrepresenting to consumers that their debts would be waived or forgiven if they accepted a settlement offer

TILA-RESPA Integrated Disclosure

AHACPA

- These forms will "_____"

TILA-RESPA Integrated Disclosures

AHACPA

- Consolidates four existing disclosures required under TILA and RESPA for closed-end credit transaction into two forms:
  - Loan Estimate issued no later than the 3rd business day after the app
  - Closing Disclosure issued at least 3 business days prior to closing
- Forms retained for 5 years
- Must be used on loans with APPs after 10/3/2015
- Applies to most closed-end consumer credit transactions except, HELOC, HECMs, chattel dwelling loans

Fee Variances

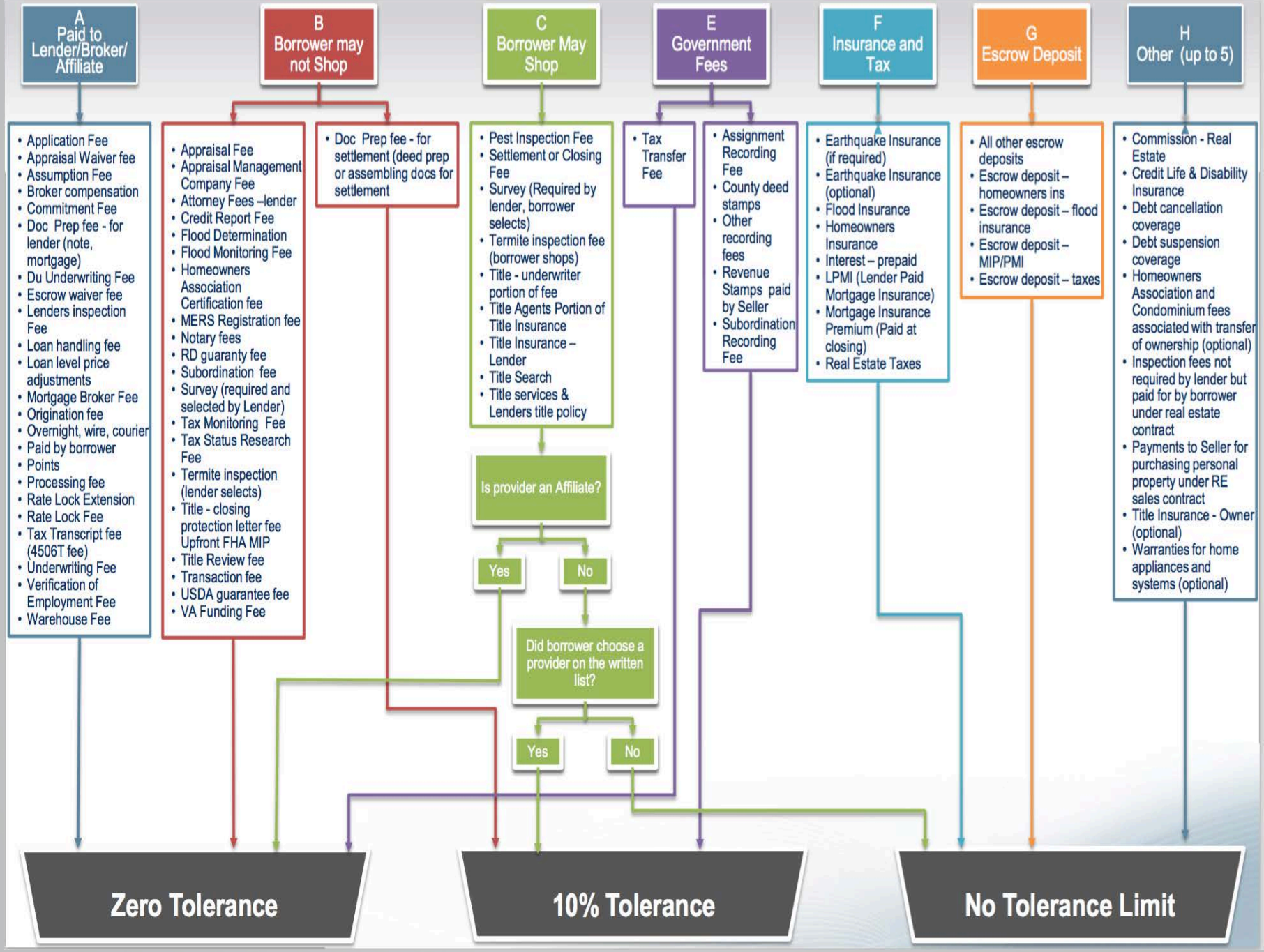
AHACPA

- Three categories with differing variances allowed
  - Zero % Variance
    - Fees that cannot increase
    - Credits that cannot decrease
  - 10% Variance
  - Charges that change (any variance)

Fee Variances

AHACPA

- Borrower Cannot Shop for Services:
  - No Variance is allowed
  - Any estimated closing cost disclosure must be honored
- 2.a Borrower Can Shop for Service:
  - Picks Your Recommended Provider. 10% Limit applies.
  - Be careful who is on Settlement Provider List
- 2.b) Borrower Can Shop for Service:
  - Picks Provider NOT on Lender's list
  - No Limit to Fee Estimate Change


A
Paid to Lender/Broker/ Affiliate
B
Borrower may not Shop
C
Borrower May Shop
E
Government Fees
F
Insurance and Tax
G
Escrow Deposit
H
Other (up to 5)
• Application Fee
• Appraisal Waiver fee
• Assumption Fee
• Broker compensation
• Commitment Fee
• Doc Prep fee - for lender (note, mortgage)
• Du Underwriting Fee
• Escrow waiver fee
• Lenders inspection Fee
• Loan handling fee
• Loan level price adjustments
• Mortgage Broker Fee
• Origination fee
• Overnight, wire, courier
• Paid by borrower
• Points
• Processing fee
• Rate Lock Extension
• Rate Lock Fee
• Tax Transcript fee (4506T fee)
• Underwriting Fee
• Verification of Employment Fee
• Warehouse Fee
• Appraisal Fee
• Appraisal Management Company Fee
• Attorney Fees –lender
• Credit Report Fee
• Flood Determination
• Flood Monitoring Fee
• Homeowners Association Certification fee
• MERS Registration fee
• Notary fees
• RD guaranty fee
• Subordination fee
• Survey (required and selected by Lender)
• Tax Monitoring Fee
• Tax Status Research Fee
• Termite inspection (lender selects)
• Title - closing protection letter fee
Upfront FHA MIP
• Title Review fee
• Transaction fee
• USDA guarantee fee
• VA Funding Fee
• Doc Prep fee - for settlement (deed prep or assembling docs for settlement
• Pest Inspection Fee
• Settlement or Closing Fee
• Survey (Required by lender, borrower selects)
• Termite inspection fee (borrower shops)
• Title - underwriter portion of fee
• Title Agents Portion of Title Insurance
• Title Insurance – Lender
• Title Search
• Title services & Lenders title policy
Is provider an Affiliate?
Yes
No
Did borrower choose a provider on the written list?
Yes
No
• Tax Transfer Fee
• Assignment Recording Fee
• County deed stamps
• Other recording fees
• Revenue Stamps paid by Seller
• Subordination Recording Fee
• Earthquake Insurance (if required)
• Earthquake Insurance (optional)
• Flood Insurance
• Homeowners Insurance
• Interest – prepaid
• LPMI (Lender Paid Mortgage Insurance)
• Mortgage Insurance Premium (Paid at closing)
• Real Estate Taxes
• All other escrow deposits
• Escrow deposit – homeowners ins
• Escrow deposit – flood insurance
• Escrow deposit – MIP/PMI
• Escrow deposit – taxes
• Commission - Real Estate
• Credit Life & Disability Insurance
• Debt cancellation coverage
• Debt suspension coverage
• Homeowners Association and Condominium fees associated with transfer of ownership (optional)
• Inspection fees not required by lender but paid for by borrower under real estate contract
• Payments to Seller for purchasing personal property under RE sales contract
• Title Insurance - Owner (optional)
• Warranties for home appliances and systems (optional)
Zero Tolerance
10% Tolerance
No Tolerance Limit

APR: RegZ §1026.4(c)(7)

Charges excluded from the finance charge

The following charges are not finance charges:

1. Application fees charged to all applicants for credit, whether or not credit is actually extended.
2. Charges for actual unanticipated late payment, for exceeding a credit limit, or for delinquency, default, or a similar occurrence.
3. Charges imposed by a financial institution for paying items that overdraw an account, unless the payment of such items and the imposition of the charge were previously agreed upon in writing.
4. Fees charged for participation in a credit plan, whether assessed on an annual or other periodic basis
5. Seller's points.
6. Interest forfeited as a result of an interest reduction required by law on a time deposit used as security for an extension of credit.
7. **REAL-ESTATE RELATED FEES**

   The following fees in a transaction secured by real property or in a residential mortgage transaction, if the fees are bona fide and reasonable in amount:

   i. Fees for title examination, abstract of title, title insurance, property survey, and similar purposes.
   ii. Fees for preparing loan-related documents, such as deeds, mortgages, and reconveyance or settlement documents.
   iii. Notary and credit-report fees.
   iv. Property appraisal fees or fees for inspections to assess the value or condition of the property if the service is performed prior to closing, including fees related to pest-infestation or flood-hazard determinations.
   v. Amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge.

Servicing

AHACPA

CFPB Bulletin 2013-12 - -Effective January 10, 2014

Impacts Virtually All Mortgage Loan Servicing Activity

Important Note: Interim Servicing is Servicing

Mortgage banks collecting first payments is Interim Servicing and is subject to all federal regulations of servicers and specifically:

- FDCPA
- FCRA
- CFPB Servicing Rules

Servicing Rules from CFPB 2013-12

AHACPA

Monthly billing statements – Periodic Statements

- Servicers are required to provide additional loan information in customers' monthly billing statements.
- If these statements aren't clear and concise, customers can be confused and overwhelmed about the information they receive

Adjusted rate mortgage (ARM) loan notices

- The first rate change notice, must be sent to customers 210 days before the payment change is due.

Note: In some cases, the information provided to the customer will be only an estimate.

Servicing Rules from CFPB 2013-12

AHACPA

QWR – Qualified Written Response

Error notice (resolution) and information Requests –

- Within 5 days, acknowledge the request or notice of error.
- Within 30 to 45 days, correct the error and provide the consumer written notification of the correction, or conduct an investigation and provide the consumer written notification that no error occurred.
- Within 30 to 45 days, provide the information or conduct a reasonable search for the requested information and provide the consumer with a written notification explaining why the information is not available.

Servicing Rules from CFPB 2013-12

AHACPA

Loss Mitigation Procedures

- Work with consumers to address loss mitigation options
- Evaluate loss mitigation applications within 30 days
- Inform consumers of whether the servicer will offer the consumer a loss mitigation option and,
- if the consumer is denied a loan modification option, of the reasons for the denial
- Evaluate timely appeals submitted by eligible consumers by different personnel who denied the application
- Halt all foreclosure process during modification process

Servicing Rules from CFPB 2013-12

AHACPA

Prompt Payment Crediting and Payoff Statements

- Periodic payments must be promptly credited as of the day of receipt.
- If you receive a payment that is less than the amount due for a periodic payment, you may place the payment in a suspense account.
- In addition, creditors, assignees, and servicers must provide an accurate payoff balance to a consumer no later than 7 business days after receipt of a written request from the consumer for that information.

Servicing Rules from CFPB 2013-12

AHACPA

Forced Placed Insurance

- You must have a reasonable basis to believe that a consumer has failed to maintain required hazard insurance before charging for force-placed insurance.
- You must send 2 notices to the consumer that you have not received evidence before you charge for force-placed insurance.
- You must cancel force-placed insurance within 15 days of receiving evidence that the consumer has required hazard insurance in place and refund to the consumer any fees or charges for periods of overlapping coverage.

Servicing Rules from CFPB 2013-12

AHACPA

Early Intervention with Delinquent Customers

- Services must make a good faith efforts to establish live contact with consumers by the 36th day of their delinquency and,
- promptly inform them of loss mitigation options that may be available
- In addition, servicer must provide the consumers with written information about any available loss mitigation options by the 45th day of delinquency
- The rules contain model language servicers may use for the written notice.

Servicing Rules from CFPB 2013-12

AHACPA

Continuity of contact with Delinquent Customers

- Servicers must assign personnel to delinquent consumers by the 45th day of the consumers' delinquency.
- Help the consumer to pursue loss mitigation options and applicable timelines.
- Servicers must retrieve the complete record of the consumer's payment history and all of the written information for evaluating a consumer loss mitigation options.
- Servicers must provide a timely live response to consumers who call and leave a message

Servicing Rules from CFPB 2013-12

AHACPA

Servicing Policies and Procedures

- Accessing and providing timely and accurate information
- Properly evaluating loss mitigation applications
- Facilitating oversight of, and compliance by, service providers - TPM
- Facilitating transfer of information during servicing transfers
- Informing consumers of the written error resolution and information request procedures
- Record retention
- Servicing file creation

Servicing Rules from CFPB 2013-12

AHACPA

Servicing Exemptions

- CFPB rules exempt small servicers
- Less than 5,000 loans
- Do not servicing for anyone else
- Items never exempt
  - QWR – Error resolution
  - Force Placed insurance
- Several other items

Third-Party Vendor Management

OCC	OCC Bulletin 2013-29 • OCC Bulletin 2001-47 • OCC Bulletin 2002-16: Foreign-Based Third-Party Service Providers
CFPB	Bulletin 2012-03 Service Providers
Federal Reserve Board	SR 13-19 Guidance on Managing Outsourcing Risk • SR 00-4 (SUP): Outsourcing of Information Technology and Transaction • Processing
FDIC	Letter: Guidance For Managing Third-Party Risk • FDIC Compliance Manual, December 2012 • FIL-44-2008: Guidance for Managing Third-Party Risk • FIL-50-2001: Bank Technology Bulletin: Technology Outsourcing Information Documents
NCUA	Supervisory Letter No.: 07-01

Fortunately expectations are similar among regulators

MBS' "Best Practices" Definition of Service Provider

AHACPA

Unofficial definition of Service Provider is:

a "service provider" is a company or person who provides a material service to a mortgage lender offering a consumer financial product including anyone who:

- talks to the borrower about personal information,
- has access to borrower information,
- transmits and holds borrower data,
- reviews borrower data or
- in any other way can access or capture borrower information

Identifying Service Providers

AHACPA

If a Vendor can see a social security number, then they are a CFPB Service Provider because they could potentially harm a consumer.

A Vendor may be considered a Service Provider if they are placed in a position to potentially harm the consumer arising out of data/communications they received about the customer/mortgagor's financial distress received directly or indirectly from Mortgage Lender

The Mortgage Lender is responsible to protect borrowers from harm by validating that third party service providers (Vendors) have the ability to comply with all federal consumer protection laws.

Service Providers are an extension of the Lender as it relates to compliance with federal consumer laws.

12 Key Dimensions

AHACPA

- Risk Classification
- Due Diligence
- On-Boarding
- Contracts
- Compliance
- Audits
- MIS / Reporting
- Scorecards
- Annual Certifications
- Complaint Handling
- Escalations
- Governance

Execute these well… satisfy your Regulators

Risk Weighting of CFPB Service Providers, continued

Risk Classification

- Risk-based segmentation
- Scope and intensity of oversight is defined here
- Must consider risks to…

- Legal & Regulatory
- Reputation
- Sensitivity of data
- Process complexity
- Customer interface/impact
- Public or private vendor

Other Considerations

- Domestic
- Offshore

- Core Bank Function
- Non- Core

- Number of similar suppliers
- Percent of volume handled

- Strategic (High)
- Major (Med)
- Basic (Low)

Due Diligence of Vendors

Due Diligence

- Assess the process of how suppliers are…
  - Sought
  - Vetted
  - Selected (and retained)
- Consider vendor questionnaire and evaluation matrix

On-Boarding

- Have a plan to implement the vendor relationship
  - Technology, telecom, recruit, train (including compliance), etc.
- Critical: System Entitlements
  - Limit vendor access to only what is "required"
  - Have a revocation process
    - Consider revoking within 24-hours of leaving

Due Diligence Scope of Work

AHACPA

Primary Objective: protecting consumers from harm.

- Obtain a **Letter of Assurance** from the vendor representing that they follow the requirements of the CFPB relating to consumer protection
- Review Vendor's Procedures, Internal Controls and Training
- Test Vendor's Compliance with Procedures

The CFPB bulletin says that you must:

1. conduct Due Diligence of the vendor's operation to verify they understand and are capable of complying with federal law and
2. review their Policies and Procedures, their Internal Controls, and their Training relating to protecting consumer data.

On-Site or Remote Due Diligence

AHACPA

High-risk vendor due diligence assessment must:

- result in obtaining reasonable assurance that the Vendor has the wherewithal to comply with consumer protection laws,
- confirm the vendor has implemented procedures based on best practices in the industry to comply with consumer financial protection laws,
- test to validate that the vendor has implemented testing to identify violations of consumer financial protection laws.

The FFIEC rules require Due Diligence is unique to:

- The Covered Person and
- The Specific Service Provider

Contracts

Contracts

- Regulators have specific expectations regarding vendor contracts
- Examples of often- overlooked clauses:

  - Use of subcontractors
  - Termination for default
  - Compliance with laws
  - Privacy policy (sensitive info)
  - Electronic Transportable Media
  - Right to audit
  - Licensing
  - Indemnification
  - Notification of complaints
  - Handling of media inquiries
  - Service level monitoring
  - Limitation of liability
  - GSA "Excluded Party List"
  - HUD's "Limited Denial of Participation"

What is required of you…
Is required of all members of your supply chain

MAKE IT CONTRACTUAL!!

Vendor Monitoring & Reporting

Compliance

- Identify all relevant compliance requirements and document how requirements are being met
- Regulatory updates and change management process effectiveness
  - Flow down to vendors (operations, contracts, scorecards, etc.)

Audits

- Do your vendors…
  - "Say what they do?" (via Policy & Procedure Manual)
  - "Do what they say?" (can vendors demonstrate it?)
- Have an audit schedule and comprehensive plan
- Ensure risks are documented and controls are in place.

How Frequent ?

Risk Classification	"Potential" Audit Frequency
Strategic (High)	Twice per year
Major (Med)	Once per year
Basic (Low)	Every other year

Example

Vendor Monitoring & Reporting, continued

MIS / Reporting

- You need timely and effective reporting in all supplier relationships.
- Demonstrate you have sufficient visibility and control.

Hard to achieve safety and soundness without robust reporting

Scorecards

- Identify key performance indicators (KPI)s, track and report on them.
- Document vendor improvement plans.
  - Drive accountability.
- Regular reviews.
  - Evidence of follow- up and actions
    - Warning notices
    - Training, certification
    - Volume adjustments
    - Expanded or decreased scope of work

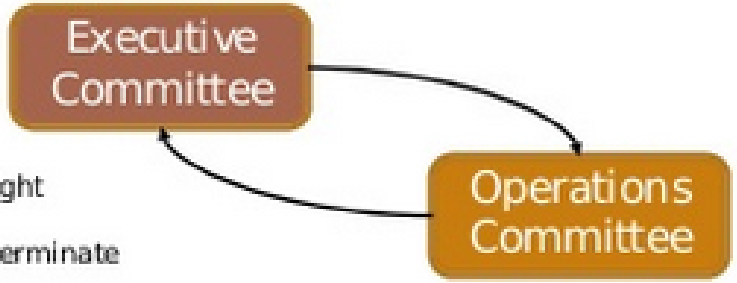
Buy-in of Governance

Governance

"General awareness" of vendors…
No longer acceptable

- Senior executive and/or Board Member engagement
  - "Fingerprints everywhere"
    - Drive and approve policy
    - Monitor vendor platform (via regular readouts)
      At- will access to vendor results
    - Sign- off on vendor selection and recertification (and action/ exit)
    - Audit trail of their engagement
- Proposed: Two Tier Governance Model

Sets "TONE at the TOP"
- Strategic Alignment
- Risk appetite
- Policy
- Verify adequate oversight
- Ask questions
- Approve, Suspend & Terminate



Drive Vendor…
- Performance / Quality
- Control & Compliance
- Risk & Change Mgmt.
- Audits
- Volume Allocations
- Contingency plans

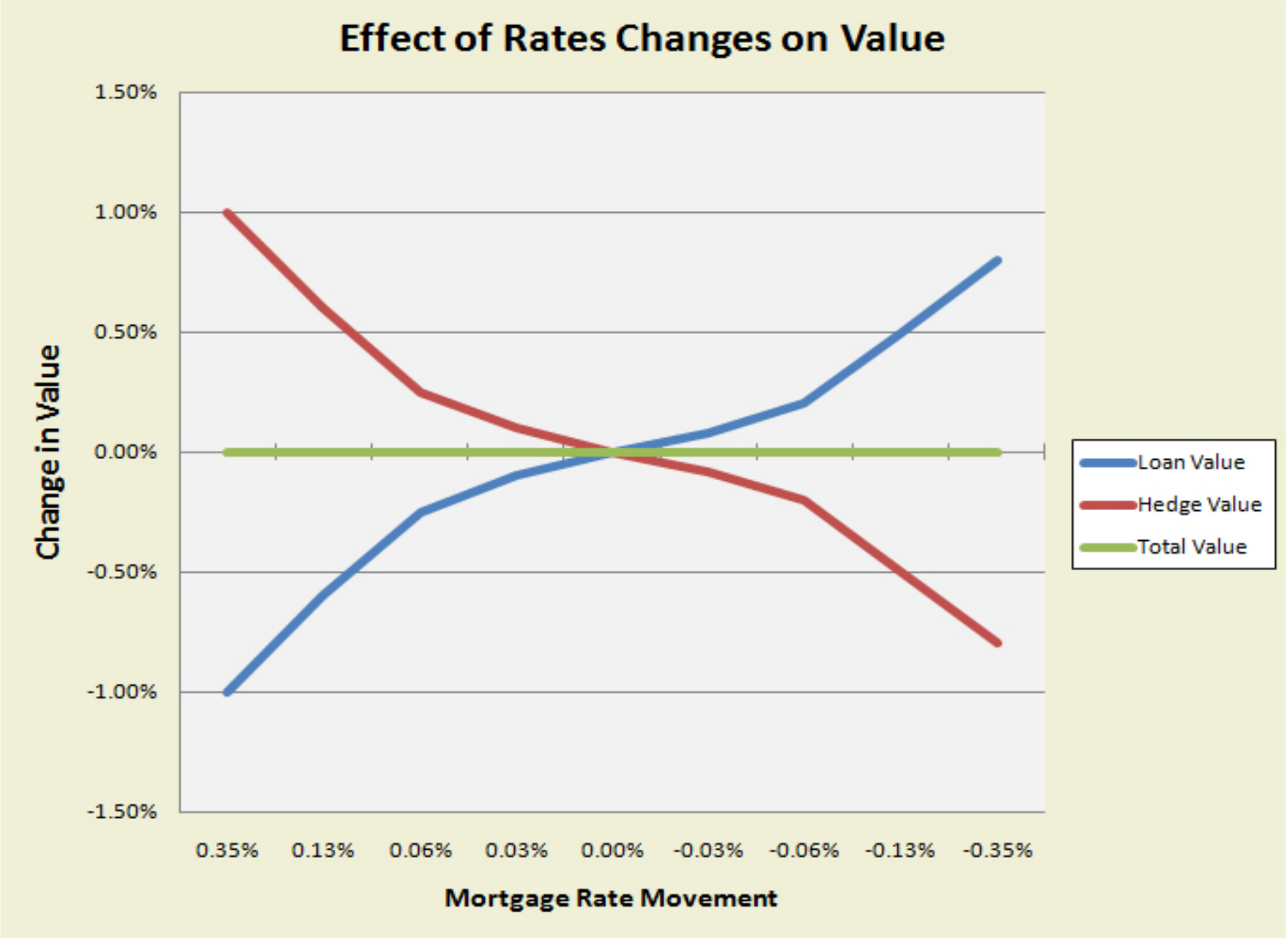
Margin Preservation & Hedging for Accountants

Hedging Off-Set

AHACPA

- The hedge transaction:
  - Establish a financial transaction that possess the same sensitivity to changes in the interest rate environment
  - But behaves with the opposite impact from rate changes
- The LONG position or originating a loan behaves with an inverse relationship to the changes in interest rates
- The SHORT position or selling an MBS has a positive correlation to changes in interest rates. If rates go up, the value of the "short" position goes up
- Being Long and Short in the same transaction offsets or cancels the impact of changes in value from changes in the interest rate environment
- This results in preserving the value of the underlying asset

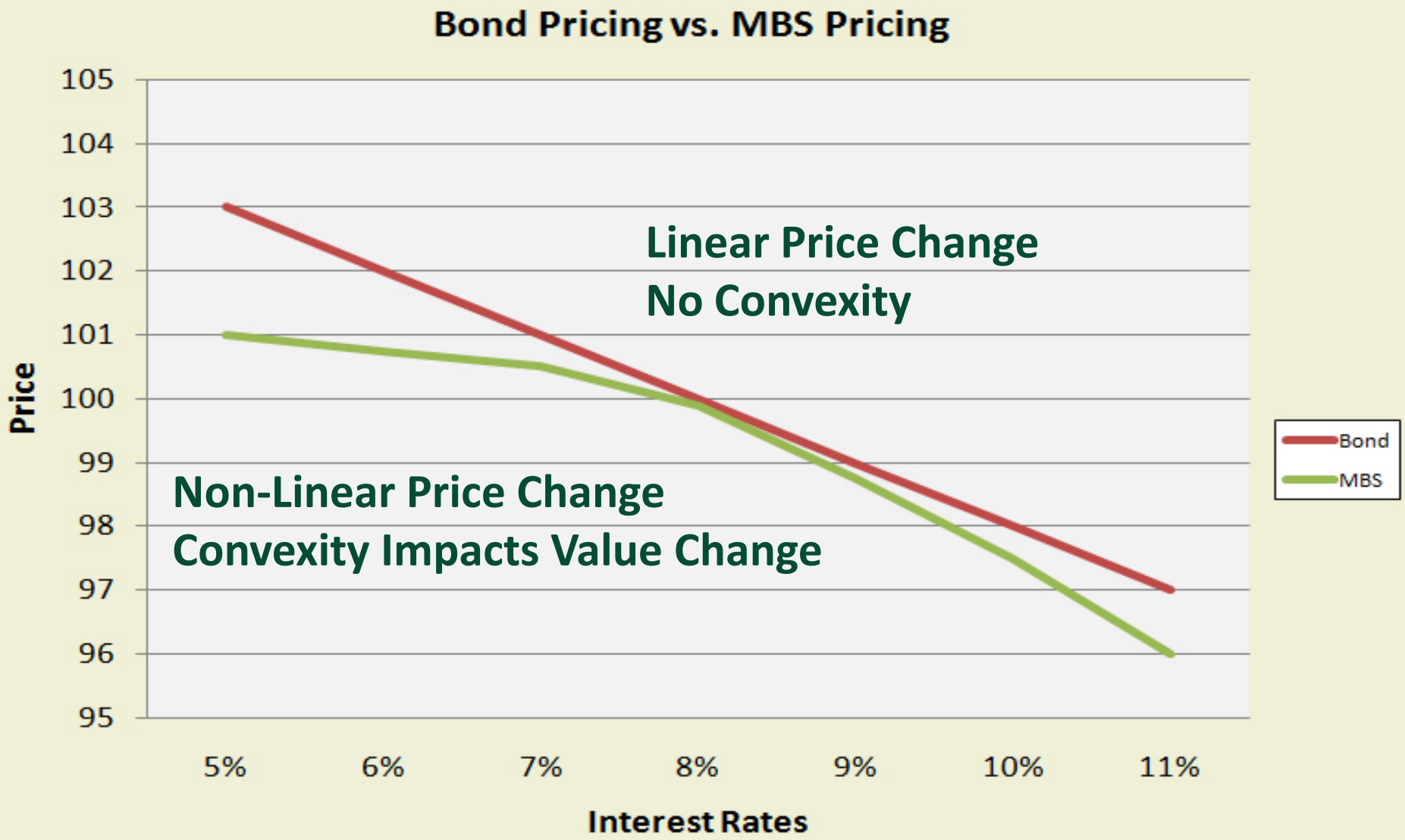
Risk Assessment of Hedging



Value of the loan and hedge react inversely to changes in rates.

Focus is margin preservation.

Risk Assessment Hedging Interest Rates



Hedge Activity Measurement

AHACPA

- Hedge Reports
  - The hedge reports display the estimated pipeline profit and loss over a range of interest rates:
    - Factoring expected changes in market prices and
    - pipeline fallout at each level of interest rate movement
- Rate Shock Analysis
  - Graphically presents the results of the gain or loss net position across a range of interest rate movements as of a specific “snap shot” in time
  - The impact of new locks, canceled locks, loan sales and price movement impact the calculation of this net position

Accountants must understand the shock report!!!

Hedge Rate Shock Report

Rates Decline left to right. Pink line is loan value rising.

Access National Mortgage

Dashboard

Loans up
Hedge down

Current Position Rate Shock

Mortgage Rate Term

Rates Decline >>>

Exhibit B

Hedge Risk Model Sample Reports

Rate Shock Report

Reference Tools
Scales of Balance & UnBalance

Scales of Coverage - Balanced

AHACPA

No Adjustment Needed

Pull-Thru Adjusted Outstanding Interest Rate Lock Commitments

Current TBA-MBS Hedge Coverage

Scales of Coverage - UnBalanced

AHACPA

IRLC more than Hedge
Sell more TBA-MBS

Pull-Thru Adjusted Outstanding Interest Rate Lock Commitments

Current TBA-MBS Hedge Coverage

Scales of Coverage - UnBalanced

AHACPA

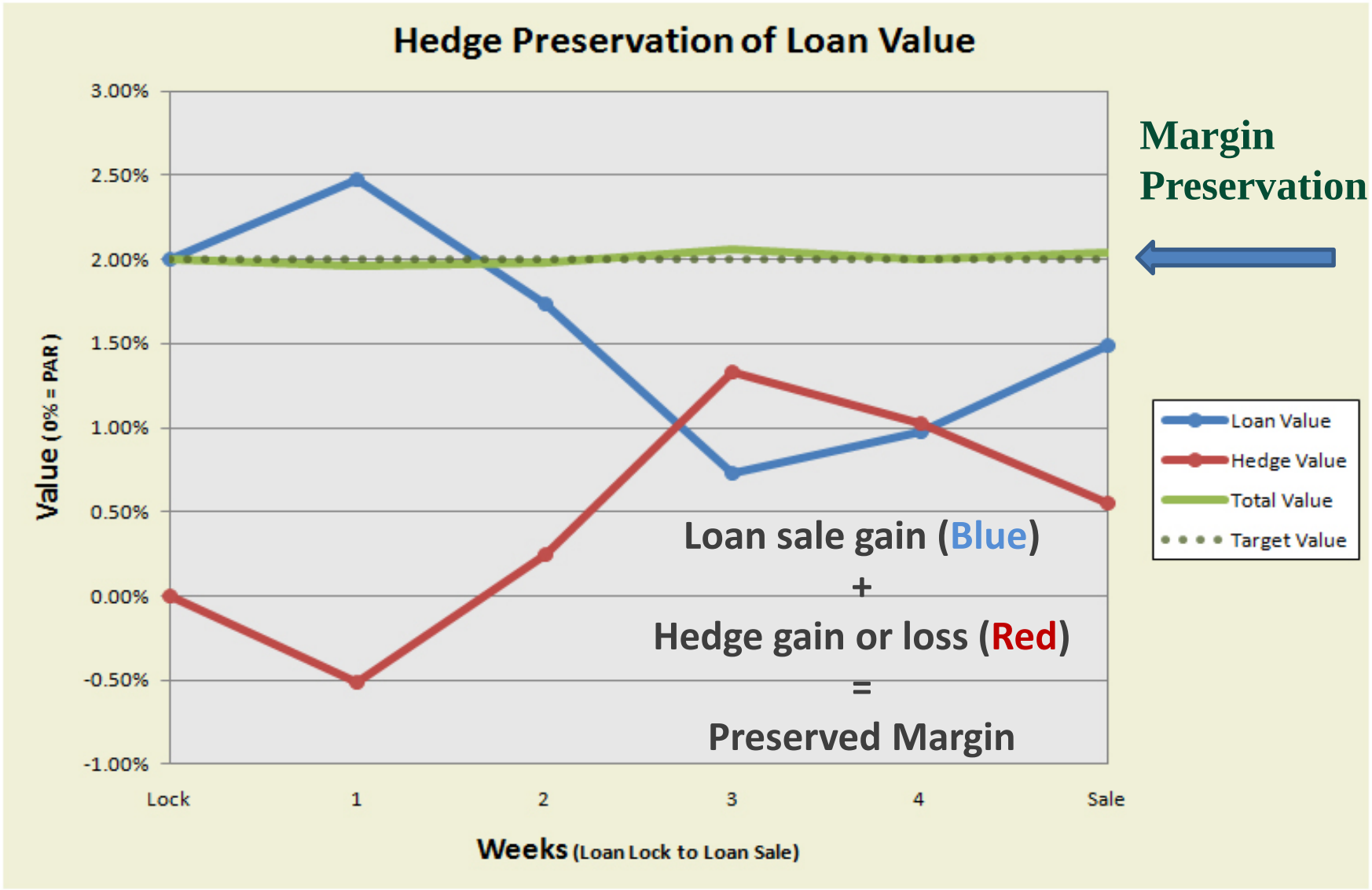
IRLC less than Hedge
Pair-off TBA-MBS

Pull-Thru Adjusted Outstanding Interest Rate Lock Commitments

Current TBA-MBS Hedge Coverage

Perfect Hedge
When it all works

Correctly Managed Hedge Position



Accounting for Mortgage Hedge Activity

Hedging Accounting Standards

AHACPA

- Accounting Standards
  - ASC 815 – Derivatives
  - ASC 820 – Fair Value Measurement
  - ASC 825 – Fair Value Option
  - ASC 860 – MSR

SFAS 133/149 ASC 815-25
Hedge & Derivative Accounting

Objective is to
Avoid Material Misstatement
from off Balance Sheet Commitments including
Derivatives and Hedging Activity

SFAS 157 ASC 820 Measurement
SFAS 159 ASC 825-10-25 Fair Value

Mark to Market Accounting

Objective is to
Report Based on Fair Value

SFAS 140 ASC 860-50-25-1 MSR

Mortgage Servicing Rights

Objective is to

Recognize Value of Future Cash-Flows

PV of Discounted NET Future Cash-flows

Amortization Method or Fair Value Method

ASC 860-50-35-9

IRLC under ASC 815

AHACPA

- An IRLC (Interest Rate Lock Commitment)
  - is an off balance sheet financial commitment
  - subject to market risk and a
  - derivative under SFAS 149 ASC 815 and
  - subject MTM under SFAS 159 ASC 825
- All IRLC are Derivatives
  - An IRLC hedged with Best Efforts is a derivative
  - An IRLC hedged with a short MBS is a derivative
  - The hedge strategy does not change the derivative

ASC 815 – Commitments

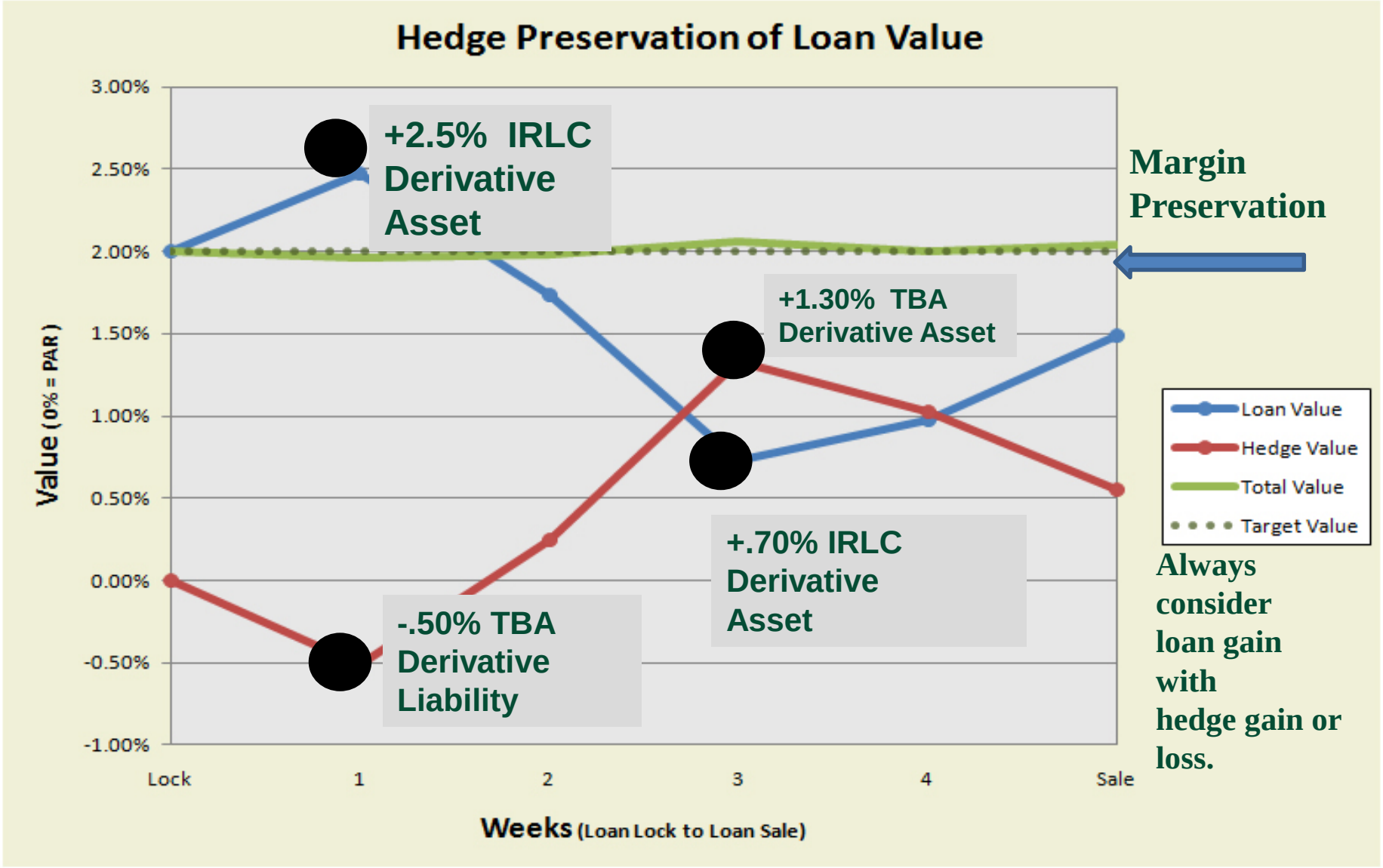
AHACPA

- Mandatory Delivery Commitments
  - Derivatives under GAAP
  - Recorded at Fair Value
- Best Efforts Commitments
  - Do not have a penalty for legitimate cancelation
  - If loan is not closed, the BE is canceled without cost
  - Avoidance of pair-off risk is not a derivative. (most agree)
  - Optional derivative under ASC 825-10-25
- If IRLC is MTM and BE locks are not MTM
  - Potential misrepresentation of gain position
  - Recommend: all commitments are Derivatives/MTM

ASC 815 – Hedge Accounting

AHACPA

- The Interest Rate Lock Commitments – IRLC –
  - IRLCs are initially issued to generate a profit
  - The imbedded profit is valued at each reporting period
  - The resulting gain is recorded as a Derivative Asset
  - It is very unlikely an IRLC will be a Derivative Liability
- Hedge Position
  - TBA-MBS can generate a gain or loss depending upon interest rate activity since the date of sale
  - A TBA-MBS gain is reported as a Derivative Asset
  - A TBA-MBS loss is reported as a Derivative Liability


Hedge Preservation of Loan Value
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
-0.50%
-1.00%
Value (0% = PAR)
Lock
1
2
3
4
Sale
Weeks (Loan Lock to Loan Sale)
+2.5% IRLC Derivative Asset
+1.30% TBA Derivative Asset
+.70% IRLC Derivative Asset
-.50% TBA Derivative Liability
Margin Preservation
Loan Value
Hedge Value
Total Value
Target Value
Always consider loan gain with hedge gain or loss.

Derivative Asset
&
Costs to Complete

Derivative Asset

AHACPA

- ASC 815-25 requires recognition in current earning of the unrealized gain or loss (Fair Value) from off balance sheet commitments
- IRLC is an off-balance sheet commitment (Derivative) subject to market risk and recorded at Fair Value
- Common application of Fair Value of the IRLC is the trading assessment from Investor or Hedge Advisor less Cost to Complete.
- Application of Cost to Complete is the challenge. More Later

Is IRLC Always a Derivative Asset?

- An IRLC is almost always a Derivative Asset because it is highly unlikely for the rates to raise fast enough for the gain on sale to be eroded to less than zero.
- Once since 1933 in February 1980
- If rates rise quickly and there is an extensive application of Costs to Complete it is possible for an IRLC to be a Derivative Liability

Warehouse Lender Capital Leverage

AHACPA

- Derivative Asset Increases Capital
  - DR Asset, CR Gain on Sale

- GAAP Capital in CPA Audited Financial is essential
- Warehouse Lenders establish Lending Limit on Capital
- 15 times Capital is common

- More Capital means is More Warehouse Line
- The DA increases when Costs to Complete decrease
- Mortgage CFO will fight for nominal Costs to Complete

Cost to Complete

101

AHACPA

- CPA Common Practice for Cost to Complete it to extend FAS91, ASC 310 and ASC 820 to include only directs and incremental loan costs

- The degree to which Cost to Complete includes Indirect Costs is hotly debated because the ASC Guidance is Fuzzy

Warehouse Lenders observe CPA firms:

- Apply Cost to Complete calculation differently
- Most significant variation related to which if any Indirect Costs are applied to Cost to Complete

Non-Authoritative Guidance

AHACPA

- The Mortgage Bankers Association believes… Cost to Complete should include:
  - direct costs to closing date, variable portion of branch manager's salary, pre-funding quality control costs
- Cost to Complete should exclude:
  - corporate overhead, branch fixed, branch depreciation, fixed portion of branch manager's salary

Lack of Guidance results in CPA Report inconsistency

Warehouse Lenders are significantly impacted by variability

Warehouse Lenders Complain

AHACPA

- CPA Audits are used to confirm Capital Level
- CPA overstate Capital by under-applying Cost to Complete
- CPAs inconsistently apply Costs to Complete

- Warehouse Lender recalculate Derivative Asset
- Warehouse Lenders apply IRLC times pretax profit to determine Net Realizable (cash-flow) Value
- Recalculated Derivative Asset is included in Capital

- Your client calls because banks reject CPA Capital
- Why should a FS User have to recalculate GAAP?

Loan Size creates Different Ratio

AHACPA

		Large Loans Hawaii	Small Loans Texas		
	Average Loan Size	450,000	180,000		
	Gain on Sale	2.85%	5.55%		
	Gross Revenue	12,825	9,990		
1)	Direct Cost per loan %	1.40%	1.90%	1)	LO Commission
	Direct Cost per loan $	6,300	3,420		Direct File Expense
					Branch Processor
	Gross Margin	6,525	6,570		
	Gross Margin %	1.45%	3.65%		
2)	Indirect Costs per loan	4,950	5,940	2)	Rent (highly variable)
	Indirect Costs per loan %	1.10%	3.30%		Underwriters (4x more)
	Relative Indirect cost	25%	75%		Closing (3x more)
					Management
	Profit before Tax	1,575	630		
	Profit before Tax %	0.35%	0.35%		

Identical IRLC: Uncorrelated

AHACPA

	Large Loans Hawaii	Small Loans Texas	
IRLC after pull-thru	50,000,000	50,000,000	
IRLC Revenue	1,425,000	2,775,000	Gain on Sale
IRLC cost to complete	700,000	950,000	Direct Costs
Derivative Asset	725,000	1,825,000	
Net Realizable Value			IRLC times PreTax Profit
Cash less all costs	175,000	175,000	Perference of Warehouse Banks

Indirect Cost Variability

AHACPA

	Large Loans Hawaii	Small Loans Texas
Example Monthly Indirect Costs Variability		
Monthly Closing	25,000,000	25,000,000
Number of loans	56	139
Number of UW	0.93	3.47
Other Indirect staff	2.78	6.94
Costs per month	$21,219	$62,211
Relative Indirect cost	25%	75%

IRLC is not Inventory… but

AHACPA

- Inventory Absorption Costing Improves Validity of Derivative Asset by including indirect costs
- Work in process cannot be worth more than finished good
- Front-loading of expected future net cash flows should include administrative functions "related to production."
- The closer the reported value of the IRLC is to the net profit margin, the better it correlates to future cash flows
- Warehouse Lenders want to include all indirect costs to directly correlate to Net Realizable (cash-flow) Value
- They are petitioning FASB to provide specific guidance
- See me if you want to contribute to FASB letter

Derivative Asset: Bottom-line

AHACPA

- Continued Confusion –
  - Gain on Sale is recognized when the loan Locked
  - Expense is inconsistently recognized as Cost to Complete or when Loan is Closed

- How can the same $50,000,000 IRLC generates vastly different Derivate Asset with Identical Cash Realization?

	Large Loans Hawaii	Small Loans Texas	
IRLC after pull-thru	50,000,000	50,000,000	
IRLC Revenue	1,425,000	2,775,000	Gain on Sale
IRLC cost to complete	700,000	950,000	Direct Costs
Derivative Asset	725,000	1,825,000	
Net Realizable Value			IRLC times PreTax Profit
Cash less all costs	175,000	175,000	Perference of Warehouse Banks

User Revolt & Opinion Risk

AHACPA

- Warehouse Lenders as "User of Financial Statements" reject Direct Cost Only Method
- At Best, CPAs are inconsistent
- At Worst, CPA Overstate Capital
- Opinion Risk –
  - Warehouse Lenders complain CPA Auditor overstate Capital
  - Overstated Capital places Warehouse Lenders at greater lending exposure
  - What happens when Warehouse Lenders have loss?

Going Concern
ASU 2014-15

ASU 2014-15

AHACPA

- Presentation in Financial Statements
- Identifying, assessing and evaluating evidence to support management's assertion
- Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.
- Effective for ALL reporting periods ending AFTER DECEMBER 15, 2016

Prior vs. New Requirements

- GAAP (per FASB statements) = NONE

- GAAS (per AU-C 570)
  - Auditor MUST evaluate whether there is substantial doubt about an entity's ability to continue as a going concern
  - For a reasonable period of time not to exceed one year beyond the balance sheet date of the financial statements being issued.
  - Auditor must also consider the possible financial statement effects, including footnote disclosures on uncertainties about an entity's ability to continue as a going concern for a reasonable period of time after the balance sheet date.

- **NEW GAAP = ASU 2014-15**

- Management is responsible to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern
- For a reasonable period of time not to exceed one year beyond the date that the financial statements are issued, or are available to be issued
- Management makes an assertion which must be audited based on evidence pertaining to relevant conditions and events that are known or knowable at the date that the F/S are issued or available to be issued

Differences are Significant

AHACPA

- Auditor no longer performs the going concern evaluation / assessment
- Auditor no longer determines whether or not to include footnote disclosures in the F/S
- Management makes an assertion, based on evidence (which has to be auditable) that the entity is or isn't a going concern
- Management develops the appropriate footnote disclosure(s)
- Determination date is when the F/S are issued, NOT the balance sheet date!

Evidence to be Developed by Management

AHACPA

- *QUANTITATIVE*
  - Current financial condition (B/S) including its liquidity sources at the date the F/S are issued
  - Projected income and cash flows
  - Unconditional and conditional obligations due or anticipated to be due within 1 year after the F/S are issued, regardless of whether those obligations are currently recognized in the F/S about to be issued
  - The funds necessary to maintain operations,
    - Current financial condition (B/S)
    - Obligations
    - Other cash flows

Evidence to be Developed by Management, continued

AHACPA

- *QUALITATIVE*
  - Other conditions / events when considered in conjunction with the Quantitative data listed in Slide #18, which may adversely affect the entity's ability to meet its obligations within 1 year after the date that the F/S are issued.
    - Negative financial trends
    - Financial difficulties
    - Internal matters
    - External matters
      - See detailed discussion in ASC 205-45-55-2

Evidence to be Developed by Management, continued

AHACPA

- Plans to dispose of assets or segment(s)
- Plans to borrow money or restructure debt
- Plans to reduce or delay expenditures
- Plans to increase owners equity