鵬元國際 PENGYUAN

Criteria for Service Evaluations

Contents

Summary

Servicing is an essential component in structured finance transactions. Servicers' capacities to process payments, mitigate delinquencies, and maximize recoveries can significantly affect the transactional performance and repayment of rated securities. To assist investors and market participants in assessing a servicer's capacity and effectiveness, PENGYUAN offers a servicer evaluation rating that provides an independent and standardized assessment on a servicer's ability to perform the servicing duties and its management of operational risks.

PENGYUAN's servicer evaluation ratings focus on the quality of the servicing operations rather than the creditworthiness of the servicer. Accordingly, PENGYUAN's servicer evaluation ratings are distinct from PENGYUAN's credit ratings and are subject to different ratings criteria and scales. PENGYUAN's servicer evaluation ratings are primarily assigned to servicers involved in securitized transactions. However, PENGYUAN may also evaluate servicers not currently active in securitized transactions.

This article describes PENGYUAN's approach to assigning servicer evaluation ratings, which assess a servicer's capabilities through an examination of various performance areas and within the context of the portfolio and servicing types. PENGYUAN's servicer evaluation ratings rank servicers in the categories of residential mortgage, commercial mortgage, and asset-backed. Within each category, a servicer evaluation rating is specific to a particular servicing role, which is typically divided into three types:

- Primary Servicers: servicers who are responsible for the day-to-day servicing and performance monitoring of the loans once the loans have been closed.
- Special Servicers: servicers who service delinquent or nonperforming loans.
- Master Servicers: servicers who are responsible for overseeing trust assets and reporting.

PENGYUAN evaluates both quantitative and qualitative risk factors when assigning servicer evaluation ratings. The key performance areas assessed by PENGYUAN include,

- Company Structure and Management
- Staff and Training
- Loan Administration
- Nonperforming Loan Management
- Procedures and Controls
- Outsourcing Vendor Arrangements
- Technology and Disaster Recovery
- Financial Condition

Based on the results of the assessment, PENGYUAN assigns the servicer's operation an evaluation rating of EXCEPTIONAL, GOOD, SATISFACTORY, WEAK and POOR, which indicates the strength of the servicer relative to other servicers performing the same servicing role in the same country.

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Role of Servicers

The servicer functions as an interface between the obligors and investors. Its servicing quality has direct impacts on the cash flows of the securitized collaterals and the performance of the rated transactions. Servicers are responsible for, among other things, administrative functions for collecting and distributing funds, loan administration, asset and property administration, defaulted loan management, and information dissemination to market participants. PENGYUAN's servicer evaluation ratings assess each aspect of the servicer based on its servicing type – primary servicer, master servicer, and special servicer. A summary of the key attributes associated with each of the servicing roles is provided below.

Primary Servicer

The primary servicer is responsible for all aspects of asset administration throughout the asset's lifetime. As the main contact for the obligor, the primary servicer processes payments, enforces reporting requirements, and provides customer services. The primary servicer also manages collections, mitigates losses, and works out the nonperforming loans. Primary servicing is generally performed by the originator. However, the primary servicing function may be outsourced to third parties. Given that the primary servicer is responsible for many servicing functions, PENGYUAN's evaluation places emphasis on whether the primary servicer has the expertise, systems, procedures, and internal controls to effectively perform all the servicing functions.

Special Servicer

The special servicer is responsible for managing and resolving delinquent or nonperforming loans. The special servicer normally takes over the servicing of loans when certain performance triggers are triggered or the loans are nonperforming. Upon the transfer of a loan to special servicing, the special servicer reviews the loan's status and establishes a resolution plan. Usually, there are various possible resolution strategies for a loan. The special servicer should devise and implement the resolution strategies that minimize the losses to the trust considering the positions of all bondholders. PENGYUAN' servicer evaluations for the special servicer mainly focus on the servicer's abilities in mitigating losses, maximizing recoveries, managing forecloses and disposing nonperforming assets.

Master Servicer

The master servicer is responsible for overseeing the primary servicer, providing performance information to investors, delivering cash remittances to the trustee, interacting with the special servicer, and ensuring compliance with serving agreements and regulatory requirements. In addition, the master servicer may be responsible for advancing scheduled payments to cover loan payment shortfalls. When evaluating the master servicer, PENGYUAN places special emphasis on the processes and systems used by the master servicer to ensure the efficient servicer oversight, accurate remittances and reporting, and effective determination of the payment advances.

Servicer Evaluation Rating Levels

PENGYUAN assigns the servicer evaluation ratings using a scale of five rating categories – EXCEPTIONAL, GOOD, SATISFACTORY, WEAK and POOR (see Table 1).

PENGYUAN also characterizes each servicer evaluation rating with an outlook, which represents an opinion on the potential revision of the rating for the intermediate term servicing duration (approximately 6 to 24 months). There are four types of outlooks used by PENGYUAN:

- Positive Outlook: rating may be raised
- Negative Outlook: rating may be lowered
- Stable Outlook: rating is not likely to change
- Evolving Outlook: rating may be raised or lowered

Table 1 Servicer Evaluation Rating Levels

Servicer Evaluation Rating	Description
EXCEPTIONAL	Servicers exhibit the highest servicing capacity, quality, and efficiency. These servicers may be characterized as companies that have a long-term stable servicing operating history, a proven track record of superior management, demonstrated expertise incorporating industry best practices, superior financial resources, advanced information technology, and excellent internal controls, policies and procedures.
GOOD	Servicers exhibit very high servicing capacity, quality, and efficiency. These servicers may be characterized as companies that have a stable servicing operating history, a proven track record of strong management, demonstrated expertise incorporating sound industry practices, strong financial resources, well-established information technology, and strong internal controls, policies and procedures.
SATISFACTORY	Servicers exhibit proficient servicing capacity, quality, and efficiency. These servicers may be characterized as companies that have an acceptable servicing operating history, a proven track record of proficient management, demonstrated expertise in line with industry practices, adequate financial resources, sufficient information technology, and adequate internal controls, policies and procedures.
WEAK	Servicers exhibit a lack of servicing capacity, quality, and efficiency. These servicers may demonstrate some of the following characteristics: an unfavorable servicing operating history, a weak management, limited experience, weak financial resources, deficient information technology, and limited internal controls, policies and procedures.
POOR	Servicers exhibit limited or no servicing capacity, quality, and efficiency. These servicers may demonstrate some of the following characteristics: a poor servicing operating history, significant weaknesses in management, very limited or no experience, insufficient financial resources, significant deficiencies in information technology systems, and very limited or no internal controls, policies and procedures.

Evaluation Process

PENGYUAN's servicer evaluation is primarily based on the analysis of the information provided by the servicer and derived from on-site meetings with the servicer's management team. In advance of the on-site meetings, PENGYUAN provides the servicer with a questionnaire that outlines the scope of the servicer evaluation and includes an information request for materials to be provided to us. Prior to the on-site meetings, PENGYUAN conducts a preliminary review of the completed questionnaire and other provided materials.

Then, PENGYUAN performs an on-site operational review of the servicer. During the on-site review, PENGYUAN meets with the servicer's management and other professional staff to discuss the servicing capacities, processes, and controls. Typically, the on-site review also includes a tour of facilities and a review of system demonstrations. Through the on-site visits, PENGYUAN seeks clarification on the servicer's responses to the questionnaire and obtains additional information on the servicer's operations.

PENGYUAN reviews and analyzes the information gathered through the questionnaire and on-site visits. In the process, PENGYUAN also considers information from other sources as appropriate. Based on the analysis of the collected information, a rating recommendation is presented to a servicer evaluation rating committee. Once the final servicer evaluation rating is assigned and the servicer decides to make it public, PENGYUAN issues the servicer evaluation rating and outlook through a press release. Following this, PENGYUAN also publishes a servicer evaluation rating report providing the rating analysis in greater detail.

PENGYUAN conducts the rating surveillance on an annual basis or more frequently in the event of any material changes, that may affect the servicer evaluation rating or outlook.

Areas of Evaluation

PENGYUAN's servicer evaluation ratings assess the key areas that are critical to the servicer's capacity and servicing quality and efficiency. In particular, we evaluate company's structural effectiveness and management depth; the staff's expertise and professional experience; the capacity of loan administration; the efficiency of nonperforming loan management; the scope and effectiveness of internal controls; the sufficiency of the servicer's financial condition; the adequacy and flexibility of outsourcing management; and the efficacy and security of the information technology environment. Each of these areas is discussed below along with some of the general expectations.

Company Structure and Management

Company structure and management experience are essential components for successful servicing. In our view, an effective management team combined with a well-designed organizational structure can significantly contribute to the servicing performances through efficient business planning and execution, and strategic responses to changes in market conditions.

PENGYUAN assesses a servicer's management by reviewing the ability of its board and executive management and the management's experience in servicing assets. The management team's tenure with servicing companies indicates their knowledge and expertise for conducting servicing activities. We generally expect a servicer's management team to have at least 10 years of relevant experience. PENGYUAN also views favorably the management team that contributes to the development of industry best practices. In addition, PENGYUAN takes into account the length of time the senior management team has worked together, since we believe the core management team who has worked together for an extended period of time ensures the consistency and continuity of strategy planning and execution.

PENGYUAN evaluates whether a servicer's operational structure is appropriate for its servicing requirements, strategies, and risk profiles. Typically, the highly rated servicer's operational structure should sufficiently support the servicer to perform servicing functions and mitigate potential risks. PENGYUAN views favorably the organizational structure that promotes effective operations, ensures compliance with regulations and laws, and adapts to the servicer's portfolios and dynamic market environments.

Staffing and Training

PENGYUAN assesses the servicer's ability to develop, motivate, and retain its talent pool. We believe that employee training is crucial in helping the servicer to maintain a skilled workforce who is aware of the loan servicing best practices. Well-rounded training programs not only expand the staff's knowledge and skills, but also motivate the employees by the fact that the company cares about their personal development. To motivate its staff, the servicer should also provide appropriate compensation plans and opportunities for career advancement. In our view, well trained and motivated staff generally contributes to higher productivity and facilitates better servicing.

As part of its evaluation, PENGYUAN reviews the scope and relevance of the employee training programs. We expect the training programs are comprehensive that include training on servicing practices, risk management, compliance, soft skills, and technology. However, the particular level and delivery method of training should depend on the servicer's size, knowledge base, and its servicing requirements. Generally, servicers that have a dedicated manager responsible for a formalized training function are viewed favorably.

We believe the turnover rate is also an indicator of organizational stability and management's ability to motivate staff. PENGYUAN reviews the staff turnover rate and compares it with the average rate for similar servicers. In our view, both excessively high and low turnover rates imply some management issues.

Staffing plans are typically assessed by workloads and volumes, and the servicer's reaction to workload changes. PENGYUAN views favorably the servicers that are able to reasonably forecast workloads, proactively respond to peak loads, and successfully react to unforeseen servicing volumes.

Loan Administration

A servicer's main function is to process payments and prevent loans from going into default. As part of its evaluation, PENGYUAN reviews the servicer's procedures and practices for new loan boarding, loan and collateral document tracking, payment processing, property and asset administration, investor reporting, advances, and property insurance administration. We expect a highly rated servicer to have efficient frameworks and effective risk controls for all its loan administration functions.

New Loan Boarding

Among the loan administration functions, new loan boarding involves establishing an accurate and complete loan record and transferring the record onto the servicer's servicing system. PENGYUAN assesses the servicer's practices and systems for ensuring the accuracy of the input data and documents. We expect that the servicer has effective controls on data input accuracy and efficient systems for completing the boarding process promptly. We view favorably automation of the boarding process since it generally improves loan-boarding efficiency and reduces errors.

Loan and Collateral Document Tracking

Accurate and complete loan documentation protects the lender's interests and lien position. PENGYUAN reviews the servicer's document tracking by assessing the effectiveness of the servicer's procedures and systems used for verifying the completeness of information and tracking the missing documents.

Payment Processing

PENGYUAN reviews the payment process to determine the efficiency of collecting and posting payments. We also examine the servicer's controls over the fund movements and timeliness of balance reconciliation. We view favorably the servicers who receive the payments electronically and automatically post them.

Property and Asset Administration

The property and asset administration are critical to the servicing of commercial mortgage loans and small balance commercial loans. When assessing a servicer's asset administration, we review the completeness and effectiveness of the servicer's procedures for monitoring portfolio performance. In particular, we consider the administration activities such as collecting and analyzing financial statements, conducting property inspections, tracking the loan and transaction covenant compliance, maintaining a watchlist of potential problem loans, monitoring property insurance, and mitigating delinquencies.

Investor Reporting

As part of the assessment of servicer's investor reporting capacity, we review the servicer's performance in terms of the timeliness, accuracy, and completeness of reporting information and remitting funds. We expect the servicer has effective policies and procedures established to control the potential errors related to information reports and fund remittances.

Advances

Servicers are sometimes required to advance funds for delinquent loan payments to ensure that the bondholders continue to receive the scheduled payments. PENGYUAN reviews the servicer's policies and procedures for advancing. We expect that the servicer follows clearly documented policies and approval procedures for determining the advances on loan payment shortfalls. The policies and procedures should clearly state the conditions for authorizing the advances and processes for their recoveries.

Property Insurance Administration

Property insurance administration is also very important for effective loan administration and operational risk management. When evaluating its property insurance administration, PENGYUAN reviews the servicer's policies and procedures for monitoring property insurance coverage adequacy and policy renewal tracking. In the case that the servicer outsources the property insurance administration to a third party, we expect the servicer can still track the information and activities using its own system.

Nonperforming Loan Management

The ultimate performance of the portfolio is directly impacted by the servicer's default management and loss mitigation strategies. While the special servicer is generally responsible for servicing nonperforming loans, the primary servicer may also perform an important role in the nonperforming loan management. The primary servicer usually manages the nonperforming loans before the loans are transferred to the special servicer under certain conditions. When evaluating the effectiveness of the servicer's nonperforming loan management, PENGYUAN focuses on the servicer's relevant experience, skills and control procedures. We review how the resolution strategies are determined and implemented. We also assess the servicer's loss management outcomes based on loss severity and resolution timing.

For primary and master servicers, we place particular emphasis on the servicer's ability to identify the potential problem loans and ascertain the borrower's ability and willingness to pay. We believe that early problem detection and proactive loss management help to prevent delinquency and reduce the loss severity.

Special servicers are expected to have sufficient nonperforming loan servicing experience and skills. Since working out defaulted loans requires knowledge on local culture and legal systems, we view favorably the servicers who have demonstrable experience and knowledge in the jurisdiction of the serviced portfolios.

There are many possible resolution strategies which may be adopted by the servicers. We are of the opinion that appropriate and effective strategies can reduce the losses and contribute to successful loss mitigation. We expect that highly rated servicers are capable to employ various work-out strategies, such as loan modifications, repayment plans, discount payoffs, enforcement, foreclosure, and bankruptcy.

In addition, PENGYUAN assesses the servicer's actual asset resolution results, such as the recovery amounts and timing. We examine the servicer's historical performances and recovery amounts relative to the collateral values. By doing that, we attempt to identify the servicer's incremental contributions to the observed resolution results.

During the resolution process, servicers generally use a number of third parties, such as legal counsel, appraisers, and property managers. As part of its nonperforming loan management evaluation, PENGYUAN examines the servicer's approval and management procedures for the appointment of the external parties.

Procedures and Controls

We believe that well-documented policies and procedures provide a foundation for consistent practices and effective quality controls. Independent internal controls and audit processes can also help to monitor operational issues and mitigates risks. When assessing the servicer's operational risks, PENGYUAN typically reviews the completeness of the servicer's policies and procedures, as well as the effectiveness and independence of its internal controls and audit processes.

We expect highly rated servicers to have detailed and well-documented policies and procedures for all major functional areas. We are of the opinion that well-designed policies and procedures ensure the quality, consistency, and compliance of the servicing functions. Accordingly, we evaluate the quality of the policies and procedures and the compliance with legal and regulatory requirements. We also assess the process of drafting, reviewing, and updating the policies and procedures.

We examine the findings raised in external and internal audit reports and corresponding management action plans. We believe that independent and effective control functions ensure that the potential risks can be identified and resolved timely. In addition, we review the procedures related to quality assurance, internal control, and auditing. We believe that more effective controls are likely to be implemented when the control functions are independent of each other.

Technology and Disaster Recovery

Technology is critical for the servicer to efficiently and accurately perform its servicing duties. It assists the servicer to automate the servicing functions, streamline the working processes, and disseminate the portfolio information. PENGYUAN reviews the systems and tools adopted by the servicer to assess the appropriateness and completeness of the technology being used. PENGYUAN's technology review typically encompasses the system functionality, information security, and the servicer's disaster-recovery and business-continuity plans.

PENGYUAN generally requests the servicer to provide demonstrations of its major systems and platforms during the on-site meetings. When assessing the systems, we focus on the system functionality and the degree of the system integration. PENGYUAN determines if the servicer is using appropriate technology in the context of the servicer's portfolio size and the long-term strategy. Other than the main system, the servicer may need to use ancillary systems and databases to satisfy its servicing requirements. As part of its technology evaluation, PENGYUAN assesses the extent to which various individual systems are integrated to communicate information and gain efficiency. In addition, PENGYUAN reviews the information security protocols and practices to ensure that the confidential information and data are properly protected and secured.

PENGYUAN's technology evaluation also includes a review of the servicer's disaster-recovery and business-continuity plans. We expect the servicer to maintain viable and comprehensive disaster-recovery and business-continuity plans, which are tested regularly. Highly rated servicers should have well-documented recovery procedures and alternate systems and work locations to ensure the continuity of the servicing functions in the event of natural disasters or other emergencies.

Outsourcing Vendor Arrangements

Use of outsourcing vendors provides the servicer needed expertise and scale flexibility. When the servicer outsources its servicing processes, PENGYUAN evaluates the vendor selection processes, the outsourcing agreements, the servicer's oversight and controls, and the servicer's contingency plans for replacing the problematic vendors. We expect that the servicer has documented procedures for vendor selection and management. The outsourcing agreements should have well-defined incentives, penalties, and the performance criteria to facilitate an effective oversight of the vendors. In addition, the servicer is expected to maintain necessary knowledge of the outsourced processes and full control over the information. If there are potential issues on the outsourcing relationship, we expect that the servicer has the ability to replace the vendors or perform the functions in-house.

Financial Condition

Although PENGYUAN's servicer evaluation is not focused on the servicer's creditworthiness, its financial profile has direct impacts on the servicer's ability to retain management staff, respond to market challenges, and finance investments to sustain or improve its servicing capacity. PENGYUAN assesses the servicer's financial profiles to determine its stability and liquidity.

If the servicer is rated by PENGYUAN, the rating would be used for the evaluation of its financial profiles and converted to a financial condition score. If the servicer is not rated, PENGYUAN would perform an internal assessment of the servicer's financial condition based on the servicer's annual reports, audited financial statements, and other relevant information. A servicer evaluation rating would not be assigned to a servicer whose risk of becoming insolvent over the next 12 to 18 months is very high.

Related Criteria and Research

- Rating Symbols and Definitions, 7 May 2018
- General Principles of Credit Ratings, 21 November 2017

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