Section 4(c)(8) of the BHC Act (Mortgage Banking)
Section 3070.0

A mortgage banker specializes in the origination, acquisition, and sale of residential real estate loans to permanent investors (the secondary mortgage market). Most mortgage banking firms that are affiliated with banks and bank holding companies primarily originate residential real estate loans, although some firms may engage in interim and other lending secured by real estate. Unlike their nonbank competitors, the vast majority of the loans mortgage banks originate are sold to permanent investors in the secondary mortgage market.

Mortgage banks can retain or sell their loans and sell or retain the servicing of their mortgages. The mortgage banking industry currently offers a wide variety of products, market mechanisms, financing vehicles, and financial strategies due to competitive pressures within the mortgage banking industry and rapid growth in the demand for loans and related securities within the secondary mortgage market. Mortgage bankers use these marketing and financing strategies to differentiate themselves from the competition in terms of interest rates, maturities, down-payment requirements, and product offerings.

The earnings stream, cash flow, and capital needs of a mortgage banking company are all highly influenced by management's decision whether to retain or sell the mortgage loans as well as the related mortgage-servicing rights. The majority of loans that are sold in the secondary market are originated under government-sponsored programs. Such loans are either sold directly or are converted into securities that are collateralized by the underlying mortgages (mortgage-backed securities). The pools of collateralized mortgage loans backing mortgage-backed securities provide a form of risk diversification for the investor.

Originations, secondary market sales, and servicing constitute the primary functional business lines within a typical mortgage company. As an originator of mortgages, the company is responsible for the initial phase of the mortgage, from original contacts with the borrowers to the closing of the loans. At closing, the company disburses its funds and becomes the lender of record. Mortgage loans can also be acquired through a network of correspondent companies. Most mortgage banking companies use a combination of origination and acquisition strategies. The decision about whether to originate or purchase loans also varies over time due to fluctuations in demand and pricing discrepancies.

The secondary marketing department is responsible for selling loans in the secondary market and managing the interest-rate risk associated with loans during the interim period. In most cases, the mortgage company retains the loans until it can find a permanent investor to purchase the loans. The mortgage banker obtains purchase commitments from permanent investors and submits completed loan documentation packages to the investors for their approvals in satisfaction of the commitments.

As part of the overall process, the mortgage banker maintains a relationship with a variety of other permanent investors to whom the originated mortgages are sold. These investors are generally institutional investors such as securities dealers, commercial banks, life insurance companies, pension funds, and other financial and nonfinancial institutions. Some of these investors are restricted by state law, charter, or bylaws as to the type of mortgages and the locations of the property in which they can invest. Accordingly, their purchase commitments should incorporate these limits as well as the price and/or required yield of the mortgage loans or mortgage-backed securities. When these commitments are filled and the mortgages sold to the investors, the mortgage banker may retain the servicing rights to the mortgages it sells to permanent investors or sell the servicing rights in the secondary market.

The servicing department manages the loans that were retained in permanent loan portfolio or those that were sold to another permanent investor. Fees paid for services rendered in administering the mortgage portfolios of investors are a principal source of revenue for most mortgage bankers. In general, the company receives a fee that is usually based on a percent of the unpaid balance of the administered mortgages. In return for the fee, the servicer is responsible for collecting and remitting payments, managing the tax and insurance escrow accounts, inspecting the properties when required, pursuing delinquent borrowers, foreclosing on the mortgages when necessary, and providing accounting support. Considering the services rendered and the generally low fees involved, the servicing portfolio must be sizable for the company to be profitable. The servicing portfolio may represent very little credit risk to the servicer and can be a valuable source of residual income to the company.

The mortgage banking industry is experiencing significant consolidation. To be competitive, participants must maximize economies of scale and efficiencies. Emphasis has been placed on using more efficient systems and technologies that enhance loan processing, underwriting, servicing, and the management of pipeline risk (the interest-rate risk associated with the holding period for the mortgages). Existing mortgage banking firms are larger and operate more efficiently (faster, cheaper, and with higher quality) than they did in the past. Operating efficiencies are achieved through the use of sophisticated information systems, such as electronic data interchange, imaging, optical character recognition, expert systems, and other forms of artificial intelligence.

Within a bank holding company, mortgage banking subsidiaries generally focus on residential mortgage lending. As discussed initially, these mortgage bankers may also engage in other forms of lending. On an industry basis, they extend loans to real estate brokers who buy properties for resale, engage in second mortgage and home improvement lending (usually through dealer agreements), and extend interim loans. Interim loans represent a means of funding a project through one or more phases, with the property and improvements as collateral for the loan. The size of interim loans may range from a single residence under construction to large industrial, commercial, or residential projects. Construction lending and other forms of lending may be provided by other such real estate lending subsidiaries located elsewhere within the bank holding company's organizational structure.

The mortgage banker, as a lender, has the flexibility to fund any and all phases of a project including land acquisition, development, and construction. Land acquisition credit may be extended for the acquisition of more than one parcel of land, which may not necessarily be identified with a specific project. More frequently, acquisition credit is tied into a specific project for which the lender expects to fund more than one phase. In development-phase lending, funds are advanced to ''improve'' the property, bring utilities on-site, cut roadways, and prepare the site for its intended use. Many residential and industrial park projects are funded through this phase, with the sale of individual parcels providing the repayment of the loan. Construction lending funds the project from the foundation to completion. For those loans that fund two or more phases, there may be no clear distinction between the phases as certain elements of each may be underway concurrently.

On large projects funded through completion, such as apartment and office buildings where the construction is to be repaid from a permanent mortgage, the lender will usually require the borrower to obtain a permanent mortgage commitment from a third party. While this ''takeout'' commitment may or may not be arranged through the lender's network of investors, this commitment provides the lender with some assurance of repayment. In some cases, particularly in unsettled market environments, these takeouts are not available, and the lender may issue a ''standby'' commitment. On occasion, no permanent financing will be available upon completion and the lender will extend a ''bridge'' loan for the interim period between project completion and the placement of a permanent mortgage. Making construction loans without takeout commitments from responsible term lenders could expose the construction lender to adverse interest-rate movements as well as the market acceptability of the project. The absence of a takeout can represent a weakness in a loan. The general lack of takeouts in a portfolio should be a criticizable management practice (unless mitigating circumstances prevail) and should be discussed with management.

This section provides inspection guidance and procedures for mortgage banking nonbank subsidiaries of bank holding companies. Except for the limited guidance that pertains only to bank holding companies, they may also serve as examination guidance and procedures for mortgage banking subsidiaries of state member banks. The way in which these procedures are used should be determined on a case-by-case basis depending on the size of a particular company and its business activities. The information in ''Board Oversight and Management,'' ''Financial Analysis,'' and ''Intercompany Transactions'' presented in this section is applicable to all mortgage banking reviews. The subsection ''Mortgage-Servicing Rights'' is recommended for use in companies that have significant risk exposure. The examiner should also target functional areas such as production, marketing, and servicing/loan administration.

3070.0.1 BOARD OVERSIGHT AND MANAGEMENT

The examiner should assess the quality and effectiveness of a mortgage banking company's board of directors (board) and executive management team, the appropriateness of its organizational structure, the nature of its internal control environment, and the effectiveness of internal control programs.[1] Such internal control programs may include internal and external audits, loan review, quality control over mortgage loans originated and/or serviced for investors, compliance, fraud detection, and related employee training programs.

The board and executive management team must be evaluated within the context of the particular circumstances surrounding each mortgage banking company. Since business complexities and operating problems vary according to the institution's size, organizational structure, and business orientation, directors and managers who are competent to effectively discharge their responsibilities under one set of conditions may be less competent as these conditions change.

Board oversight and management should be rated satisfactory, fair, or unsatisfactory based on both objective operating results and more subjective criteria. Performance must be evaluated against virtually all the factors necessary to operate the mortgage banking company's activities in a safe, sound, and prudent manner, including the ability to anticipate and plan for future events that may have a material impact on the company's financial condition. Such a rating should also be considered when assigning a consolidated rating of risk management (see section 4070.1 and SR-95-51).

3070.0.1.1 Board Oversight

The mortgage banking company's board provides oversight, governance, and guidance to the executive management team. The board may include executives of the mortgage banking company, executives of the bank holding company and other affiliated companies, and outside directors.

The examiner should determine whether a separate board exists, as well as the identity and qualifications of the members. Minutes of board meetings should be reviewed to determine whether directors are fulfilling their fiduciary responsibilities. At a minimum, directors should—

- select and retain a competent executive management team;
- establish, with management, the company's short- and long-term business objectives and adopt operating policies to achieve those objectives in a safe and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the mortgage banking company's business performance; and
- ensure that the mortgage banking company meets the community's residential mortgage credit needs.

The examiner should assess whether directors exercise independent judgment in evaluating management's actions and competence, attend board and committee meetings regularly, remain well informed regarding the company's activities and the mortgage banking industry overall, and are knowledgeable regarding all applicable state and federal laws and regulations. The examiner should also review the quality of board reporting. Board reports must provide accurate and timely information to directors with respect to operating results, asset-quality trends, liquidity and capital needs, and relevant industry and peer-group performance statistics for each operational area. Directors should also receive information regarding exceptions to established policies and operating procedures, volume-related processing backlogs, and the effectiveness of the internal control programs. Information on hedging products and strategies should be routinely provided to the board and to holding company management. In connection with this portion of the review, examiners should also request and review information regarding all loans to insiders and their related interests to ensure that no preferential transactions have been extended to these parties.

3070.0.1.2 Management

The executive management team generally consists of a president and chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), and senior executives in charge of production, marketing, and servicing/

1. See section 1010.1 of the *Commercial Bank Examination Manual* and a report, ''Internal Control—Integrated Framework,'' which was issued in September 1992 by the Committee of Sponsoring Organizations of the Treadway Commission, for a more detailed discussion of internal controls. The Treadway Commission report broadly defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

loan administration. Management formulates operating policies and procedures and oversees the day-to-day administration of mortgage banking activities. Management should be evaluated in terms of its technical competence, leadership skills, administrative capabilities, and knowledge of relevant state and federal laws and regulations. The management assessment should evaluate management's attitude toward risk, as evidenced by the type of products that are offered; the existence of effective hedging programs; and/or the degree of reliance that is placed on the resources of affiliate banks, nonbanks, and other entities to support mortgage banking company activities.

Prudent operating policies and procedures that are consistent with the business needs and risk-management practices of the parent bank holding company should be in place for each functional area. An effective risk-management program should also be in place. Without adequate management oversight, excessive errors can occur, fraud or other violations of law may go undetected, and financial information may be reported incorrectly. Any of these events can damage the company's image, impair its access to external funding sources, and jeopardize its ability to originate and sell mortgage loans in the secondary market.

It is management's responsibility to develop and maintain management information systems (MIS), which should be dedicated to obtaining, formatting, manipulating, and presenting data to managers when needed. Such systems should generate accurate financial statements; identify the need for financial, human, technological, and physical resources; and produce timely and useful management exception reports.

Management should also be evaluated on its ability to plan effectively. Effective planning entails the annual approval of an operating budget and the development of a long-term strategic plan that helps management anticipate changes in the internal and external environment and respond to changing circumstances. Because losses on the origination of mortgage loans are common in the mortgage banking industry, management should assess the servicing time necessary to recapture costs and achieve required returns. This information is critical to decisions to purchase mortgage-servicing assets, and it should be incorporated into hedging strategies.

The strategic plan should identify the company's strengths and weaknesses, growth targets, and other strategic initiatives (including management's philosophy toward the business, the extent of financial risk-taking, commitments to maintaining procedures and controls in managing the business, and management's commitment to staff development) over a one- to three-year time horizon. Planning efforts should also address system deficiencies and technological advancements within the industry. Without appropriate planning, the company can only react to external events and market forces.

Management should be results-oriented, but not at the expense of sound risk-management practices. Goals and objectives should be specific and measurable. Management should develop a performance measurement system that tracks progress toward achieving both financial and nonfinancial goals.

3070.0.1.3 Organizational Structure

The organizational structure should be reviewed to determine, on a legal-entity basis, the relationship between the mortgage banking company, the bank holding company, and any other bank or nonbank subsidiaries. The structure should also be reviewed to determine whether the lines of authority are clearly defined, the responsibilities are allocated logically, and management depth is sufficient within each division, department, or functional area.

The president and CEO usually reports directly to the mortgage banking company's board of directors, as well as to an executive management committee at the affiliate bank or the bank holding company level. Other reporting lines may exist between functional area executives and their counterparts at either a bank affiliate or the holding company level.

3070.0.1.4 Control Environment

Management's attitude toward risk is communicated to employees through the company's corporate culture. In general, the CEO should establish and communicate a corporate culture that promotes safe, sound, and prudent business practices. The corporate culture should provide a positive control environment, set high standards, and reward ethical, desirable behavior.

Management's failure to communicate acceptable standards of behavior may encourage impermissible or high-risk business practices. For instance, compensation programs that are incentive-based may generate poor-quality loans. Below-market pricing strategies or overly aggressive growth targets may further exacerbate asset-quality problems or generate loans in excess of processing and servicing capabilities.

3070.0.1.5 Control Programs

Management controls in a mortgage banking company consist of an internal audit, an external audit, loan review, compliance, quality control over loans originated and/or serviced for investors, fraud detection procedures and related employee training programs, insurance coverage, and legal review. The examiner should review recent reports conducted by internal loan review, state and federal agencies, and private investors to determine the scope of the review, the nature of any problems noted, and the adequacy of management's response.

3070.0.1.5.1 Internal Audit

The internal audit function in a mortgage banking company is responsible for detecting irregularities; determining compliance with applicable laws and regulations; and appraising the soundness and adequacy of accounting, operating, and administrative control systems. Accounting, operating, and administrative control systems are designed to ensure the prompt and accurate recording of transactions and a proper safeguarding of assets.

Internal audit activities may be conducted through a separate department located on-site or through the internal audit department of the bank holding company. Very small financial institutions that do not maintain a separate audit function may rely solely on their external auditor to perform these functions.

Regardless of the organizational structure, internal auditors must be independent of the line areas being reviewed, have access to all company records, and maintain sufficient status and authority within the company. The internal auditors' findings should be reported directly to the board or a designated committee thereof.

The scope, frequency, and coverage provided through the internal audit program should reflect the size and complexity of the institution. The audit schedule should cover underwriting practices and other high-risk areas of mortgage banking, including the most significant balance-sheet accounts, income statement accounts, and internal control systems.

To yield meaningful results, the department must be adequately staffed with individuals who are experienced and knowledgeable about mortgage banking. Audit staff should receive ongoing training and be encouraged to hold professional industry certifications. Internal audit reports should be issued and responded to by line management in a timely fashion. Follow-up procedures should be in place to ensure that corrective measures are taken.

3070.0.1.5.2 External Audit

External auditors generally review and assess the mortgage company's financial condition and the adequacy of internal controls. The engagement letter sets forth the external auditor's responsibilities, scope, and extent of reliance that is placed on the internal audit department with respect to the type of engagement. When an external audit is to be performed, the audit is an examination that is conducted to determine that the present financial condition of the company and the results of operations are fairly stated and are in conformity with generally accepted accounting principles.

Examiners should review the most recent external audit report to determine whether the opinion regarding the company's financial statements and their disclosures was qualified in any manner. If applicable, examiners should note any significant concerns or weaknesses in the company's internal control structure. Examiners should also review management's written response to the audit to determine whether corrective measures were appropriate, complete, and timely and whether the response reveals any internal control weaknesses.

The reason behind any changes in external audit firms used should be investigated. Unusual items and areas of potential concern should be discussed with management and/or the external auditor. If questions arise during the safety-and-soundness review, the examiner should determine whether the area of concern was considered to be a material item by external auditors, the nature of audit work performed, and the outcome of that review. If questions persist, the examiner may want to request access to specific external audit workpapers.

3070.0.1.5.3 Loan Review

Loan review activities may be conducted at the mortgage banking company or in conjunction with the loan review activities of either an affiliate or the parent bank holding company. In any event, loan review should determine whether mortgage loans that are originated and/or purchased meet underwriting standards as defined in the internal loan policy. Loan review may also sample loans to determine whether they meet underwriting criteria established by investors. The scope of the loan review program should be evaluated. The examiner should also review a copy of the most recent loan review to determine whether problems are identified and addressed in a timely manner.

3070.0.1.5.4 Quality Control

Mortgage banking companies that service loans for investors must also maintain a separate quality control department to test the quality of loans produced and serviced for investors. Investors such as the Government National Mortgage Association (GNMA or Ginnie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and FannieMae issue very specific guidelines that must be met with respect to the scope and frequency of such reviews.

At a minimum, these investors require that the mortgage banking company sample at least 10 percent of all closed loans each month and conduct a quality control review to determine the extent of accuracy, completeness, and adherence to agency underwriting standards. Random samples should include loans originated through the company's own production network, purchased loans, loans for which work was performed by a third party (outsourced), and loans with various product characteristics, such as a high loan-to-value or a convertible feature.

Quality control personnel reverify loan documentation, including the appraisal, down payment, employment, and income information. After each review, the department should issue a comprehensive report detailing specific quality control findings and recommendations. Quality control reviews must be completed within 90 days of closing. Exceptions to company policy or investor underwriting standards should be documented and communicated to executive management. Corrective measures should be initiated promptly.

The quality control function should serve as an early warning system that alerts management to situations that may jeopardize the financial strength, image, or origination and sale capacity of the company. To function as an effective management control, the quality control department should operate independently from the production and servicing/loan administration departments. Quality control should complement, not substitute, work performed by the internal audit and loan review functions.

3070.0.1.5.5 Insurance Program

The insurance program should be reviewed to determine whether coverage adequately protects the mortgage banking company and its affiliates against exposure to undue financial risk. Insurance policies should be reviewed and approved by the board at least annually.

3070.0.1.5.6 Litigation

The legal department should be contacted to determine whether existing or pending litigation exposes the mortgage banking company or its affiliates to undue financial risk. Particular attention should be paid to the status of any actual or pending class action lawsuits of a material nature.

Examiners should also determine whether procedures exist to detect and investigate suspected fraud, either internal or external. In many instances, the legal department coordinates fraud training and investigations, as well as the submission of criminal referral or suspicious activities reports and the initiation of legal action. If a separate fraud division or unit does not exist, examiners should determine whether procedures governing the detection, investigation, and referral of potentially fraudulent situations exist and function effectively. Examiners should also determine whether management reports adequately detail and track potential exposure.

3070.0.1.6 Inspection Objectives—Board Management and Oversight

1. To assess the composition, qualifications, and degree of oversight provided by the mortgage company's board and executive management team.

2. To determine whether the organizational structure is appropriate given the nature and scope of the mortgage banking company's operations.

3. To evaluate the reasonableness of the operating budget, long-term business planning, performance measurement systems, and MIS and related management and board reports.

4. To determine the nature of the company's internal control environment and the effectiveness of its system of internal controls, including internal and external audits, loan review, quality control, suspicious activities and fraud detection (including criminal referral and suspicious activities reporting) and related employee training programs, insurance coverage, and pending litigation.

3070.0.1.7 Inspection Procedures—Board Management and Oversight

Board Oversight

1. Review biographies of the board of directors and minutes from board and committee meetings to determine whether directors are qualified and fulfilling their fiduciary responsibilities.

2. Review the most recent package of information that was provided to directors. Do they receive sufficient detail regarding the financial condition, internal controls, and risk-management techniques employed within the company?

Management

1. Review biographies of members of the executive management team to determine their level of experience, technical knowledge, leadership skills, and administrative capabilities. Discuss whether salaries are commensurate with management's experience level and expertise.

2. Evaluate the quality of operating policies and procedures within each division or functional area and the extent to which compliance with such policies and procedures is monitored and reported.

3. Evaluate the output from the planning process, including the most recent operating budget, business plan, and related performance measurement system reports. Determine whether objectives, goals, and growth targets are reasonable.

Organizational Structure

1. Review the organization chart to determine whether the organizational structure is appropriate, as well as the appropriateness of the division of functional responsibilities and the degree of management depth within each division or functional area.

Internal Control Environment

1. Evaluate the nature of the internal control environment and how risk parameters are communicated to employees.

Internal Control Programs

1. Assess the effectiveness of internal controls in identifying and controlling risks. Internal controls include internal and external audits, quality control for mortgage loans, insurance coverage, and fraud detection procedures and related employee training programs.

Internal Audit

1. Determine whether a separate internal audit function exists and, if so, its degree of independence.

2. Review the qualifications of the internal audit manager and his or her staff for mortgage banking and accounting and auditing expertise. Consider the size of the department and its ongoing training programs, as well as the experience levels, educational backgrounds, and professional certifications of the department's staff.

3. Determine the scope and frequency of the internal audit program to ensure that all high-risk areas are reviewed regularly.

4. Review all internal audit reports, management responses to them, and follow-up audit reports for work conducted since the previous inspection.

5. Select a significant sample of internal audit reports and respective workpapers and conduct an intensive review of the internal audit program. Determine that all issues and exceptions were brought forward to the final audit report, the report was presented to the board or a committee thereof, and that any detected and disclosed problems or control weaknesses received appropriate management attention.

6. Evaluate the internal audit department's system for following up on issues and exceptions. Determine whether prompt, satisfactory resolution of issues was effected.

External Audit

1. Review the engagement letter for the most recent external audit to determine the external

auditor's scope, responsibilities, and extent of reliance on the internal audit department.

2. Review the most recent external audit report to determine whether the opinion regarding the company's financial condition was qualified in any way and whether any internal control weaknesses were noted. Review the notes to the financial statements for appropriate disclosures.

3. Discuss any unusual items and areas of potential concern with management and/or the external auditor. Determine whether any areas of concern were considered to be material items by the external auditors, based on the nature of audit work performed, management's representations in the management letter, and the outcome of that review. If questions persist, consider the need to request and review specific external audit workpapers.

4. Discuss the reasons for any recent changes in external auditors with management.

Compliance and Disaster Recovery

1. Review the methods used to ensure compliance with state and federal laws and regulations by—

a. interviewing the person who is responsible for compliance to determine the nature of outstanding problems and the adequacy of corrective measures that have been taken, and

b. reviewing the system for logging, tracking, and responding to customer complaints.

2. Determine whether the disaster recovery plan is adequate.

Quality Control

1. Review the quality control department's policies and procedures to determine whether the quality control program meets minimum investor requirements.

2. Review a sample of reports issued by the quality control unit to determine whether they were issued in a timely manner and conclusions were adequately documented.

3. Determine whether quality control results are relayed to executive management and whether follow-up procedures are adequate.

4. Determine whether the quality control unit is sufficiently staffed and independent.

5. Determine whether quality control outsources work to outside parties. If so, are adequate controls in place to ensure that such outsourcing meets the company's own quality standards?

Insurance

1. Review insurance policies maintained for the mortgage banking company to determine whether coverage is adequate and whether the majority of insurable risks is included, giving consideration to a cost versus benefits analysis.

2. Review board minutes to ascertain the date the board last reviewed and approved the insurance program.

Litigation

1. Review all current and pending litigation of a material nature and determine whether adequate reserves are maintained to cover anticipated financial exposure.

Fraud Detection and Training

1. Determine whether a separate fraud unit exists and whether procedures are in place regarding the detection and investigation of suspected fraudulent activity and the issuance of related management reports.

2. Evaluate the company's early warning system for detecting potential fraud. Is the level of training adequate?

3. Review any criminal referral or suspicious activities forms filed since the prior inspection and discuss their status with management.

3070.0.2 PRODUCTION ACTIVITIES

Loan production covers the process of originating or acquiring loans. Production begins with the initial loan application and ends when a loan has been underwritten and processed, closed, and reviewed by post-closing.

3070.0.2.1 Types of Loans

Loans are categorized as either government or conventional loans. *Government loans* generally carry a below-market interest rate and are either insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). Both agencies protect investors holding such securities against losses in the event of a borrower default, thereby slightly reducing investors' required yields. To be insured or guaranteed, a loan must meet agency standards regarding the size, interest rate, and terms. The lender can obtain a certificate of insurance or guaranty to give support to a loan for securitization. A certificate of insurance or guaranty may not be needed for a loan to be securitized.[2]

Loans that are not FHA-insured or VA-guaranteed are referred to as *conventional loans*. Conventional loans are generally originated for larger loan amounts and made to stronger borrowers. Conventional loans typically require higher down payments and bear market interest rates. Most lenders that offer programs with smaller down-payment terms require that the borrower purchase private mortgage insurance for the top 5 to 20 percent of the loan principal balance so that a proportionate share of the credit risk is borne by a private mortgage insurance (PMI) company.

The extent of credit risk associated with a loan often depends on the marketing program under which the loan is originated. Marketing programs and participants are described briefly here; for a more detailed description, see ''Marketing Activities'' later in this section.

The market for residential real estate loans is dominated by three government-sponsored entities: the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FannieMae). GNMA is a government agency that guarantees the timely payment of principal and interest on pass-through securities that are backed by pools of FHA-insured or VA-guaranteed mortgages. These guaranties are backed by the full faith and credit of the U.S. government. Although investors will get paid in full, servicers may retain some risk of loss, particularly with respect to VA loans (see subsection 3070.0.4.5 for additional information on ''VA no-bids'').

Pass-through securities provide for monthly installments of interest at the stated certificate rate plus scheduled principal amortization on specific dates, despite the delinquency status of the underlying loans, as well as any prepayments and additional principal reduction. The issuer collects the mortgage payments and, after retaining servicing and any other specified fees, remits monthly payments to the certificate holders.

Although FHLMC and FannieMae are not extensions of the U.S. government, the market believes that there is an implicit guaranty that their securities will be repaid. FHLMC and FannieMae securitization involves the purchase of conventional loans from lenders and the selling of mortgage-participation certificates, which are similar to GNMA pass-through securities. Participation certificates represent an ownership interest in pools of conventional loans. FHLMC and FannieMae guarantee the monthly pass-through of interest, the scheduled amortization of principal, and the ultimate repayment of principal. Unlike GNMA pass-throughs, however, participation certificates are not backed by the full faith and credit of the U.S. government.

Conventional loans are classified as either conforming or nonconforming. *Conforming* loans must comply with FannieMae's and/or FHLMC's underwriting and documentation guidelines in order to be sold in the secondary market. Conforming mortgages may be sold to FannieMae or FHLMC on either a recourse or nonrecourse basis.

Private pools of *nonconforming* loans that do not meet FannieMae or FHLMC guidelines may be sold in the secondary market under a private label structure. Nonconforming loans are often ''nontraditional'' products such as loans with teaser rates, limited documentation, and graduated payment schedules, as well as ''jumbo'' loans that exceed maximum agency size requirements. To improve salability, pools of nonconforming loans may be insured through third-party credit enhancements (for example, letters of credit) or various senior/subordinate structures. Since the underlying mortgages generally already carry private mortgage insurance, such pools are, in effect, doubly insured.

3070.0.2.2 Production Channels

Mortgage loan applications are generated through either *retail* (internal) or *wholesale* (external) production channels. Retail loans are originated through the company's own branch network. A branch network is relatively costly, since origination costs often exceed the origination fees received from the borrowers.

Wholesale production channels (where contact with the borrower is made by another party) take several forms. Whole loans can be purchased either individually or by using bulk commitments. Bulk commitments either require the correspondent to deliver a set amount of loans (mandatory) or deliver all registered loans that close (best effort or optional).

2. See the appropriate agency seller/servicer guide for standards and requirements regarding certificates of insurance or guaranty.

Loans may be closed in the buyer's own name using its own funds, closed in the seller's name using the buyer's own funds, or closed and funded by the seller with delivery to the buyer within a certain number of days. If the seller closes in its own name, the mortgage and note are generally assigned to the buyer simultaneously upon closing.

Three hybrid production channels are worth mentioning here. Examiners should note that terminology within the industry varies greatly. Under the first method, *table funding*, a mortgage banking company funds loans at closing that have been originated by a correspondent or broker according to the company's own specifications. Historically, the company's ability to record mortgage-servicing rights depended on the degree of independence that was maintained and the extent of risk borne by the originator. See subsection 3070.0.6, on ''Mortgage-Servicing Assets and Liabilities.''

The second hybrid method, *assignment of trade*, involves the bulk purchase of loans and investor commitments to sell the loans in the secondary market. The purchaser bears virtually no market risk under this production method. The third hybrid method, *co-issue*, entails the acquisition of servicing rights only, at the time a security is issued.

Most mortgage originators operate on a nonrecourse basis. For purchasers of correspondent production, credit risk increases to the extent that the lender relies on other parties to correctly process and underwrite the loan. Contracts with correspondents should include representations and warranties from the correspondent that loans delivered meet the underwriting requirements of the agency or investor program for which the loan was originated. Approved correspondent lenders should be continually monitored for the quality of the product delivered and the financial ability to repurchase mortgages that do not meet the standard representations and warranties under which the mortgages are sold.

3070.0.2.3 Production Strategies

A successful production strategy combines high credit-quality standards with cost containment and effective marketing. In contrast, an overly aggressive or inappropriate strategy leads to heightened production risk. High-risk production strategies can be evidenced by relaxed credit standards, low documentation requirements, an executive officer's compensation based on volume, an emphasis on high-risk product types or geographic areas, and/or dependence on a limited number of production channels. Examiners are responsible for recognizing and reaching agreement with management to better control such high-risk production strategies where appropriate.

3070.0.2.4 Production Process

There are five principal steps in the retail production process: (1) pipeline entry, (2) processing, (3) underwriting, (4) closing and funding, and (5) post-closing. Each of these functions should be independent from one another and separately supervised to ensure the quality of the loans produced. Each step is briefly discussed below.

1. *Pipeline entry*. A loan has entered the pipeline when a prospective borrower completes a loan application. The applicant authorizes the lender to verify his or her employment, credit history, bank deposits, and other information that evidences repayment capacity.
2. *Processing*. The application is then processed to qualify the applicant and the property for the loan. Processing personnel verify the applicant's employment history and credit information and order an appraisal on the property. Processing activities should be controlled through standardized procedures, checklists, and systems.
3. *Underwriting*. The underwriting unit approves or disapproves applications based on underwriting criteria that are established by the FHA, VA, FannieMae, and FHLMC and by private mortgage insurers and institutional investors. To ensure objectivity, the underwriting unit should not report to management of the production function.
4. *Closing and funding*. After an application has been approved, the lender generally issues a commitment letter to the borrower, which states the interest rate and terms of the loan. At closing, the lender or its agent obtains all the legal and related documents executed by the parties to the sale, disburses the proceeds of the loan, and collects certain funds from the borrower.
5. *Post-closing*. After closing, a post-closing review is performed to ensure that documents were properly executed and underwriting instructions were followed. The post-closing review also identifies any trailing or missing documents that must be tracked and obtained to meet investors' pool certification requirements. Specific

agency requirements are detailed in the agency seller/servicer guides. Before the loan is transferred to the delivery or shipping department, processing begins for the final mortgage insurance (from the private mortgage insurer or from the FHA/VA guaranty certificate). Receipt of the actual certificate may take 45 to 60 days or longer. Pool custodians and investors will allow the lender to complete the sale if final documentation, including the insurance certificate, is expected to be received within a reasonable timeframe.

3070.0.2.5 Production Risks

The production process can present risks of both a short- and potentially long-term impact. Operational inefficiencies can result in high management and staff turnover, an inability to meet investor documentation requirements, an increasing number of pools that have not received final certification, or an unusually high production cost structure. Operations risk often increases during peak volume periods. If additional resources (which can include independent service providers) are not allocated to the processing, underwriting, closing, and post-closing areas, delinquency levels may increase and workloads may exceed existing capacity.

Management should be prepared to quickly respond to interest-rate cycles and related volume increases or declines, since failure to act promptly can affect earnings and capital. During the pooling and securitization process, for example, if the number of pools that lack final certification exceed a certain limit, the company may be required to seek financial support in the form of a letter of credit from an affiliate bank or bank holding company to ensure that all required loan documentation is secured in a timely manner. Credit risk and operational inefficiencies may also create liquidity problems and additional interest-rate risk if the company is unable to sell its loans in the secondary market.

To the extent a company retains servicing on either its retail or correspondent production, long-term credit risk issues may develop. These include exposure to the pools being serviced through recourse arrangements, potential nonreimbursable foreclosure costs, or costs associated with VA ‘‘no-bid’’ options.

3070.0.2.6 Overages

In certain instances, originators and loan brokers may have the ability to deviate from mortgage loan prices that are established by the marketing department. An overage exists when a lender permits an originator or broker to impose a higher number of points (or a higher interest rate) on a loan to certain borrowers than is imposed for the same product offered to other borrowers at a given point in time. (See CA-94-6.)

Overages are often used as an incentive to compensate originators or brokers. The amount that is received over the expected price is often shared by the mortgage banking company and the originator or broker. The practice of permitting overages may contribute to or result in lending discrimination under the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHAct).

Examiners should review the mortgage banking company’s lending policy and determine whether overages are permitted and whether the practice has resulted in lending discrimination. If a more detailed review of overages is deemed necessary, such review should be performed in conjunction with the appropriate Federal Reserve System’s legal and consumer compliance staff.

3070.0.2.7 Inspection Objectives—Production Activities

1. To determine the types of loans offered to borrowers and any significant changes in product mix.
2. To determine whether mortgage loans are securitized; if so, to determine whether mortgage-backed securities are insured or otherwise guaranteed by government-sponsored agencies or private entities.
3. To determine what channels are used to originate loans.
4. To determine if production processes are consistent with operational risk controls and efforts to minimize risk.
5. To determine whether production processes can handle cyclical changes in volume.
6. To determine whether overages are permitted and to assess whether the practice has resulted in lending discrimination.

3070.0.2.8 Inspection Procedures—-Production Activities

General

1. Review organization charts to determine

the structure of the production function and its status within the company. Verify that functional units such as underwriting and quality control are independently managed.

2. Determine the types of mortgage products offered and the company's target markets. Evaluate portfolio trends for overreliance on one product type and undue concentrations in one geographic area.

3. Discuss the company's credit culture, compensation methods, and growth targets to determine whether income and loan volume are emphasized over credit quality.

4. Determine whether the level of nonconforming or unsalable loans being originated present undue risk and whether the quality and delinquency trends for such loans are adequately monitored.

Originations

1. Review policies and procedures for retail branch originations. How are originators compensated? Determine whether originators have the authority to alter loan pricing parameters set by the marketing unit.

2. Determine the size of the branch network and its cost structure. Is the network growing or shrinking? How does management plan for anticipated changes in loan volume?

3. Determine if the mortgage banking company is involved in overage activities. If so—

a. determine whether management has developed comprehensive policies and procedures, detailed documentation and tracking reports, accurate financial reporting systems and controls, and comprehensive customer complaint tracking systems to adequately monitor and supervise overage activities;

b. review whether overages are an essential component of the mortgage banking company's earnings and origination activities, and review the percentage of mortgages originated since the previous inspection that resulted in overages and the average overage per loan;

c. determine if management reviews overage activity for disparate treatment and disparate impact; and

d. determine if overages are a major component of loan officer and/or broker compensation.

4. Review policies and procedures for wholesale purchases. Which production channels are used and how do they work? Channels may include whole loan purchases (production flow), table funding, assignment of trade, or co-issuances (bulk purchases of servicing rights only). For each production channel, review how brokers and correspondents are compensated.

5. Review the method for reviewing and approving brokers and correspondents and specific programs under which wholesale loans are purchased. Is there an approved list of correspondents? How is it updated and how frequently? Determine whether exceptions to this list are made and by whom, and whether controls are in place to prevent unauthorized purchases.

6. Evaluate the process for conducting financial reviews on correspondents. How often are financial statements obtained, and who analyzes them?

7. Determine whether adequate controls are in place to detect changes in the financial condition of a correspondent, test and monitor the quality of loans purchased, and evaluate the correspondent's financial capacity to perform under contractual repurchase obligations.

8. Select a sample of contracts for the largest correspondents for additional review. Do contracts clearly state pricing structures, maximum dollar volumes, recourse arrangements, and whether loans are purchased on a mandatory delivery or a standby basis? Have any legal issues arisen as a result of the contract language? How frequently does management put back loans to its largest correspondents?

9. Determine whether management information systems adequately track approvals and denials by loan type and production channel. Are exceptions to policy adequately tracked and monitored?

Processing

1. Determine whether processing is performed in-house or by another party (a third-party contractor or the originator). Review checklists and procedures for the processing unit and determine whether loan tracking systems are adequate.

2. Review steps that have been taken to address any audit or quality control findings. Determine whether additional corrective actions are necessary.

Underwriting

1. Determine whether underwriting is performed in-house, by third-party underwriters, or by the originator. Is management planning for

peak volume periods and are controls over the underwriting process adequate?

2. Review policies and procedures to gain a reasonable assurance that underwriting standards are prudent and comply with investor guidelines. If individual underwriters perform this function, determine whether management has established approval limits, developed exception procedures for loans that are rejected or suspended, and receives reports that track loan quality for each underwriter. If a committee performs the underwriting function, review its charter, composition, and minutes. If a scoring system is used, review credit scoring methodology. Can the system be overridden? If so, by whom?

3. Review a representative sample (preferably a statistical sample) of current loans to test the underwriting policies and procedures and also determine the validity and adequacy of documentation supporting loans held for sale or investment.

4. If an unusual increase in unmarketable loan inventory has been noted, select a small sample of loans in current production for additional review. Does underwriting comply with established guidelines? If a credit scoring system is used, focus on loans that are of the lowest acceptable grade. If deficiencies are noted, consider expanding the review sample.

5. Review loans that were rejected and then approved. Did the proper authority approve such loans, and was management's rationale adequately documented?

Closing/Post-Closing

1. Evaluate procedures, checklists, and systems for closing loans. Are all required documents obtained from the borrower before funds are disbursed? If not, evaluate the appropriateness of suspense items.

2. Determine if a post-closing documentation review process exists to differentiate, track, and obtain both trailing and missing documents. Assess its effectiveness.

3. Determine if wholesale loans are re-underwritten at delivery. If not, how does management ensure that loans are re-underwritten in accordance with secondary marketing program requirements?

4. Determine the number of pools that lack final pool certification. Has this number exceeded the maximum allowable limit since the previous review? Why has this problem occurred, and what steps are being taken to secure the necessary documentation? Has a letter of credit been posted? Does the situation pose undue financial risk for the company or any of its affiliates?

3070.0.3 MARKETING ACTIVITIES

The marketing department is typically responsible for the development of mortgage products, determination of products to be offered, and the establishment of daily mortgage prices. The marketing department, which is also referred to as secondary marketing, is also responsible for the sale of mortgage loans to investors. Given these roles, the marketing department acts as an intermediary between the borrower and the investor. All of these activities require close coordination to be effective and are appropriately placed within one department.

3070.0.3.1 Oversight

Marketing activities are generally supervised by a marketing committee, which may consist of the chief executive officer, chief operating officer, chief financial officer, and the executive officers responsible for marketing, production, and servicing/loan administration. The marketing committee is responsible for the formulation of marketing policies, departmental operating procedures, pricing strategies, and parameters governing the use of various mortgage-related products and strategies used to hedge the interest-rate risk associated with certain mortgage loans.

3070.0.3.2 Securitization

The marketing department's primary tool in performing its activities involves securitization outlets. Securitization activities are discussed in SR-90-16, which transmitted the following documents: (1) the Examination Guidelines, (2) An Introduction to Asset Securitization, and (3) Accounting Issues Relating to Asset Securitization. There is also a discussion of these activities in the *Commercial Bank Examination Manual*, section 4030.1. A review of the securitization process can provide a clearer understanding as to the value the marketplace assigns to a mortgage banker's production. Mortgage securities, however, are usually issued by an entity other than the mortgage banking company under inspection (such as government-sponsored agencies, securities affiliates, or brokerage firms).

Many approaches are used for securitization, but the great majority of activity occurs with conduits such as GNMA, FHLMC, and FannieMae. Conduits provide many programs that a mortgage originator can use to deliver a mortgage or pools of mortgages in return for cash or securities. To investigate current program requirements and available options, the examiner should consult the seller guidelines issued by the agencies.

The securitization process presents the marketing department with a complex set of options to consider when deciding how to sell the company's loan production for maximum profit. If the company's own servicing valuation differs from pricing offered by the agencies, for instance, the marketing department can use some flexibility in pool formation guidelines to retain or divest servicing cash flows. Recourse to the originator or servicer can be negotiated to reduce agency guaranty fees. Agencies also alter guaranty fees based on different methods of remitting principal and interest payments. Sales to the agencies can be on a best-efforts or mandatory basis. A best-efforts basis is when loan delivery is not required if the loan does not close. Better prices are received for the lender's acceptance of the more rigid performance requirements of mandatory commitments. Master commitment contracts can be reviewed by the examiner to determine negotiated terms.

Although most securitization activity occurs within the programs already mentioned, private security issues are also used. The private issues are used primarily for loans that do not meet the underwriting criteria of the agencies, commonly due to larger than accepted loan amounts (jumbo loans). Nonconforming loan production is usually sold to brokers or security affiliates who have marketed the product to investors, sometimes using complex real estate mortgage investment conduits (REMICs).

3070.0.3.3 Pooling Practices

As an intermediary between the borrower and the investor, marketing personnel coordinate the flow of loan documents from the shipping department to the pool custodian and the ultimate holder. If servicing is retained, the loan will be input into the company's servicing system soon after closing. Staffing levels should be adequate to ensure that processing backlogs are managed and workloads remain reasonable. Temporary help and/or outsourcing may be used during peak volume periods.

Operating procedures governing the selection of mortgage loans for pooling, packaging, and sale should be evaluated to ensure that the shipping and pooling processes are efficient and that loan files ultimately contain complete documentation. Management reports should identify and track the number of pools that lack final agency certification and the status of missing (unavailable) and trailing (delayed) documentation.

If third-party guaranties are used during the securitization process, procedures should also establish methods for evaluating and monitoring the financial condition of all third-party entities that provide credit enhancement. If loans or securities are sold with recourse, management reports should identify and track potential recourse obligations. Management should also analyze historical recourse losses by investor and product type and determine the appropriate level of reserves to cover estimated recourse exposure.

3070.0.3.4 Marketing Risks and Risk Management

3070.0.3.4.1 Techniques

The marketing department manages several risks, which can be categorized as follows:

- unsalability
- pricing
- fallout
- counterparty performance

3070.0.3.4.2 Unsalability

Under most circumstances, a mortgage banking company will originate mortgage products that are acceptable to GNMA, FannieMae, FHLMC, or other major investors. This minimizes the risk that mortgage products originated will not be marketable to investors and have to be retained as a portfolio investment. However, the marketing department may also initiate certain products that are intended for the loan portfolio of the mortgage company or portfolios of bank or nonbank affiliates. In the case of production for bank affiliates, underwriting and pricing arrangements must be structured to ensure compliance with the restrictions imposed by sections 23A and 23B of the Federal Reserve Act. See the subsections on production activities (3070.0.2) and intercompany transactions (3070.0.7).

3070.0.3.4.3 Pricing Risk

The mortgage banking business is volume driven. Because profit margins are thin and fixed costs associated with loan production can be large (especially in the case of a retail origination network), it takes a significant volume of mortgages to generate profits. Mortgage pricing decisions are critical because the price is a major determinant in the volume of mortgages originated.

Pricing strategies can be affected by divisional profit and loss allocations or external industry practices. A neutral price structure sets mortgage prices that are equivalent to the expected price for which the mortgages will be sold to investors, plus a normal servicing spread of 25 to 50 basis points depending on the type of loan. Daily adjustments are usually made to prices to reflect market changes for future settlement of mortgage-backed securities (MBS).

Due to regional or local competition, mortgage banking companies often find it necessary to deviate from a purely neutral pricing strategy to maintain volume in certain markets. However, large deviations from market price in either a lower or even upward direction can have adverse consequences. In addition to causing marketing losses, price cutting could place operational strains on the production and servicing areas. Premium pricing can position the company as a lender of last resort with adverse credit quality implications.

The marketing department attempts to minimize price risk by matching origination pricing with the price it expects to receive from investors. However, estimating the price at which the mortgages can be sold can be difficult because it is determined in large part by external factors such as interest rates. The longer the elapsed time between when the mortgage applicant decides to lock in a loan rate and the time the loan closes, the greater the risk that the prices for which the mortgages can be sold will change. Some companies encourage customers to "float" their interest rate until closing approaches to reduce the volume and costs of hedging.

3070.0.3.4.4 Fallout

A third type of risk that the marketing department manages relates to pipeline "fallout." This is the risk that the proportion of loans in the rate-committed pipeline that are expected to close will change with a given change in interest rates. As market interest rates decline, fewer mortgages in the pipeline will close because applicants will opt to make new applications at the lower rates. As interest rates rise, the proportion of pipeline loans that will close increases as more applicants choose to lock in rates. Mismatches that occur in the long and short positions can result in financial losses when the institution needs to settle its trades.

3070.0.3.4.5 Hedging Strategies

The most common hedging strategy used to protect the inventory of closed loans and the rate-committed pipeline against adverse interest-rate movements involves the use of mandatory and optional forward sales of MBS. Under this hedging strategy, the inventory and rate-committed pipeline (the long position) are generally covered through short sales (mandatory delivery contracts with settlements corresponding to expected delivery volumes). Put and call options on MBS are sometimes purchased to manage heightened fallout risks during periods of volatile interest-rate fluctuations.

The typical practice is to hedge 100 percent of the closed loan inventory that is marketable. In addition, pipeline loans very near to closing are generally also hedged at or close to 100 percent. However, a significant degree of uncertainty exists as to the amount and timing of 30- and 60-day rate-committed pipeline closings due to interest-rate fluctuations, underwriting delays, and cancellations. To control exposure to rate movements, management must estimate the percentage of the rate-committed pipeline that is expected to close in the current economic environment.

Although estimation techniques vary, data are generally collected on a number of pipeline characteristics such as product type, whether the loan is a purchase or refinance, and whether it is retail- or wholesale-originated. Fallout behavior can vary depending on these and other factors. Based on this information, management then derives an estimated closing percentage that becomes management's operating target for coverage of the rate-protected pipeline.

Marketing personnel often use simulation modeling to assess fallout percentages, assist in balance-sheet valuations, and develop appropriate hedging strategies. Such models may be either purchased from outside vendors or developed in-house, and they vary greatly in their degree of sophistication. In any event, the primary assumptions and inputs to the model should be reasonable, well documented, and reviewed periodically by both the marketing committee and by an independent source such as an internal or external audit. Results from the marketing simulation model should be provided to management through summary reports. Information may also be provided to bank holding company personnel for asset/liability management purposes.

Other products may also be used to hedge inventory loans and the rate-committed pipeline, particularly loans with an adjustable rate feature or other specialized characteristics. The marketing committee should review and approve all specialized hedge products used, the degree of correlation between the hedge product and the underlying position being hedged, and the degree of risk that each strategy or position entails. The accounting department should also determine whether such products qualify for hedge accounting treatment, establish appropriate management reports, and establish accounting policies. See subsection 3070.0.6, ''Mortgage-Servicing Rights.''

3070.0.3.4.6 Position Reports

To limit risk, the marketing committee should place prudent limits on the amount of exposure that can be incurred through hedging operations. Limits, which may be contained in the marketing policy, might establish a constraint on the size of uncovered long positions, require that coverage be maintained at the marketing committee's current closure estimates, or establish a constraint based on an earnings-at-risk measurement.

Compliance with limits should be monitored through regular position reports, which should be provided to senior management (the marketing committee and perhaps the treasury function of the parent company, if they participate in decisions or policy enforcement) at least weekly. Position reports should detail the company's long and short positions in relation to limits, as well as unrealized and realized gains and losses on loans and securities. Department managers generally require daily position reports in order to effectively monitor the position. Marketing position reports may not reconcile directly with reports prepared by the accounting department for financial reporting purposes. Significant differences should be investigated.

3070.0.3.4.7 Counterparty Performance

The marketing committee is also generally responsible for managing investor/counterparty performance risk. The marketing committee (or the treasury department of the parent bank holding company) should approve all brokers and dealers to which securities are sold before trading commences. Dealer limits should be established to limit the maximum amount of trades outstanding with each firm. Frequent position reports should be prepared to monitor compliance with established limits. The accounting department may be responsible for the ongoing monitoring of the financial capacity of the brokers and dealers.

3070.0.3.5 Inspection Objectives—Marketing Activities

- To review the types of products developed.
- To determine the pricing strategies offered to borrowers and investors.
- To review pipeline fallout estimation techniques.
- To review hedging methods as they relate to loan production.
- To determine whether information systems are adequate for senior management to monitor fallout behavior and hedge performance.

3070.0.3.6 Inspection Procedures—Marketing Activities

Management Oversight

1. Review the composition of the marketing committee and minutes from recent committee meetings to determine the nature and scope of its responsibilities, the frequency of meetings, and the degree to which oversight over marketing activities is provided.
2. Review the marketing policy as it relates to product offerings, pricing strategies, loan sales, and hedging operations. Are all relevant marketing risks identified? Note the date the marketing policy was last reviewed and approved by the board of directors.
3. Determine how management measures and controls interest-rate risk associated with closed loans in inventory and rate-locked loan applications in the pipeline. How are limits established and quantified (i.e., earnings at risk, economic value of equity at risk, percentage of capital, etc.)? Are such limits reasonable? Evaluate management's oversight of asset securitization

activities in accordance with SR-90-16, as applicable.

4. Assess the adequacy of management information systems and related management reports that are designed to track compliance with established policy. Determine the extent to which operational practices adhere to policy. How are exceptions handled?

Securitization and Pooling Practices

1. Determine the secondary marketing programs used to sell mortgages to investors and the volume of sales under each program.

2. Discuss the strategies and procedures used for the selection of mortgage loans for pooling, packaging, and sale. Are there quality control procedures in place to ensure that the files of pooled loans contain complete documentation? What impact does strategy have on departmental profitability?

3. Evaluate the company's securitization practices:

- Determine how much risk the company retains and in what form.
- Determine the source, conditions, and costs of third-party guaranties. Verify that the financial condition of all third-party credit enhancers is substantiated.
- Determine the procedures used to obtain final pool certifications from investors (coordinate with the examiner(s) assigned to the production function). Determine the number and volume of securities that lack final certification. Is management doing everything possible to obtain missing documents? Are problems volume-driven or due to a lack of internal controls?

4. Determine whether loans or securities are sold with recourse. If so, are management information systems in place to track recourse obligations? Are analyses of recourse losses conducted by investor and product type? Are reserves held for recourse loans? What is the methodology for determining the adequacy of reserves? Review actual and potential losses. Are reserve levels adequate to cover identified exposure? Is compensation tied to trading profit?

Unsalability

1. Review the marketing policy to determine whether all mortgage products originated by the mortgage company are intended to be salable in the secondary market (for example, do they conform to guidelines issued by GNMA, FannieMae, FHLMC, or other major investors?). How is actual salability monitored?

2. Determine if mortgage loans that are not salable are generated specifically for the permanent investment portfolio of either the mortgage banking company or its bank or nonbank affiliates.

3. Determine who is responsible for the review of temporarily unsalable loans, the frequency of such reviews, the actions taken to correct documentation and/or credit deficiencies, and if internal controls are adequate. This information is needed to ensure that hedge volumes are accurate.

Pricing Strategies

1. Review the current list of mortgage product offerings and the daily price sheet. Are prices determined centrally and are they uniform? Discuss pricing strategies with management to determine whether the company uses a neutral, above-market, or below-market pricing strategy.

2. Ascertain what procedures are in place to ensure that deviations from the approved pricing policies receive the proper degree of scrutiny and approval by senior management. If such discrepancies are common, why is this occurring (competition, compensation schemes, or departmental profitability considerations)? What impact have such deviations had on production volumes and the company's overall profitability?

3. Determine what policies are in effect regarding customer rate-locks. If a rate-lock expires, is it automatically renewed or is it renegotiated at current interest rates? Are the number and dollar volume of loans with expired rate-locks adequately monitored and tracked?

Fallout

1. Discuss the methodology used to predict the volume of applications that are expected to ''fall out'' of the mortgage pipeline. Is fallout methodology well documented?

ALCO/Simulation Modeling

1. Determine whether the expected fallout ratio is based on intuition, historical data, or an empirical model. Are assumptions reasonable? Are volatility assumptions based on historical performance or on implied volatility levels in the market? Who is responsible for reviewing model assumptions, and are these individuals sufficiently independent from the process itself? Does management also engage in sensitivity analyses to determine the impact interest-rate fluctuations will have on expected fallout levels?

2. Determine to what extent management uses output from these models in business planning, financial management, and budgeting.

3. Assess the degree to which mortgage banking activities are incorporated into the parent company's asset/liability management reports and program.

Hedging Practices

1. Discuss management's philosophy and strategy to determine the amount of interest-rate risk they are willing to accept. How successful has the company's marketing strategy been over the past few years and how is it changing? What are management's primary sources of market information? Are sources sophisticated enough given the size of the company and the scope of its activities?

2. Review the marketing policy to determine products and strategies used to hedge the interest-rate risk associated with inventory loans and rate-locked loan applications in the pipeline. Review actual hedging practices to determine whether they conform with established policy limitations and guidelines. What percentage of closed loans held in inventory and loan applications in the pipeline are matched against specific investor commitments? How are coverage levels determined and how have they changed over time? Is the basis for this coverage ratio adequately documented? Determine whether the current coverage ratio exposes the company to undue risk associated with potential marketing losses.

3. Determine the adequacy of management's strategies for hedging loans that have special risks (ARMs with interest-rate caps and floors).

4. Ascertain if basis risk exists for any hedging products, whether such risks are significant, and the impact on correlation. How is basis risk identified, monitored, and controlled?

5. Determine whether call options are written to enhance inventory yields. If so, verify that they are written against covered positions. Determine whether management is speculating in any way and whether this activity subjects the company to undue risk.

6. Obtain profit/loss reports on hedging activities. How frequently are they prepared, how are they used, and to whom are they distributed? Evaluate the financial results of the hedging program over the past three years. Is management taking on excessive risk to record profits in this area?

7. Review management reports relating to pipeline and closed-loan hedging operations. Determine whether such reports are complete, accurate, and timely. Do such reports adequately limit excesses, record exception approvals, and detail risk exposures?

8. Review information provided to executive management and the board to determine whether hedging practices are adequately supervised.

Counterparty Risk

1. Review the marketing committee's list of approved brokers and dealers. Have appropriate dealer limits been established and are such limits adhered to? How are exceptions monitored, reported, and controlled?

3070.0.4 SERVICING/LOAN ADMINISTRATION

Mortgage banking companies that originate and sell residential real estate loans in the secondary market often retain the right to service those loans for the investor for a fee. In return, the servicer collects monthly payments from mortgagors, collects and maintains escrow accounts, pays the mortgagors' real estate taxes and insurance premiums, and remits principal and interest payments to the ultimate investors. The servicer also maintains records for the mortgagor, collects late payments on delinquent accounts, inspects property, initiates and conducts foreclosures, and submits regular reports to investors. Such functions and responsibilities should be documented within a formal written servicing agreement.

3070.0.4.1 Revenue Generation

The right to service mortgage loans provides a stable source of earnings and the potential for one-time gains. For this reason, servicing portfolio growth has become a primary objective for many mortgage banking companies.

Mortgage-servicing revenues are derived from six sources. The primary source is the contractual servicing fee. Because this fee is usually expressed as a fixed percentage of each outstanding mortgage loan's principal balance, servicing-fee revenues decline over time as the loan balance declines.

The second source of servicing income arises from the interest that can be earned by the servicer from the escrow balance that the borrower often maintains with the servicer for the payment of taxes and insurance on the underlying property. This income may vary, however, as some states require that interest payments on escrow balances be paid to the borrower.

The third source of revenue is the float earned on the monthly loan payment. This opportunity for float arises because of the delay permitted between the time the servicer receives the payment and the time that the payment must be remitted to the investor.

The fourth source of revenue consists of income late fees charged to the borrower if the monthly payment is not made on time. A fifth source is income in the form of commissions that many servicers receive from cross-selling credit life and other insurance products to the borrowers. The sixth and last source is when the servicer might generate fee income by selling mailing lists to third parties.

3070.0.4.2 Cost Containment

Long-term profitability is achieved through cost containment, technological improvements, and economies of scale, which reduce the per-unit cost of servicing. Servicing costs vary widely across institutions depending on portfolio characteristics such as product type, loan size and age, delinquency status, and foreclosure statistics. Nevertheless, two efficiency measures frequently used within the industry to measure cost containment are unit-servicing costs and the number of loans serviced per employee. The minimum size of a loan-servicing portfolio needed to achieve economies of scale varies across institutions and depends on portfolio characteristics and the servicer's expertise and technological capabilities.

Servicing data are available through the Mortgage Bankers Association's publication, "Mortgage Banking Performance Report." Based on detailed financial-statement information from a sample of companies, the report presents a compilation of performance data on all aspects of the mortgage banking industry.

3070.0.4.3 Growth Strategies

Many companies have established aggressive growth targets for their servicing portfolios. The size of the portfolio may be increased through originations, purchases of loans (individual or bulk), or purchased servicing rights. Portfolio size is reduced through normal runoff, prepayments, and sales of either loans or servicing rights only. Management's growth strategy should be examined in light of its expertise and systems capabilities.

3070.0.4.4 Servicing Agreements

The servicer generally operates under a written contract with each investor. This contract, also known as a servicing agreement, establishes minimum conditions for the servicer such as its fiduciary responsibilities, audit requirements, and fees. Contracts may be standardized or tailored to the individual investor.

Under most servicing agreements, the servicer warrants that full principal has been advanced, the mortgage is in fact a first mortgage on the property, and that the first mortgage position will be maintained by the servicer. Additional warranties that are either unwritten or implied may create significant exposure for the servicer.

A servicer may also enter into an agreement with another company to subservice certain loans or portfolios of loans. The company's method of evaluating and monitoring the financial condition of its subservicers should also be reviewed. Servicing and subservicing agreements should be evaluated in terms of the subservicer's responsibilities, reporting requirements, performance, and fees. They should also be reviewed to determine that no additional liabilities, real or contingent, are imposed upon the company beyond its responsibilities as a servicing agent.

3070.0.4.5 Recourse Obligations

A servicing agreement may contain specific recourse obligations that go beyond the servicer's customary fiduciary obligations. A mortgage banking company can choose to service loans for investors either with or without recourse back to the mortgage banking company. Servicing agreements should be reviewed to determine the extent of any recourse obligations. The risk of recourse should also be discussed with management to assess whether the risk is being identified and effectively managed.

The degree of recourse varies by investor. FannieMae offers either ''regular'' or ''special'' servicing options. With FannieMae's regular option, the servicer retains all risk of loss from mortgage default. With FannieMae's special servicing option, the mortgage banking company only retains exposure for normal representations and warranties. FHLMC offers similar servicing options. FannieMae and FHLMC generally limit eligibility for the regular servicing option to participants with the knowledge and financial wherewithal to make good on their recourse obligations.

GNMA servicing carries no contractual recourse. However, in the event of mortgage default, the servicer may have exposure to principal loss and other nonreimbursable expenses, particularly with respect to VA-guaranteed loans. If a borrower defaults on a VA-guaranteed loan, the VA can exercise a ''no-bid'' put option, which allows the VA to pay out its guaranty and leave the property with the servicer for disposition.

When a borrower defaults on a VA-guaranteed loan, the VA makes a calculation that will guide its decision to accept or reject conveyance of the property. The VA's decision to exercise its no-bid option is based on the net value of loan collateral and the VA's guaranteed percentage of the indebtedness. The mortgage servicer, at its option, could pay down the outstanding principal balance on the loan to a point where the VA would not be expected to exercise its no-bid option. Such ''buydowns'' result in additional foreclosure losses for the servicer.

The risk-based capital guidelines require a charge to capital when any risk of loss is retained on such recourse obligations. The charge would be at the bank holding company, the bank, or both,[3] depending on ownership of the risk. For this reason, the accuracy of reported recourse obligations should be verified.

3. If at the bank, then it is also consolidated at the bank holding company level.

3070.0.4.6 Guaranty Fees

The amount of guaranty fee the mortgage banking company pays the government-sponsored agencies (or private issuer) is negotiated. Guaranty fees vary based on the amount of recourse assumed by the mortgage banking company (the servicer) and the timing of the cash flows. A smaller guaranty fee is negotiated when the guarantor assumes less risk or receives payments sooner in the remittance cycle. Remittance cycles vary by investor.

The examiner should discuss with servicing personnel the amount of risk that has been taken on by the marketing department in exchange for reduced guaranty fees. Excessive risk accepted by the mortgage banking company should be incorporated into the assessment of management.

3070.0.4.7 Internal Controls

The servicing process begins after the post-closing review has been completed and the loan has been set up on the mortgage banking company's servicing computer system. Servicers are responsible for adequately safekeeping loan documents. Documents must be stored in a secured and protected area such as a fireproof vault. Servicers must also maintain a tracking system for following up on missing documents.

The control environment that sets the tone of a servicing department's operation should be assessed. A servicing department's management faces a variety of risks that it should identify and control. In addition to identifying and controlling risks, management also needs to institute adequate and effective internal controls to match a servicing portfolio's growth and the department's technological changes. When assessing the control environment, the examiner needs to consider the extent to which management uses internal and external audits, quality control reports, and investor audits to ensure that its policies and procedures are followed.

The servicer's performance should be evaluated, with any loss of servicing due to operating inefficiencies or excessive risk-taking discussed and noted. A discussion of the risks within each operational area, as well as the management reports and internal controls, follows.

- *Loan accounting*. Incoming payments may be processed in-house, through a lockbox, or through some combination of both. Payments are deposited into a clearing account and then transferred to the respective investor custodial bank accounts the next day. Investor remittances may be required daily, weekly, monthly, or as funds are received. In certain cases, servicing agreements may specify that payments be sent directly to security holders. Numerous accounts through which incoming and outgoing payments pass should be reconciled daily to avoid costly processing errors. The reconcilement process should be reviewed with management to ensure that reconcilements are performed on a timely basis and without chronic discrepancies.

- *Escrow administration.* In addition to receiving and remitting payments, servicers are also responsible for paying taxes and insurance on the underlying property. Accurate information must be maintained for each loan regarding a legal description of the property; the appropriate taxing authority, due dates, and amounts for taxes owed; and the insurance provider and due dates and amounts for insurance owed. Failure to maintain such information may result in missed tax and insurance payments on the property, which may lead to penalties and/or lapsed insurance coverage. The servicer's record of tax penalties paid over the past several years should be reviewed to determine whether a problem exists in this area.

  Escrow account balances should be adequate to meet expected tax and insurance obligations. If the servicer advances its own funds to cover an escrow overdraft, such payments may be capitalized and recorded as a receivable only if the servicer is to be reimbursed by either the mortgagor or the investor. Escrow receivables should be aged, with stale or otherwise uncollectible receivables charged off.

  Escrow accounts should be analyzed at least annually, with a copy of the analysis sent to the mortgagor. Shortages (overdrafts) may be billed or spread out over 12 months. Overages should be returned to the borrower or handled in a manner consistent with federal and state laws and regulations. For loans that were set up without an escrow account, the examiner should verify that adequate information has been obtained from the mortgagor to ensure that taxes and insurance are current.

- *Investor reporting.* Investor remittance and reporting requirements vary greatly. Remittances are contractually arranged. In some instances, the servicer may be required to advance to investors funds that have not yet been received from the mortgagor (for example, cash advances to ensure timely payment of principal and interest). In such cases, a receivable is created on the balance sheet. Receivables relating to investor remittances should be aged in the same manner as escrow receivables and periodically reviewed by a supervisor. Stale or otherwise deemed uncollectible receivables should be periodically charged off in a timely manner.

  Investor reports should include detailed account reconciliations and information on the mortgagor's name, principal balance outstanding, escrow balance, delinquency status of the account, and any foreclosure activity or transfer to the servicer's other real estate owned account. The quality and accuracy of investor reporting should be periodically reviewed by internal or external auditors.

- *Collections, foreclosures, and other real estate (ORE).* Investor requirements also vary concerning contact with delinquent borrowers, forbearance policies, and reimbursement for foreclosure expenses, ORE write-downs, and related losses. Detailed policies concerning collection efforts and foreclosures should be in place and followed. The property should be inspected regularly to ensure that its condition is adequately monitored. Delinquency and foreclosure statistics should be tracked by product type and originator.

  Foreclosures are generally initiated after three full installments are due and unpaid. The servicer notifies the mortgagor of its intent in writing and refers the case to an attorney. Detailed records should be maintained for all expenses that are incurred. If the loan is insured, claims may ultimately be filed against the FHA, VA, or private mortgage insurance (PMI) company. However, it should be noted that certain interest expenses and collection or foreclosure costs are not reimbursable.[4] These expenses are a cost of doing business that must be factored into the servicing fee charged for providing these services.

  The timeframe for taking title on foreclosed property varies widely and is determined by state law. *Once title is taken, the property should be classified as ORE.* Although

4. For a detailed list of both reimbursable and nonreimbursable expenses, see the agency seller/servicer guides.

all ORE is generally managed through a centralized unit, for accounting purposes, ORE may fall into one of two distinct categories: ORE that is owned by the mortgage banking company, and ORE that is serviced on behalf of the investor. ORE that is owned should reconcile to the balance sheet, whereas ORE that is serviced for others is an off-balance-sheet item. ORE appraisal, valuation, and financing policies should be consistent with regulatory policy. In-substance foreclosures and any troubled debt restructurings should be properly identified and accounted for.

- *Payoffs*. Loans are considered ''paid off'' when the loan matures, the loan is refinanced, or the property is sold. Prior to payoff, the servicer is responsible for sending payoff instructions to the mortgagor. After a loan has been paid off, the servicer makes a satisfaction remittance to the investor or the pool; obtains documentation; cancels the note; and forwards the satisfied mortgage documentation plus an escrow refund check, if applicable, to the mortgagor. A high level of refinance activity may strain payoff personnel's ability to perform this obligation accurately and promptly. Management reports should monitor the level of payoff activity and alert supervisors to operational backlogs, the need to hire temporary personnel, or the need to outsource work to third parties.
- *Customer service*. Poor service may damage the mortgage banking company's business reputation (reputation risk) and ability to originate, sell, and service loans within the community. Because of name recognition, problems in this area may also adversely affect affiliate banks or the bank holding company and its nonbank companies.

  For this reason, servicers should maintain an adequate system for logging, tracking, and responding to customer inquiries and complaints. Management reports should track the volume and disposition of such inquiries and complaints. Inordinate volumes of complaints may be an indication of operational backlogs, inefficiencies, or mishandling of accounts. If this occurs, corrective measures should be initiated immediately.

3070.0.4.8 Data Security/Contingency Planning

The servicing system should be of a complexity and size necessary to accommodate both the current and the projected volume of transactions. Examiners should obtain information on the servicing system in use and any limitations it might pose in terms of future growth plans.

Procedures for maintaining physical security in the workplace, data security, and file backup also should be discussed with management. A contingency plan should describe the use of alternative backup sites, as well as procedures that would be followed to reconstruct altered or destroyed files. Contingency plans should be reviewed and approved at least annually and tested regularly.

3070.0.4.9 Inspection Objectives—Servicing/Loan Administration

1. To assess the adequacy of management oversight of risk through policies and procedures, management information systems and reports, and other internal and external audits, with respect to the following:

- collecting monthly payments from mortgagors
- reporting loan activity and remitting funds to investors
- monitoring escrow account balances
- disbursing property insurance and real estate tax payments
- monitoring delinquencies, initiating collection activities, and initiating foreclosure proceedings in a timely manner

2. To evaluate the level of risk assumed by the mortgage banking company through servicing recourse arrangements.

3070.0.4.10 Inspection Procedures—Servicing/Loan Administration

Management Assessment

1. Obtain an organization chart for the servicing department and resumes for senior management and key staff members. Evaluate management's qualifications and expertise.

2. Review servicing policies and procedures manuals to determine whether reasonable operating standards have been established for each functional area. Also assess whether management reports adequately monitor compliance with established policies and procedures. Determine how exceptions are identified and addressed.

3. Review internal and external audits, quality control reports, and investor audits to determine whether internal controls are functioning effectively.

4. Evaluate safeguards in place for loan documents and determine if an adequate document tracking system exists.

5. Verify that a disaster recovery plan is in place that covers all in-house servicing functions. Verify that backup systems exist should primary systems fail. Determine if backup systems would provide information to substantiate servicing portfolio asset values.

6. Obtain a list of subservicers and vendors, if any, employed to perform servicing functions.

- Determine if a periodic review of services provided by each subservicer is conducted. In addition, the financial condition of each subservicer should be evaluated at least annually.
- Determine whether a contingent operating plan has been established should subservicers and vendors be unable to perform their contractual obligations.

Profitability Analysis

1. Review business line profitability for the servicing department to identify significant trends and/or areas of potential weakness. Discuss and review key efficiency measures such as unit cost and cost per employee.

2. Analyze servicing income and expenses to determine whether operations are profitable and economies of scale are being achieved in line with industry norms:

- Determine whether all direct and indirect costs are included.
- Compare servicing revenues with costs.
- Assess the impact of any bulk servicing purchases or sales on departmental profitability.
- Analyze efficiency in light of management's growth projections.

3. Review servicing portfolio trends and characteristics, including the following:

- investors (GNMA, FannieMae, FHLMC, private)
- recourse provisions
- loan types (30-year fixed, 15-year fixed, ARM, balloon)
- average loan size
- interest rates (particularly those above market)
- remaining contractual life
- projected life
- geographic distribution of mortgagors
- delinquency statistics
- foreclosure statistics
- number of subserviced loans and servicers

Loan Accounting

1. Review with management the procedures for receiving payments from mortgagors and depositing funds into segregated accounts. Determine that the segregation of duties and other controls over custodian accounts are adequate.

2. Review any outstanding advances to investors. Evaluate the collectibility of advances, the timeliness of charge-offs, and the adequacy of reserves.

3. Determine whether outstanding items related to investor account reconciliations are being resolved in a timely manner. Are reconciliations routinely reviewed and approved by a supervisor?

Escrow Administration

1. Review with management the system in place for ensuring the timely payment of taxes, insurance, and other obligations.

2. Review the servicer's method for analyzing the amount and adequacy of escrow account balances, and evaluate its effectiveness. Assess procedures relating to shortages and overages in escrow accounts:

- Determine whether procedures comply with 12 U.S.C. 2609 (RESPA) and to the extent possible with state laws.
- Determine whether the borrower is sent an analysis statement showing the amount of discrepancy, how it occurred, and an explanation of how it is to be corrected.

3. Determine the volume of loans with no escrow requirement and procedures for ensuring that insurance payments and taxes are current.

4. Determine how escrow funds are invested, assess the appropriateness of the investment vehicles, and review management's analysis of yield on escrow funds.

5. Evaluate whether controls are in place to prevent the use of escrow custodial accounts to meet other obligations.

6. Review outstanding escrow advances, and determine if claims for reimbursement are processed in a timely manner. Evaluate the collectibility of outstanding advances and verify that uncollectible advances are charged off in a timely manner.

Investor Reporting

1. Review the list of investors for which servicing is performed.

2. Review servicing contracts to verify that signed, current contracts exist. Discuss with management the nature of any recourse provisions, forbearance requirements, and nonreimbursable collection and/or foreclosure expenses.

3. Review the most recent investor audit reports on the servicing function. Discuss findings with management and evaluate the adequacy of any actions taken to correct deficiencies.

4. Determine whether any servicing contracts have been terminated for cause or are likely to be lost in the near future. Determine the reason for any termination and the extent of any corrective actions taken.

Collections and Foreclosures

1. Review and assess, on a statistical-sample basis, the accuracy and adequacy of loan delinquency reports by product type and originator. Ascertain the reasons for poor or declining asset quality within the servicing portfolio.

2. Review policies and procedures for collecting late payments.

- Determine when collection efforts start once an account becomes delinquent.
- Verify that all attempts at collecting past-due payments are documented, including each date of communication with borrowers, the nature of the communications, and the customers' replies.

3. Select a sample of files for borrowers who are 120 days or more delinquent and determine whether foreclosure proceedings are instituted in a timely manner.

- Determine if borrowers and investors are appropriately notified of the initiation of foreclosure action.
- Verify that contacts with borrowers are documented.
- Determine whether property inspections are conducted in accordance with policy.
- Verify that foreclosure practices comply with FHA/VA/PMI requirements and guidelines.

4. Determine the average foreclosure costs for each product type. Foreclosure costs include inspections, legal and administrative costs in excess of those defined as normal and customary, VA no-bid, and VA write-downs.

5. Obtain a list of loans in foreclosure in which action has been delayed, and determine if the justifications for delay are reasonable.

6. Determine the number and dollar volume of delinquent loans that were purchased from the servicing portfolio (buyouts or buybacks).

- Assess the impact of repurchases on profitability, the appropriateness of this practice, and the accounting procedures for these loans.

7. Discuss with management the effect that negotiated guaranty fees may have on the level of losses associated with foreclosures.

Payoffs

1. Review procedures for payoffs to determine whether—

- payoff instructions are sent to the mortgagor before payoff;
- satisfaction remittances are made to the investor or to the pool, necessary documentation is obtained, notes are canceled properly, and documentation plus any escrow refund checks are sent to the mortgagor in a timely manner; and
- internal controls are in place to ensure that funds are not misappropriated and employee fraud is detected and reported according to policy.

Other Real Estate

1. Determine the number and dollar volume of ORE by geographic location.

- Compare the volume of ORE with historical levels and the industry average for similar-sized servicers.

- Evaluate the impact of ORE on profitability.
- Review the policies and practices for ORE accounting, property supervision, and marketing. Verify that policies are consistent with investor guidelines and regulatory policies.

2. Determine whether ORE parcels are purchased from the servicing unit by the bank holding company or its affiliates.

- Evaluate the controls in place to limit or prevent this practice and the accounting treatment for such loans.
- Verify that information regarding ORE is properly reported to the parent bank or holding company for consolidation into regulatory reports.

Customer Service

1. Review the system for logging, tracking, and responding to customer complaints. Has the volume of complaints grown? Are complaints addressed promptly with any problems resolved in a timely manner?

2. Review the servicer's customer-complaint file to gain more insight into the nature of the complaints. Do complaints suggest that internal policies and procedures are not being followed or that staffing levels are inadequate?

3070.0.5 FINANCIAL ANALYSIS

This section provides the examiner a framework with which to analyze the financial condition of a mortgage banking company. The analysis begins with a review of the mortgage company's balance sheet and income statement. The financial analysis should incorporate a review of primary balance-sheet and income-statement levels and trends, off-balance-sheet assets and liabilities, asset quality, market share and earnings performance, funding sources, liquidity needs, and capital adequacy. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or its parent bank holding company to undue financial risk should be brought to management's attention and documented in page one, Examiner's Comments and Matters Requiring Special Board Attention. The examiner should focus on items that are either large relative to the company's operations or that may pose undue financial risk. The examiner should also investigate any trends that appear inconsistent with the mortgage banking company's industry peer group, business orientation (such as wholesale versus retail, originations versus servicing, etc.), and future growth plans or with the current economic and interest-rate environment.

Financial-statement presentation may vary across mortgage banking companies. If questions arise, financial-statement presentation and accounting should be reviewed with the company's internal and/or external accountants for propriety. During the review of the financial statements, the examiner should establish whether regulatory reports are prepared accurately. Banks must conform to the reporting requirements of the Commercial Bank Reports of Condition and Income (call report). Bank holding companies and their direct subsidiaries must conform to generally accepted accounting principles (GAAP). Relevant GAAP statements of the Financial Accounting Standards Board include SFAS No. 65, ''Accounting for Certain Mortgage Banking Activities,'' as amended; SFAS No. 91, ''Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases''; SFAS No. 115, ''Accounting for Certain Investments in Debt and Equity Securities''; SFAS No. 125, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities;'' and SFAS No. 80, ''Accounting for Futures Contracts.'' Other relevant accounting pronouncements are identified in appendix B, Accounting Literature.

The financial analysis should also include an assessment of asset quality, earnings, liquidity and funding, and capital. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or the parent bank holding company to undue financial risk should be brought to management's attention and discussed in the Examiner's Comments and Matters Requiring Special Board Attention.

3070.0.5.1 Balance Sheet

3070.0.5.1.1 Assets

The asset side of the balance sheet may consist of cash, reverse repurchase agreements, marketable securities, receivables and advances, mortgage loans held for sale, mortgage loans held for investment, mortgage-servicing assets (MSAs) (including mortgage-servicing rights), reserves for loan and other credit-related losses (contra accounts), other real estate owned (OREO), and other assets.

3070.0.5.1.1.1 Mortgage-Related Securities

The examiner should determine whether the accounting treatment for mortgage-related securities reported on the balance sheet is consistent with SFAS 115. SFAS 115 applies to equity securities having readily determinable fair values and to all debt securities. It does not apply to loans purchased.

Under SFAS 115, at acquisition and at each subsequent reporting date, all debt and equity securities that fall under the scope of the statement should be classified into one of the following categories:

- trading securities
- available-for-sale securities
- held-to-maturity securities

Both debt and equity securities can be assigned to the above first two categories. The third classification can only consist of debt securities.

Trading. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value. Debt securities not held to maturity and equity securities that have readily determinable fair values should be classified as trading securities when (1) they are held for short periods of time and (2) they have been acquired with the expectation of a profit from short-term price differences. Securities that are actively traded should be carried at fair value on the balance sheet, with net unrealized gains or losses included in income.

Available-for-sale. Debt and equity securities having readily determinable fair values that are not otherwise classified, as above, should be categorized as available-for-sale and carried at fair value on the balance sheet. Unrealized holding gains and losses should be reported in a separate component of shareholders' equity and should not be included in income.

Held-to-maturity. For a security to qualify as held-to-maturity under SFAS 115, the mortgage banking company must demonstrate the positive intent and ability to hold it until maturity.

3070.0.5.1.1.2 High-Risk Securities

The examiner should also review any high-risk mortgage securities that are on the balance sheet, such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), CMO and REMIC residuals, and stripped mortgage-backed securities (stripped MBSs). See sections 2126.1 and 2190.0.5.

3070.0.5.1.1.3 Mortgage Loans Held for Sale

The examiner should determine whether the accounting treatment for mortgage loans held for sale is consistent with SFAS 65, as amended. Mortgage loans held for sale shall be reported at the lower of cost or market value, determined as of the balance-sheet date.[5] The amount by which the cost exceeds market value shall be accounted for as a valuation allowance. Changes in the valuation allowance shall be included in net income of the period in which the change occurs.

3070.0.5.1.1.4 Mortgage Loans Held for Investment

Mortgage loans held for investment may include loans that (1) do not meet secondary-market guidelines and are therefore unsalable, (2) loans that were repurchased from an investor due to poor documentation and/or improper servicing, (3) loans put back to the mortgage banking company under recourse agreements, and (4) loans intentionally originated for portfolio.

SFAS 65 states that a mortgage loan transferred to a long-term investment classification shall be transferred at the lower of cost or market value as of the transfer date. The securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan

5. According to SFAS 65, as amended, the capitalized costs of acquiring rights to service mortgage loans, associated with the purchase or origination of mortgage loans, shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or market value.

and the purchase of an MBS classified as a trading security at fair value. Any difference between the carrying amount of the loan and its principal balance shall be recognized as an adjustment to yield by the interest method.

A mortgage loan shall not be classified as a long-term investment unless the mortgage banking company has both the intent and the ability to hold the loan for the foreseeable future or until maturity. If the ultimate recovery of the carrying amount of the loan is doubtful and the impairment is considered to be other than temporary, the carrying amount of the loan shall be reduced to its expected collectible amount, which becomes the new cost basis. The difference is recognized as a loss. A recovery of the new cost basis shall only be reported as a gain upon sale, maturity, or disposition of the loan.

3070.0.5.1.2 Liabilities

The liability side of the balance sheet may include repurchase agreements, commercial paper, revolving warehouse lines of credit, long-term debt instruments, intercompany payables, and equity capital.

3070.0.5.1.2.1 Repurchase Agreements

A mortgage banking company may finance its mortgage loans or MBSs held for sale by transferring mortgage loans or MBSs temporarily to banks, nonbanks, or other financial institutions under formal repurchase agreements that indicate that control over the future economic benefits relating to those assets and the risk of market loss are retained by the mortgage banking company.

Repurchase agreements can provide a cost-effective method of holding mortgage-backed securities before their sale to investors. Securities dealers repo the securities for a period of 30 to 180 days at a substantial cost advantage to warehouse facilities. Repurchase agreements involve delivery of the security to the dealer with an agreement to repurchase it on a specified date. Upon receipt, the dealer wires the haircut proceeds to the mortgage company. The mortgage company then reduces the amount of its outstanding warehoused loans. If the repo is being handled by the dealer that is arranging the ultimate sale of the security, the amount of that discount should approximate the discount on the sale. If another dealer is involved in the ultimate sale, the haircut may be greater because the security must be repurchased and redelivered to the second dealer. This may also require a rehousing to provide funds to honor the repurchase commitment. Most warehouse lenders allow traditional warehouse lines to be collateralized by individual mortgages and mortgage-backed securities.

A mortgage banking company may use repurchase agreements in conjunction with sales of loan pools. The company may use repurchase agreements to pledge mortgage loans and/or MBSs as collateral for borrowings. In return, it receives advanced funds against future deliveries. The lenders are repaid through the sales of MBSs. The amount outstandings bear interest for the number of days the funds are outstanding.

Under repurchase agreements, the same loans or MBSs are generally reacquired when they are sold to permanent investors. Mortgages or MBSs may also be transferred temporarily without a repurchase agreement. However, some type of informal agreement generally exists. Mortgage loans and MBSs held for sale that are transferred under either formal or informal repurchase agreements shall be accounted for as collateralized financing arrangements and reported as either mortgage loans held for sale or MBSs classified as trading securities on the mortgage banking company’s balance sheet.

3070.0.5.1.2.2 Commercial Paper

Another source of short-term funding is the issuance of commercial paper. In general, commercial paper represents unsecured notes with maturities up to 270 days from the date of sale. Because of its short maturity, proceeds should be limited to current transactions with short-term maturities. Commercial paper proceeds should not be used to fund loans held for sale for a period greater than one year.

Commercial paper can be less reliable than warehouse lines of credit. If commercial paper funding is used, examiners should review related commercial paper backup lines of credit and ratings issued by credit rating agencies. The reason for any rating changes during the prior year should be investigated. Additional guidance on this topic is set forth in sections 2080.05, 2080.1, and 5010.23.

3070.0.5.1.2.3 Revolving Warehouse Lines of Credit

Short-term revolving warehouse credit lines are often used to fund loans held for sale, which is generally the largest asset on the company's balance sheet. Revolving credit lines may be obtained from an affiliate bank, the parent bank holding company, or an unrelated third party.

The extension of credit for a particular loan is paid off when the mortgage lender sells the mortgage loan to a government-sponsored agency such as GNMA, FannieMae, or FHLMC or to a private investor. Lenders who provide warehouse lines of credit typically enter into a warehouse credit agreement with the borrower. Under the agreement, the warehouse lender agrees to extend credit to the mortgage banking company for the purpose of originating loans. The mortgage banking company agrees to repay each extension of credit within the terms of the agreement. Each extension of credit is secured by placing a lien on the originated mortgage loan. The warehouse lender perfects its security interest by taking possession of the original promissory note executed by the borrower, endorsed ''in blank,'' together with an assignment of the mortgage securing the loan. To further protect its security interest, the warehouse lender usually takes the responsibility of delivering the loan package to the secondary market investor for purchase. The investor, in turn, delivers the purchase price of the mortgage directly to the warehouse borrower (mortgage banking company). Each portion of the warehouse line may be priced separately to reflect various levels of risk and the documentation requirements of each.

The details of all credit lines should be specified in formal, written credit agreements. Revolving credit lines may be either unsecured or secured by a lien on the underlying mortgages. Under most secured lines, a formula is used to calculate the borrowing base, which generally consists of cash, cash equivalents, loans held for sale, securities, and a percentage of the mortgage-servicing portfolio less certain short-term indebtedness. Some credit lines require the maintenance of compensating balances.

Internal credit arrangements (conducted either by a mortgage banking subsidiary of a bank or bank holding company) must comply with sections 23A and 23B of the Federal Reserve Act. See sections 2020.1 and 3070.0.7 of this manual.

Examiners should evaluate the adequacy and efficiency of warehouse funding operations. The examiner should determine whether the warehouse lender is of a sufficient size and whether it is well positioned financially to provide adequate lines of credit, as needed. Examiners should ascertain whether funding must be regularly derived from more than one warehouse lender (including whether the warehouse line has to be participated out to other lenders) and whether the lender has proper internal controls to safeguard collateral documents for pool certification. The examiner should also determine what management's contingency plans are for the use of alternative financing sources beyond standard warehouse lines of credit for backup financing and lower-cost efficiency purposes. Has management (1) explored variations in existing lines of credit to reduce overall borrowing costs and (2) determined what competitor lenders are paying for similar financing facilities?

Procedures should be in place to monitor compliance with all short-term debt covenants. Covenants may limit servicing of loans with recourse, limit total debt to specified levels, and/or require minimum tangible net worth, leverage, and current ratios. Most credit agreements also limit the borrower's financial flexibility if the company's long-term debt ratings decline or the company becomes unrated or if certain events occur related to securities.

3070.0.5.1.2.4 Long-Term Debt

Longer-term assets are more appropriately funded through the issuance of longer-term liabilities or capital. Toward this end, mortgage banking companies may issue medium- or long-term public debt securities (including warrants to purchase debt securities). Debt may be issued in the form of fixed-rate or floating-rate notes with various repayment or redemption terms. Loan agreements should specify all relevant terms and conditions and may contain debt covenants similar to those found in the warehouse funding arrangements.

Long-term debt may incorporate restrictive covenants which limit the company's activities in certain respects. These covenants may set limits on the amount of senior debt outstanding and the minimum amount of liquid net worth (as defined by the documents), and may limit the proportions of specific categories of assets. Such covenants should be reviewed to make certain that they are not too restrictive and that they permit financial flexibility.

3070.0.5.1.3 Equity Capital

Funding is also provided through equity capital, which may be supplemented by capital contributions from the parent company or the direct issuance of equity securities.

3070.0.5.2 Income Statement

Mortgage banking revenues generally consist of the following: loan servicing/administration revenue; loan-origination-fee revenue; interest income; gains (losses) on the sale of mortgage loans, mortgage securities, or mortgage-servicing rights; and management and other fee income. The examiner may find that gross gain (loss) on the sale of mortgage loans or securities is reported on the income statement net of loan-origination fees and direct loan-origination costs such as personnel and office expenses.

Expenses may include interest expense; salaries, commissions, and other personnel costs; interest losses on MBS pools; amortization of mortgage-servicing assets and any other purchased intangible assets; electronic data processing and other selling, general, and administrative costs; occupancy and equipment; depreciation; provision for foreclosure and other loan losses; and a provision for income taxes. Some companies net amortization of MSAs directly against loan-servicing revenues.

3070.0.5.3 Unique Characteristics

The financial analysis should reflect certain operational characteristics that are unique to the mortgage banking industry. Many of these characteristics are cyclical based on interest rates and economic conditions.

For example, the cost of funding loans in the warehouse is relatively inexpensive during periods of low interest rates, but may increase significantly as interest rates rise. Marketing operations are also highly dependent on the interest-rate cycle. During periods of falling interest rates, the company may experience substantial gains on the sale of mortgage loans and securities to permanent investors. Alternatively, during periods of rising interest rates, the company will usually experience losses on the sale of mortgages and securities. Interest-rate volatility can cause large fluctuations in warehouse funding costs and marketing gains and losses.

The examiner should also consider the impact of current economic conditions on the size and composition of the mortgage banking company's balance sheet. When the economy expands, loan volume increases and the overall size of the balance sheet tends to grow. During recessions, the balance sheet should contract, reflecting the lower demand for new loans. Management's planning efforts should incorporate this type of economic trend analysis in their growth targets. Steady annual growth may or may not be anticipated.

Efficiency measures, such as activity ratios (inventory turnover and efficiency ratios), should be used to determine management's ability to originate and sell loans efficiently. The inventory of loans held for sale is transitory, lasting between 45 to 60 days. A buildup of loans on the balance sheet may indicate processing delays and/or asset-quality problems that may prevent their ultimate sale to permanent investors. Because of the transitory nature of the balance sheet, traditional leverage ratios (asset-to-equity capital) may not be meaningful and should be used sparingly.

Another unique characteristic of a mortgage banking company is the economic value of its mortgage-servicing operations, which constitutes an off-balance-sheet item. Failure to incorporate this economic value into the financial analysis may overstate the degree of financial leverage that is employed within the company.

3070.0.5.4 Asset Quality

The quality of assets that are on the balance sheet is evidenced by the following: compliance with original underwriting standards; the existence of effective loan review and quality control programs; borrower payment and agreement performance; the fair value of MBSs held for sale or investment; the collectibility, independent valuation, nature, volume, and existence of recorded assets; the application of GAAP in accounting for the assets; and the degree of protection afforded by real estate mortgage collateral, including any private mortgage insurance. The value afforded by real estate mortgage collateral includes the extent of compliance with the Federal Reserve Board's real estate appraisal regulations and guidelines. (See section 2231.0.) Asset quality should be analyzed in terms of regional and national economic factors as well as portfolio and managerial factors.

For any review of any loan portfolio, a sampling of real estate appraisals should be included to determine whether the appraisal results reasonably support the amount loaned. If the property appears to be overappraised or if there is a problem with the appraisal (for example, the appraisal is obsolete or the validity of the appraisal is in question), the examiner should consider recommending that a new appraisal be performed.[6] It may be necessary for the examiner to classify the loan (i.e., as a loss) and for the parent holding company to increase its allowance for loan and lease losses.

Bank holding companies and/or their nonbank subsidiaries should be criticized if initial appraised values appear to be inadequate and/or not properly supported by proper documentation. If corrective action is not taken by management, formal enforcement action should be considered. Such actions may require the bank holding company to revamp its appraisal activities and/or collection procedures and, if warranted, to retain the services of an independent appraiser to conduct an evaluation of loan collateral.

With respect to MBSs, the quality characteristics of the underlying mortgage collateral should be considered. If the securities are backed by GNMA, FannieMae, or FHLMC, the rating agencies consider such securities to be the highest quality asset because of their linkage to the federal government. If the collateral consists of unsecuritized mortgages, the examiner should consider the geographic dispersion, type of mortgage and property, underwriting standards, and term to maturity of the underlying pool of mortgage loans. External factors can affect the value of mortgage securities directly, such as the default or downgrading (by a credit rating agency) of a private mortgage insurer.

To a large extent, insurance and guaranties provided by government-sponsored agencies and other third parties (for example, private mortgage, bankruptcy protection, fraud, and mortgage pool insurers, as well as performance bond insurers and other guarantors) mitigate credit risk for an originator; however, the originator still remains responsible for the quality of loans sold to investors for at least the first 90 days, as well as for any loans sold under recourse arrangements. As a servicer, the company also can be held liable if it does not initiate collection and foreclosure actions in strict accordance with investor-servicing agreements. In addition, certain interest losses and expenses relating to collections, foreclosure, and ORE are not fully reimbursable and should be anticipated.

The mortgage banking company must maintain adequate management reports to measure and track the quality of originated, purchased, and serviced assets. Proper administration over loans and other assets held for sale or investment requires the use of aging and other tracking reports. For assets held for sale, the reports should identify loans and other marketable assets, other than marketable securities,[7] that have been in this category longer than 60 days. In such instances, a determination should be made as to whether credit quality problems and/or documentation deficiencies exist that will prevent the timely sale of the loan in the secondary market. If problems are not correctable within a reasonable timeframe, the loans and other related assets should be revalued and transferred to the held-for-investment category. Procedures governing the valuation and transfer of poor-quality assets should be in writing and should be followed.

The MIS should also generate for management's review reports on the delinquency status of loans held for investment and loans serviced for investors. Such reports provide an early warning system and an analysis tool to evaluate internal collection activities. If a loan becomes delinquent (30 days or two payments past due), the borrower should be contacted. Collection efforts should be strengthened if the delinquency continues. If the loan becomes severely delinquent, foreclosure proceedings should be initiated consistent with the investor-servicing agreement, and the value of the collateral supporting the loans should be assessed. Anticipated shortfalls should be recognized as losses in a timely manner.

MIS should also include an internal loan-grading system, which tracks the borrower's ability to meet its monthly payment obligations. Although MIS should be tailored to meet management's needs, information should be consistent with loan-grading systems that are used by the controlling bank holding company and federal bank regulatory agencies. Reports should also track collection and foreclosure actions initiated by the servicer and repurchase requests initiated by a permanent investor or other third party.

Examiners should also verify that appraisal practices are consistent with the Board's

6. For certain credits, the bank holding company should develop criteria for obtaining reappraisals or revaluations as part of a prudent portfolio review and monitoring program.

7. For mortgage-backed securities available-for-sale, similar account classification procedures apply, but those are accounted for in accordance with SFAS 115.

appraisal regulations,[8] the interagency appraisal and evaluation guidelines (see SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-95-31), and any other state and federal laws and regulations. Mortgage banking companies that are subsidiaries of either state member banks or bank holding companies are subject to the same appraisal standards and requirements as their parent companies.

3070.0.5.4.1 Classification Procedures

The classification process begins with an analysis of delinquent loans. The examiner should begin by obtaining an aged listing of all delinquent loans in the held-for-sale and the held-to-maturity portfolios. Clear-cut shortfalls in property values compared with loan or investment values should usually be classified unless there are mitigating circumstances. Usually loans or investments with doubtful or loss elements have other significant weaknesses that will ordinarily justify a classification of substandard for the remaining balance. Loans secured by collateral such as real estate should be classified in accordance with these guidelines and the applicable classification guidance found in sections 2060.1 and 2090.1 of the *Commercial Bank Examination Manual* and sections 2010.2, 2065.1, 2240.0, and 5010.10 of this manual.

Portions of these loans may warrant a more severe classification if the value of the underlying collateral is insufficient to fully repay the loan. The identification of potential or actual loss exposure may warrant the use of either a split (substandard and loss) or a doubtful rating.

The examiner should also review the ORE portfolio, notes and accounts receivable, and other investments on the company's balance sheet for potential classifications. ORE may usually warrant a substandard classification due to an investment's nonearning status and an increased probability of loss on disposal of the underlying assets.

Assets that represent illegal or impermissible holdings or those that are subject to some regulatory concern should not be classified, per se, for these factors. Such holdings should be treated separately within the report. In those instances where a credit-quality issue is also present, the classification and the separate treatment should be cross-referenced.

8. See Regulation Y, subpart G (12 C.F.R. 225.61–67), and its incorporation by reference into Regulation H (12 C.F.R. 208.18).

The examiner should also review any off-balance-sheet exposure for which credit risk is retained. Loans sold to investors on a recourse basis have the potential of being put back to the servicer. The portion of the recourse portfolio that is severely delinquent should be classified according to the guidelines provided previously, since the exercise of this ''put option'' is highly likely.

At the end of the classification process, the examiner should evaluate the level and trend of classified assets to determine whether asset quality poses undue financial risk to the mortgage banking company or its parent bank holding company. A list of total classifications should be compiled and left with management.

As part of the analysis of asset quality, the aggregate of loss classifications plus an amount expected to ultimately be loss should be compared with the existing allowance for loan and lease losses. If the aggregate exceeds the existing contra asset balance(s) then additional loan-loss provisions are needed. In such situations, the parent company should be advised of the deficiency and reminded of its responsibility to ensure that an adequate allowance for loan and lease losses, as well as other contra asset valuation balances, is maintained by the subsidiary for its asset portfolio.

Any discrepancies between the classifications list and information contained on the company's MIS should also be discussed with management. If asset quality presents undue or excessive risk, appropriate comments should be documented and brought forward on Examiner's Comments and Matters Requiring Special Board Attention, page one of the report.

3070.0.5.4.2 Presentation of Classifications

As a minimum standard, brief write-ups stating the reason for classifications should be provided for any nonbank subsidiary's asset whose doubtful and/or loss classification exceeds the lesser of $100,000 or 5 percent of the subsidiary's total assets. In general, substandard assets should be listed without a write-up, regardless of size. However, a brief write-up is required for any asset whose classification is challenged by management. The examiner has the option to provide a write-up for any classified assets, regardless of size.

While the following presentation guidelines may be useful in structuring the write-ups, the examiner may include any other format appropriate to the situation:

- recapitulation of the status and purpose of the loan, the lien position, type and appraised value of the collateral, its delinquency and accrual status, guarantors and other debit or credit balances related to the loan
- the problems with the loan, borrower, or collateral, presented in a concise, descriptive narrative
- the examiner's evaluation of the situation, indicating estimated values, major assumptions, and mitigating or negative factors
- the classification, which should represent a logical combination of the relevant factors presented in the first three elements

Within the elements presented, the examiner should stress accuracy, brevity, and clarity in the presentation, as well as a logical pattern leading to the classification. Historical information and financial data that are not pertinent or that are too stale to have a direct bearing on the present situation should not be included.

Presentations for OREO properties need not include the original loan date, history, and financial information, unless there is some relevance to the current condition (for example, the property has been foreclosed on for the second time or some circumstance before foreclosure continues to have an impact). For those companies in which numerous loans and OREO properties are classified, a summary of classifications, segmented by loans and real estate owned and indexed to the pages containing the classifications, presents clear benefits to the users of the report. This becomes more pertinent when numerous assets below the write-up line are included in total classifications. In addition, both management and the subsequent examiners will have an official listing of the classifications.

3070.0.5.4.3 Reserves

Management should establish and maintain adequate contra asset allowances and other contingency reserves to cover identified loss exposure. Policies and procedures, and financial statement disclosures, should clearly state the purpose of and intended accounting treatment for each reserve. Management should evaluate the level of each reserve account at least quarterly, document this analysis, and replenish each reserve as necessary.

The financial presentation for reserves varies. Reserves maintained for on-balance-sheet exposure are generally reported as a contra asset. Reserves maintained for contingent liabilities relating to the sale of loans and servicing of loans for investors may be shown as a liability in practice.

Disclosures relating to valuation reserves should be consistent with GAAP. Examiners may wish to confer with the mortgage banking company's external auditors regarding the nature or appropriateness of any reserve accounts that are unusual.

3070.0.5.5 Earnings Performance

Earnings performance should be assessed in terms of the level, composition, quality, and trend of net income. The earnings analysis should consider internal factors such as the company's business orientation and management's growth plans, as well as relevant external factors such as interest rates and economic trends.

Unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, provisions for losses, salaries and overhead items, or income taxes should be discussed with management, as well as with internal or external auditors. Large write-downs or amortization adjustments relating to mortgage-servicing rights should also be investigated. (See section 3070.0.6.)

Current and historical ratio trend analysis, compared with published industry results (for example, see the Mortgage Bankers Association's annual statistics in the "Mortgage Banking Performance Report"), should also be incorporated into the profitability analysis, where appropriate. This includes income structure, expense structure, and operating performance ratios. However, ratios that compare earnings to average assets or equity may be of limited use unless the examiner also considers the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage. Finally, the examiner should consider the company's ability to generate sustainable positive earnings consistently over time, as well as the proportionate share of consolidated earnings (or losses).

3070.0.5.6 Liquidity and Funding

Management's ability to satisfy the company's liquidity needs and plan for contingencies without placing undue strain on affiliate bank or nonbank resources or reliance on the parent bank holding company is crucial. Liquidity needs depend on the size of the warehouse, the nature and extent of longer-term assets, opportunities to issue debt at a reasonable price, and management's ability to forecast and plan for contingencies. Liquidity is often dependent on cash generated through short-term liquid assets and on short-term borrowings to fund operations. Earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity plans are all significant factors in the evaluation of liquidity. Liquidity can quickly erode if investor perceptions of a company's credit standing change. Consequently, the ability to fund mortgage operations under economic duress and access to alternate liquidity sources become key considerations.

Funding needs are driven by the need to temporarily finance mortgage loans and MBSs before their sale to a permanent investor. The examiners should do a trend review of external liquidity to assess how easy it is to sell mortgage-backed securities by the firm in the secondary market. The analysis should include the normal trading volume in MBS securities, the volume of loans held for sale and their market value, and the size of the ''floating'' supply of mortgage securities or loans that are not closely held. Liquidity needs must also take into consideration longer-term assets such as fixed assets, mortgage-servicing rights, and permanent loan and MBS portfolios. (See section 2080.05.)

3070.0.5.6.1 Financial Flexibility

The liquidity analysis should include a determination as to the company's financial flexibility. Financial flexibility is the ability to obtain the cash required to make payments as needed. Cash can be obtained from (1) business operations; (2) liquid assets already held by the company either in the form of cash or marketable securities or by selling liquid assets such as receivables or inventories for cash; and (3) external lines of credit, bank borrowings, or the issuance of debt or equity securities in the capital markets.

3070.0.5.6.2 Cash-Flow Analysis

The liquidity analysis should also include a review of the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. The examiner's analysis of cash flows may reveal transactional trends between cash inflows and outflows. For example, within the Cash Flows from Operating Activities, cash flow from the sale and principal repayments on mortgage loans held for sale may correlate with originations and purchases of mortgage loans available for sale. With regard to investing activities, attention should be given to the differences between short-term purchases of mortgage loans held for investment versus principal repayments on mortgage loans held for short-term investment. In addition, purchases of real estate owned from the loan-servicing portfolio may correlate with net sales of real estate owned. A review of the financing activities should indicate if there is sufficient cash flow provided from revolving warehouse lines of credit, commercial paper, proceeds from the issuance of any other short-term debt, and net changes in advances payable to affiliates.

The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity. When analyzing liquidity, the examiner needs to consider the principles and guidelines set forth in section 2080.05, ''Funding (Bank Holding Company Funding and Liquidity)'' of this manual.

3070.0.5.6.3 Asset/Liability Management

In general, funding liability maturities should closely approximate the maturities of underlying assets to mitigate the risk of a funding mismatch. Otherwise, the company is exposed to short-term interest-rate fluctuations unless appropriately hedged. Funding mismatches can lead to significant earnings volatility in the event that interest rates change rapidly. Management's asset/liability management program should be evaluated in terms of the degree of matching, risk aversion, and the accuracy of information that is provided to the holding company through daily, weekly, or monthly management reports.

3070.0.5.7 Capital Adequacy

Capital must be adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by third-party creditors and investors.

At a minimum, a mortgage banking company must meet the nominal capital levels required by investors such as FannieMae ($250,000) or FHLMC ($1 million, based on financial reporting under GAAP, or $500,000, adjusted for certain assets and any deferred-tax liability). Additional capital is required based on the outstanding principal balance of loans serviced for investors. If these requirements are not met, the company may not be able to sell mortgages to and/or service mortgages for these investors.

As noted above, these are minimum capital requirements. Management should identify the level of capital that is required to support current operations and projected future growth, given the risk tolerance preferences of management and the board. Capital levels, dividend payments, and capital planning should be addressed in a written capital plan that is reviewed and approved by the board at least annually in conjunction with the budgeting and strategic planning activities.

There also may be a need to meet minimum leverage ratios established by the parent bank holding company or to meet debt covenants set forth in either warehouse credit facilities or long-term debt instruments. Companies that have excessive off-balance-sheet risk or high growth expectations may require additional capital. In addition, risk-based capital guidelines impose certain reporting requirements and limitations regarding the amount of MSA mortgage banking companies may include in their regulatory capital.

Capital levels should be monitored and reported to the company's board of directors regularly to mitigate the risk of inadequate or eroding capital. Management and the board are further encouraged to adopt a capital policy that specifically addresses the particular needs of the company.

The examiner should evaluate capital adequacy, the amount of dividends that are upstreamed to the parent bank holding company, and the extent to which the parent company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. In some instances, the parent company may operate on the premise that the mortgage banking company requires little capital of its own as long as the parent company remains adequately capitalized.[9] Under the Federal Reserve's source-of-strength doctrine, the parent company must be prepared to support its subsidiaries should the financial need arise. If the parent is not prepared to inject capital and capital levels have declined, the examiner should comment on the mortgage banking company's extended leveraged position on page one of the inspection report. Under extreme circumstances, the examiner should also recommend that its leverage be reduced and its capital structure augmented to ensure that mortgage operations are conducted in a safe, sound, and prudent manner.

3070.0.5.8 Overall Assessment

The overall financial condition of the mortgage banking company should reflect its financial statement presentation, asset quality, earnings, liquidity and funding practices, and capital adequacy. Report comments should be prepared to the extent necessary.

3070.0.5.9 Inspection Objectives

1. To evaluate the financial condition of the mortgage banking company based on a review of the following:

- primary balance-sheet and income-statement levels and trends
- off-balance-sheet exposure such as the servicing portfolio
- asset quality
- earnings performance
- funding sources and liquidity needs
- capital adequacy

2. To determine the accuracy of regulatory reporting (regulatory accounting practices (RAP) and GAAP) and compliance with applicable state and federal laws and regulations.

3. To evaluate the quality of the mortgage banking company's assets for collateral sufficiency, performance, credit quality, and collectibility.

4. To assess earnings performance through the analysis of the level, composition, and trend of net income. If material, interest income, impairment of mortgage-servicing assets, gains and losses on asset sales, and personnel and other expenses should be factored into the analysis.

9. When MSAs are valued for inclusion in capital, the risk-based capital guidelines for banks and BHCs require the discount rate to be not less than the original discount rate inherent in the intangible asset at the time of its acquisition, based on the estimated future net cash flows and price paid at the time of purchase.

5. To assess the funding and liquidity needs of the mortgage banking company through ratio analysis and a review of the funding instruments used.

6. To assess capital adequacy by ensuring that investor minimum requirements are met and by comparing capital levels with peer and industry data. Consideration of the capital needs of the individual mortgage banking company should override any comparison with peers.

3070.0.5.10 Inspection Procedures

Financial Statement Level and Trends

1. Review the mortgage banking company's financial statements and related notes over the previous three-year period.

2. Discuss significant balance-sheet and income-statement categories with management, as well as with internal and external auditors.

3. Determine whether financial trends are consistent with the economic environment, interest-rate movements, the company's business orientation, and management's intended growth strategy.

4. Determine whether reports filed with regulatory agencies are prepared accurately and submitted in a timely manner, with particular attention paid to the reporting for mortgage-servicing assets and recourse obligations retained by the mortgage banking company.

Asset Quality

1. Spread past-due and nonaccrual loans by balance-sheet asset category (for example, mortgage loans held for sale, mortgage loans held for investment), product type, and delinquency status (for example, 31–90 days, 91–180 days, and 181 days and over). Include any loans in the process of foreclosure.

2. Obtain a trial balance and delinquency listing for loans held for sale and loans held for investment.

a. Reconcile balances of the real estate held for sale and investment to the respective general ledger accounts.

b. Classify severely delinquent loans as required based on the financial condition of the borrower, his or her inability to make monthly payments as required, and the protection afforded by current collateral values.

c. Determine accounting policies and practices with respect to these loans. Review aging reports for loans held for sale and for investment. Discuss the frequency of reviews for loans held for sale, revaluation practices, and transfers among accounts. Verify that accounting practices are consistent with GAAP and RAP.

3. Obtain a listing of loans in the process of foreclosure and bankruptcy and discuss these with management for potential classification.

4. Reconcile all other real estate owned by the mortgage banking company to the general ledger and classify based on risks and any income-producing characteristics of the properties. Compare current appraisals to carrying value for potential write-downs.

5. Obtain a list of loans sold under recourse arrangements and assess for potential classification.

6. Discuss the methodology used to establish foreclosure reserves and related accounting procedures. Review analysis used to project future foreclosures.

- Evaluate the adequacy of foreclosure reserves based on the volume of projected foreclosure actions, average foreclosure costs, and the past history of reinstated loans.

7. Review other reserve accounts and assess for reasonableness.

Earnings Performance

1. Assess earnings performance in terms of the level, composition, and trend of net income. Consider internal factors, such as the company's business orientation and management's growth plans, and external factors, such as interest rates and the economic environment, when evaluating earnings trends.

2. Discuss any unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, reserves, write-downs or adjustments in MSA amortization, salaries and overhead items, or income taxes with management, as well as with internal or external auditors.

3. Incorporate ratio and industry comparisons into the earnings analysis, where appropriate. Bear in mind that ratios that compare earnings to total assets or equity are of limited use unless the transitory nature of the balance sheet and the impact of off-balance-sheet servicing

activities on the company's use of financial leverage are taken into consideration.

Liquidity and Funding

1. Determine the mortgage banking company's liquidity needs based on a review of the size of its warehouse and the nature and extent of other longer-term assets.

2. Determine whether sources of liquidity are adequate, both under current conditions and economic duress. Consider earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity-planning capabilities.

3. Evaluate financial instruments used to fund mortgage operations. Financial instruments may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and/or long-term debt. Review related credit agreements and systems used to monitor compliance with debt covenants.

4. Establish whether excessive borrowing activities have led to a highly leveraged financial condition that exposes the company to money market changes in the cost of funds. Evaluate the impact a change in the company's cost of funds would have on its net interest margin and earnings.

5. Determine the degree of financial flexibility the company maintains. Financial flexibility is the ability to obtain the cash required to make payments as needed. Does the company possess adequate financial strength and have access to lines of credit and/or assets that can be easily collateralized?

6. Review the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. Determine whether sufficient positive cash flow exists from the level of current transactions. The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity.

7. Review asset/liability management practices to determine whether funding maturities closely approximate the maturities of underlying assets or whether a funding mismatch exists. Is the company exposed to short-term interest-rate fluctuations that may lead to significant earnings volatility in the event that interest rates change rapidly?

Capital Adequacy

1. Determine whether capital levels are adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by investors whose loans are serviced and other external parties.

2. Review policies and procedures to determine whether management adequately monitors and reports capital levels to the board of directors. Review the capital plan to determine whether it adequately addresses the particular needs of the company.

3. Evaluate the amount of dividends that are upstreamed to the parent bank holding company, as well as the extent to which the parent company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. Is the parent company prepared to support its subsidiaries should the financial need arise? Are cash dividends paid by the mortgage banking subsidiary to the parent company reasonable?

Accounting

1. Review accounting procedures for retail loans. Determine whether loan fees in excess of cost are deferred in accordance with SFAS 91. Verify that income is recognized over the estimated life of the asset and not in the current period and that fees and costs are allowable under SFAS 91. Are controls in place to ensure proper recognition for net fee income when loans are sold? (SFAS 91 applies to loans held in portfolio, as well as to loans swapped for securities when the securities are retained.)

2. Determine if the accounting for recognizing sales of loans and mortgage-backed securities (including participation agreements) is in accordance with the three conditions for true sales recognition specified in SFAS 77, ''Reporting for Transfers of Receivables with Recourse.''[10] Also determine if the sales price

10. A transfer is recognized as a sale if—

a. The transferor surrenders control of the future economic benefits of the receivables;

b. The transferor's obligation, under the recourse provisions of the sale agreement, can be reasonably estimated. The transferor should have had past experience with the recourse provisions so that a reasonable estimate can be made. The current transferred receivables should possess characteristics was adjusted for all probable adjustments (as defined in SFAS 5, ''Accounting for Contingencies''). If the mortgage banking company is a subsidiary of a bank, refer to the bank call report, glossary entry on ''sales of assets.''

3. If servicing is retained, determine if a ''normal servicing fee'' is set and how it conforms to FannieMae/FHLMC fees and to FASB Technical Bulletin 87-3, ''Accounting for Mortgage-Servicing Fees and Rights.''[11] If the mortgage banking subsidiary is a subsidiary of a bank, see the reporting instructions for Schedule F of the bank call report (Schedule RC-F for Other Assets, Item 3—Excess residential mortgage-servicing fees receivable).

Overall Financial Condition

1. Evaluate the overall financial condition of the mortgage banking company, considering its asset quality, earnings, liquidity, and capital adequacy. Update the financial component of the supervisory rating and prepare report comments as necessary.

3070.0.6 MORTGAGE-SERVICING ASSETS AND LIABILITIES

This subsection discusses mortgage-servicing assets (MSAs) and liabilities and provides guidance with respect to the measurement, impairment testing, and financial reporting requirements of MSAs. The subsection concludes with a discussion of MSA hedging practices and instruments.

SFAS No. 125 ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' was issued in June 1996 as an amendment to SFAS Nos. 65, 76, 77, and 115. The provisions of SFAS 125 supersede SFAS 122 and are to be applied prospectively in fiscal years beginning after December 31, 1996. The statement requires that a liability be derecognized when either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor.

Under SFAS 125, a mortgage banking company is required to recognize as separate assets or liabilities the right to service mortgage loans for others, however those servicing rights are acquired. Servicing of mortgage loans includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interest in the mortgage loans. Servicing is inherent in all mortgage loans; however, it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

3070.0.6.1 Measurement

A mortgage banking company initially acquires MSAs either by (1) purchasing the right to service mortgage loans separately or (2) purchasing or originating mortgage loans and selling those loans with servicing rights retained. When a mortgage banking company purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related MSAs.

With respect to SFAS 125, when an entity incurs an obligation to service financial assets, it must record servicing assets or a servicing liability for each servicing contract, unless it securitizes the assets and retains all of the resulting securities, classifying them as debt securities that are to be held to maturity. When servicing assets or liabilities are assumed, rather than being acquired by a sale or undertaken in a securitization of the financial assets that are to

similar to previously transferred receivables evidencing the transferor's relevant prior experience.

c. The transferor cannot require the transferee to repurchase the receivables, except as stated in the agreement's recourse provisions.

11. According to FASB Technical Bulletin No. 87-3, the servicing-fee rates set by GNMA, FHLMC, and FannieMae in servicing agreements should be considered a normal servicing-fee rate for transactions with those agencies. If the normal service fees are expected to be less than the estimated servicing costs, the expected loss should be recognized at the time the loans are sold. If a seller/servicer sells mortgage loans directly to private-sector investors and retains servicing on the loans, the seller/servicer should consider the normal servicing-fee rate that would have been specified in comparable servicing agreements if the loans had been sold to or securitized by one of the federally sponsored secondary market makers. As of May 1995, normal servicing-fee rates established by GNMA, FHLMC, and FannieMae were 44, 25, and 37.5 basis points, respectively.

be serviced, they are measured initially at fair value (that is, the price paid). A servicing asset or liability is amortized in proportion to and over the period of estimated net servicing income (loss). Any impairment of a servicing asset or liability is determined based on fair value.

When the mortgage banking company sells or securitizes the loans and retains the MSAs, management shall allocate the total cost of the mortgage loans (the recorded investment in the mortgage loans including net deferred loan fees or costs and any purchase premium or discount) to the MSAs and the loans (without the MSAs) based on their relative fair values if it is practicable to estimate those fair values. If a mortgage banking organization undertakes a servicing liability in a sale or securitization, the servicing liability should initially be measured at fair value.

The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information that is available, including prices for similar assets and the results of valuation techniques used by management. Valuation techniques may include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved; option-pricing models; matrix pricing; option-adjusted spread models; and fundamental analysis. Valuation techniques for measuring MSAs should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates. If it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs), the entire cost of acquiring the mortgage loans shall be allocated to the mortgage loans (without the MSAs) and no cost shall be allocated to the MSAs.

The amount capitalized as MSAs shall be amortized in proportion to and over the period of estimated net servicing income. Estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental-cost basis.

MSAs are highly subject to interest-rate and prepayment-rate risk since the amount of future cash flows that are provided to the holder is derived from, and is thus dependent on, the outstanding balances of the underlying mortgage loans.[12] Prepayments of underlying mortgage loans accelerate during periods of declining interest rates as borrowers take advantage of the option they hold to refinance their loans. As interest rates decline, holders of MSAs are exposed to a risk of prepayment of the underlying loans, and thus a diminished amount of cash flow from their investment. Holders of interest-only stripped securities (I/O strips) are exposed to similar interest-rate and prepayment risks when interest rates decline. I/O strips possess very similar prepayment risk characteristics.

A particular mortgage company's exposure to prepayment risk can also be influenced by portfolio composition factors such as geographical mix, loan-to-value ratios, and the proportion of government (FHA/VA) and conventional loans in the portfolio. Government loans that may be assumable by the purchaser of a home are generally for smaller amounts and may be extended to borrowers with limited financial resources. As a result, government loans tend to prepay more slowly than conventional loans.

Unanticipated changes in interest rates, prepayment speed, or other valuation assumptions may impair the carrying value of MSAs and require accelerated amortization or a write-down. Therefore, the recoverability of the unamortized balance should be evaluated periodically, and amortization and/or the value of the asset should be adjusted accordingly. To the extent that impairment is not recognized, MSA values may be inflated. As a result, assets, earnings, and capital may be overstated.

12. Several conventions exist for quantifying prepayment speed. The most common convention is a measure developed by the Public Securities Association (PSA). The PSA measure was based on actual historical experience of FHA mortgages, but it is not predictive. The PSA measure assumes that mortgages prepay at a rate of .2 percent per year in the first month, increase by .2 percent each subsequent month up to 30 months, and remain at 6 percent per year thereafter until maturity. This 6 percent level is referred to as 100 percent PSA. Mortgages that prepay at 200 percent PSA pay off twice as fast as a mortgage that is performing at 100 percent PSA. Another convention is known as the conditional prepayment rate (CPR) measure. CPR assumes that a constant fraction of the remaining principal is prepaid each period, ''conditional'' on the previous period's remaining balance. Typically, CPR is computed over a one-month time period. The PSA model simply represents a series of stable CPR assumptions.

3070.0.6.2 Impairment Testing

SFAS 125 states that a mortgage banking company shall measure impairment of capitalized MSAs[13] based on their fair value. For the purpose of evaluating and measuring impairment of capitalized MSAs, management should stratify those assets based on one or more of the predominant risk characteristics of the underlying loans.[14] Those characteristics may include loan type, loan size, note rate, date of origination, term, and geographic location.

Impairment shall be recognized through a valuation allowance for an individual stratum. The amount of impairment that is recognized shall be the amount by which the capitalized MSAs for a given stratum exceed their fair value. The fair value of MSAs that have not been capitalized shall not be used in the evaluation of impairment.

Subsequent to the initial measurement of impairment, management shall adjust the valuation allowance to reflect changes in the measurement of impairment. Fair value in excess of the capitalized MSAs shall not be recognized. If the fair value of a mortgage-servicing liability increases above the book value, the increased obligation shall be recognized as a loss in current earnings. SFAS 125 does not address when a mortgage banking company should record a direct write-down of capitalized MSAs; therefore, examiner judgment in this area is required.

3070.0.6.3 Disclosures

SFAS 125 requires that the fair value of capitalized MSAs, and the methods and significant assumptions used to estimate that fair value, be disclosed. If no cost is allocated to certain MSAs, management shall describe those MSAs and describe the reasons why it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs). The risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment shall also be disclosed. For each period for which results of operations are presented, the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances shall be disclosed.

3070.0.6.4 Intercompany MSAs

Intercompany MSAs may arise when a mortgage banking company originates loans, sells the loans to an affiliate bank, and the affiliate bank records related MSAs. Intercompany MSAs should be evaluated closely to determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

3070.0.6.5 Table Funding

One method of acquiring mortgage loans, and recording related MSAs, is through so-called ‘‘table-funding arrangements.’’ In a table-funding arrangement, the mortgage banking company provides the original funding when a mortgage broker or correspondent closes the mortgage loan with the borrower. Concurrent with the loan closing, the mortgage banking company acquires the loan and the related MSAs.

Emerging Issues Task Force Issue No. 92-10 (EITF 92-10), ‘‘Loan Acquisitions Involving Table Funding Arrangements,’’ clarified under what conditions these arrangements could be characterized as loan purchases. According to EITF 92-10, a mortgage banking company may account for a loan acquired in a table-funding arrangement as a purchase only if *all* of the following conditions are met:

- The correspondent is registered and licensed to originate and sell loans under the applicable laws of the states or other jurisdictions in which it conducts business.
- The correspondent originated, processed, and closed the loan in its own name and is the first titled owner of the loan, with the mortgage banking company becoming a holder in due course.

13. The term ‘‘capitalized mortgage-servicing rights’’ refers to the cost originally allocated to the MSAs less the amount amortized.

14. SFAS 65, as amended, applies to impairment evaluations of all capitalized MSAs. However, a mortgage banking company may continue to apply its previous accounting policies for stratifying MSAs to MSAs that were capitalized before the adoption of the amendments to SFAS 65.

- The correspondent is an independent third party and not an affiliate of the mortgage banking company as defined in SFAS 65. As a nonaffiliate, the correspondent must bear all of the costs of its place of business, including the costs of its origination operations.
- The correspondent must sell loans to more than one mortgage banking enterprise and not have an exclusive relationship with the purchaser.
- The correspondent is not directly or indirectly indemnified by the mortgage banking company for market or credit risks on loans originated by the correspondent. However, a commitment by the mortgage banking company for the purchase of loans from the correspondent is not considered to be an indemnification for purposes of this requirement.

If any one of the above criteria is not met, the mortgage banking company must account for the loan as an origination. MSAs that were recorded before the adoption of the SFAS 65 amendments should be reviewed to ensure that they were originated and funded consistent with the above requirements. MSAs that are recorded under SFAS 125 may arise in connection with either originated or purchased mortgage loan transactions.

3070.0.6.6 Regulatory Reporting

The examiner should also determine whether the method used to value MSAs is in accordance with the instructions for the Bank Report of Condition and Income (call report) and the BHC reporting instructions (FR Y-9C). If capitalized MSAs are not appropriately valued, they cannot be included in capital. Management should review the carrying amount at least quarterly, adequately document this review, and adjust the book value as necessary.

3070.0.6.7 Risk-Based Capital

Readily marketable MSAs may be included in a bank or bank holding company's tier 1 capital subject to certain limitations. Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and limited qualifying cumulative perpetual preferred stock.[14a] Tier 1 capital excludes goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, exceed 25 percent of tier 1 capital;[15] all other identifiable intangible assets; and deferred-tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations.

The amount of MSAs which may be included in capital is also limited to the *lesser* of—

- the amount recorded on the balance sheet under GAAP, or
- 90 percent of their fair market value. If both the application of the limit on MSAs and the adjustment of the balance-sheet amount for MSAs would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

3070.0.6.8 Previously Recognized Excess Servicing-Fee Receivables

SFAS No. 125, ‘‘Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities’’ (paragraph 20), addresses the accounting treatment for excess servicing-fee receivables based on contracts that were in existence before January 1, 1997. Previously recognized servicing rights and excess servicing-fee receivables are to be combined, net of any previous servicing obligations under the contract, as a servicing asset or a servicing liability. Any previously recognized excess servicing-fee receivables that exceed contractually specified servicing fees are to be reclassified as interest-only strips receivables.

3070.0.6.9 MSA Hedging Practices and Instruments

During the refinancing waves of 1992 and 1993, several mortgage banking companies experi-

14a. Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.

15. Amounts of MSAs, non-MSAs, and PCCRs in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital requirements in determining tier 1 capital. Identifiable intangible assets, however, exclusive of MSAs and PCCRs, acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes. They will, however, continue to be deducted for applications purposes.

enced large losses due to the impact of rising prepayments on the value of servicing rights. As a result, many companies have begun to hedge MSAs. An effective hedge program should reflect a solid understanding of the underlying MSA risk characteristics.

3070.0.6.9.1 Hedging Practices

Interest-rate and prepayment-rate risk are often reduced through the natural offset between the production and servicing functions; however, the degree of protection afforded by this relationship depends on the company's business orientation (originations versus purchases) and can be very difficult to measure.[16] Other financial instruments are also used to mitigate interest-rate and prepayment-rate risks. The remainder of this subsection discusses existing hedge accounting guidance and rudimentary descriptions of certain customized MSA hedge products. Examiners should also refer to the Federal Reserve System's *Trading Activities Manual* for additional guidance on derivatives.

3070.0.6.9.2 Hedge Accounting

Existing accounting literature is vague with respect to the accounting treatment for MSA hedge products, particularly in the area of derivatives. However, analogies exist that facilitate the application of existing accounting standards. SFAS No. 80, "Accounting for Futures Transactions," provides financial reporting standards for exchange-traded futures contracts on both interest-rate products and raw materials (commodities). Several EITF issues releases provide financial reporting guidance for interest-rate swap transactions. Finally, an issues paper prepared by the American Institute of Certified Public Accountants (AICPA), "Accounting for Options," provides informal but nonauthoritative guidance relating to options contracts. The AICPA issues paper addresses options on all tangible goods, including both exchange-traded options and nonexchange traded options on interest-rate caps and floors.

16. When interest rates fall, increases in production volumes and related revenues tend to offset runoff in the servicing portfolio and reductions in servicing-fee income. Alternatively, to the extent that the marketing department hedges less than 100 percent of its estimated long position (closed loans plus rate-locked loans that are expected to close) and interest rates fall, the resulting marketing gains on the uncovered position tend to offset a portion of any required write-downs in the servicing portfolio.

To qualify for hedge-accounting treatment under SFAS 80, a financial instrument must meet two criteria:

- The hedged item exposes the entity to price or interest-rate risk.
- The financial instrument used as a hedge reduces that exposure and is designated as a hedge.

SFAS 80 states that at the inception of the hedge and throughout the hedge period, changes in the market value of the financial instrument used as a hedge should correlate highly with changes in the fair value of, or interest income or expense associated with, the hedged item(s) so that the results of the financial instrument(s) used as a hedge will substantially offset the effects of price or interest-rate changes on the exposed item(s). Although required correlation levels are not specifically defined, the accounting industry has determined that 80 percent is a reasonable benchmark.

Before claiming hedge-accounting treatment, management must obtain an opinion from its CPA or internal accountant confirming that the instrument that is proposed would qualify for such treatment. If these criteria are not met, the financial instrument should be carried at its market value (i.e., marked to market). Hedge performance should be monitored daily and reported to the responsible management or board committee at least quarterly.

3070.0.6.9.3 Relevant MSA Characteristics

To evaluate a mortgage banking company's hedge program for MSAs, one must first understand how MSAs perform. Duration, convexity, and amortization are useful concepts that will be reviewed as they relate to MSAs. Duration measures the change in the value of MSAs (or their cash flows) for a given change in interest rates. Duration can be either positive or negative. An asset with a positive duration, such as a fixed-income bond, tends to increase in value as interest rates fall. Conversely, an asset with a negative duration, such as an MSA, tends to decrease in value as interest rates fall.

Convexity measures the rate of change in an instrument's duration, or the nonlinearity of its price/yield curve. Like duration, convexity can be either positive or negative. An asset with a positive convexity will rise more in value for a given change in interest rates than it will fall if interest rates move equally in the opposite direction. Conversely, an asset with a negative convexity will decline more in value for a given change in interest rates than it will increase in value if interest rates move equally in the opposite direction. Because of their prepayment characteristics, MSAs and most other mortgage-related assets are negatively convex within a specified range of interest rates. Borrowers can be expected to exercise their option to prepay a loan at a time that is most disadvantageous to the MSA holder.

MSAs are also an amortizing asset. When a prepayment occurs, the loss of value is permanent and cannot be recovered. The use of a nonamortizing asset as a hedge would necessitate an active hedge-management strategy to adjust the position as the unamortized balance of the MSAs declines. If the position is not adjusted correctly, this strategy may expose earnings and capital to additional risks that are not within the scope of the company's MSA hedge program.

3070.0.6.9.4 Hedge Instruments

An effective MSA hedge instrument will possess characteristics that mitigate the interest-rate and prepayment risks associated with MSAs without assuming additional basis risk. Basis risk measures how well changes in the value of the hedge instrument correlate to changes in the value of the MSA. An effective hedge should also be reasonable in terms of transaction costs and management's time.

Several types of specialized derivative products have evolved to meet the needs of mortgage banking companies. Early MSA hedge products were interest-rate-driven, utilizing zero-coupon Treasury bonds or interest-rate swaps. However, the basis risk of such hedges proved to be excessive. Next came principal-only (PO) and super-principal only (SPO) bonds, which were prepayment-driven.[17] However, these products also proved ineffective due to geographic basis risk, potential average-life mismatches, additional capital requirements, and dissimilar accounting treatment which led to accounting losses.

MSA hedge products generally fall into three categories: bond hedges, short-term option hedges, and long-term option hedges. Bond hedges use Treasury bonds, ''plain vanilla'' interest-rate swaps, interest amortizing rate swaps, positive convexity swaps, POs, and SPOs. Bond hedges may be either interest-rate-driven or prepayment-rate-driven. Prepayment-rate-driven products reduce more basis risk and are therefore more expensive. Although most bond hedges are positively convex, they fail to provide enough positive convexity to offset the negative convexity in MSAs. In other words, when interest rates decline, the value of the bond hedge will not increase in an amount sufficient to offset the simultaneous decline in the MSAs. Another disadvantage to bond hedges is that the downside risk is generally unlimited.

Short-term option hedges consist of over-the-counter (OTC) Treasury options, options on futures contracts, and options on OTC mortgage securities. Short-term option hedges generally contain enough positive convexity to offset the negative convexity of MSAs, and the downside risk is limited to the option premium paid at inception. However, option strategies using these products require frequent rebalancing, are therefore expensive, and do not work well in a rapidly changing interest-rate environment because they are not amortizing assets.

Long-term option hedges include prepayment caps, interest amortizing rate (IAR) servicing hedges, LIBOR floors, and swaptions. These products may protect the servicer and/or seller against changes in either interest rates or prepayments. As off-balance-sheet products, they impose very few capital constraints on the MSA holder.

A prepayment cap is an off-balance-sheet, prepayment-driven option product that can be used to hedge a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a payment from the counterparty every month that the option is ''in the money.'' The option is in the money if the difference between the ''strike balance'' and the actual balance of a ''reference portfolio,'' less the sum of previous balance differences, is positive. Each month the option is in the money, the counterparty will pay the ''strike price,'' usually the book cost of the servicing portfolio, multiplied by this balance shortfall. The reference portfolio, strike price, and strike balance can be customized to match the servicer and/or seller's risk parameters and individual portfolio.

17. A special class of REMIC securities backed by POs. SPOs are a more leveraged type of PO.

An IAR servicing hedge is an off-balance-sheet, interest rate–driven option product that can be used as either a revenue or a balance-sheet hedge of a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a series of payments from the counterparty to the extent that amortization of a ‘‘reference balance’’ exceeds scheduled amortization of a ‘‘strike balance.’’ The main difference between an IAR and a prepayment cap is that with an IAR, option payments are based on the performance of a ‘‘reference portfolio’’ rather than the seller and/or servicer’s actual portfolio. For an IAR revenue hedge, the option payout is based on the current balance shortfall between the reference and strike balances. For an IAR balance-sheet hedge, option payouts are based on the cumulative excess amortization of the reference balance over the strike balance. IAR hedges are less expensive than comparable prepayment-linked hedges because they contain basis risk. If actual prepayments occur more rapidly than predicted at the onset of the hedge, the servicer and/or seller will be underhedged.

Numerous other types of customized hedge products are available. The advantages and disadvantages of each product should be well understood before it is incorporated into a mortgage banking company’s interest-rate risk management strategies.

3070.0.6.10 Inspection Objectives

1. To determine whether MSAs pose a significant financial risk to earnings and capital.

2. To evaluate management’s expertise and the oversight provided by the board of directors.

3. To determine whether policies and procedures used to initially record, amortize, and reevaluate MSAs are in conformance with GAAP and risk-based capital requirements, and whether actual practice is consistent with stated policies and procedures.

4. To verify that asset values are fairly stated.

5. To evaluate the methods used to hedge interest-rate and prepayment risks associated with MSAs, the degree of oversight provided by management or the board of directors, the adequacy of written policies and procedures, and the effectiveness of the company’s hedge program for MSAs.

6. To identify any excessive risk-taking which is caused by the company’s business mix and/or strategy.

3070.0.6.11 Inspection Procedures

1. Determine the extent of financial risk associated with MSAs through a review of the following:

a. Significant changes in the size of the servicing portfolio. Obtain a reconciliation for the servicing portfolio for the prior fiscal year and the most recent interim period. If significant growth has occurred, determine whether loans were originated, purchased individually (on a flow basis), purchased in bulk transactions, or acquired through whole company acquisitions. If the portfolio size has declined, determine the reason for such decline (sales of servicing rights, prepayments) and the impact on the remaining servicing portfolio.

b. The proportion of capitalized MSAs relative to the outstanding principal balance of mortgage loans in the servicing portfolio.

c. Other unusual characteristics of the servicing portfolio that may present undue risk, such as the weighted average coupon rates, weighted average maturities, delinquency characteristics, or mix of government (FHA/VA) loans versus conventional loans.

If the level of financial risk is sufficient to place earnings and capital at risk, the examiner should complete the remainder of the MSA procedures.

2. Review the qualifications of the individuals who are responsible for initially recording, amortizing and evaluating MSAs. Does management possess the necessary accounting expertise and experience with respect to valuation methodologies?

3. Review the accounting systems used to track MSAs. Is the necessary information being maintained in an understandable and useable form? Does the adoption of SFAS 65, as amended, and 125 pose any system problems for the company? Are such problems being addressed in a timely manner? At a minimum, MSAs should be tracked by product type and year of origination. The following information should be maintained for each pool of loans: the original and current principal balance for each pool; original and current book values of related MSAs; prepayment speeds, normal servicing fees, and the original discount rate used; and the actual historical payment experience for each pool.

4. Review written policies and procedures for initially recording, amortizing, and periodically revaluating MSAs. Determine the manage-

ment or board committees responsible for approval of such policies, the date of last approval, and the frequency of their review.

5. Determine whether MSA policies and procedures are in conformance with GAAP and risk-based capital requirements and whether actual practice conforms with established policies and procedures. At a minimum, policies and procedures should clearly address the following areas:

a. Initial valuation of MSAs and related pricing policies. With respect to MSAs, policies and procedures should describe the method for allocating the total cost of originated and purchased mortgage loans to the MSAs and the related loans (without the MSAs) based on their relative fair values at the date of origination or purchase; procedures to be followed if a definitive plan for sale of the loans does not exist and loans are sold at a later date; procedures to be followed in the event that it is not practicable to estimate the fair value of the MSAs and the related loans (without MSAs); and MSAs recorded under table funding relationships with correspondents and/or brokers.

b. The method for amortizing MSAs over the estimated lives of the assets, and instances where amortization lives may be adjusted.

c. The method for measuring impairment of capitalized MSAs based on their fair value. Policies and procedures should address the basis for stratification of MSAs based on the risk characteristics of the underlying loans; the types of valuation allowances used to reflect changes in the measurement of impairment; the method used to arrive at the fair value of assets (quoted market prices, estimated prices for similar assets, and the results of valuation techniques); the frequency of revaluation tests; the presentation of valuation test results to senior management and the board of directors; instances where write-downs would be required; disclosures; and the basis for assumptions used.

6. Verify that the valuation techniques for measuring MSAs are consistent with the objective of measuring fair value. Review model output and related manuals and/or marketing materials. Evaluate the reasonableness of all key parameters and assumptions, with an emphasis on the source for prepayment speed estimates, the number of interest-rate ‘‘paths’’ used (vectoring or binomial models being more desirable than a single interest-rate projection path), the basis for the interest rate used to discount cash flows, and the source of servicing revenue and cost data.

7. Review the most recent quarterly valuation process and the related output to determine whether necessary write-downs or amortization adjustments were made, management or board oversight was adequate, and actual practice is consistent with established policies and procedures. Ensure that any significant changes to the model's parameters and/or output are approved by the appropriate management or board committee and that such changes are adequately documented.

8. Verify that disclosures are accurate with respect to the following:

- the fair value of capitalized MSAs
- the methods and significant assumptions used to estimate that fair value
- a description of MSAs for which no cost has been allocated and the reasons why it is not practicable to estimate the fair values of those MSAs and the mortgage loans (without the MSAs)
- the risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment
- the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period; aggregate additions charged and reductions credited to operations; and aggregate direct write-downs charged against the allowances

9. Obtain a list of intercompany MSAs as of the close of business for the most recent quarter-end. Determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

10. Review policies and practices regarding the sale of MSAs and liabilities to investors.

11. If the company sells loans with recourse, are recourse reserves established at the time of sale? Are estimated losses factored into the calculation of gain/loss on sale of loans?

12. Obtain an organizational chart to determine the individuals responsible for hedging MSAs. Review biographies to ensure that staff members responsible for this function are knowledgeable regarding accounting guidance, hedge products, and related strategies.

13. Review methods used to hedge the interest-rate and prepayment-rate risk associated with MSAs. Verify the management or board committee responsible for approving hedge instruments, the list of approved products, and the frequency and date of last review.

14. Review management reports to determine the correlation between hedge instruments and the underlying assets, the accounting treatment for hedges, related gains and losses, and the overall effectiveness of the company's hedge program. If hedge accounting treatment is being used, management and/or the company's external accountants must perform the appropriate level of due diligence and maintain adequate supporting documentation. In determining the effectiveness of the hedging program, the examiner should compare the actual results of hedge performance with the expected results.

15. Evaluate the quality of information that is communicated to senior management, the board of directors (if applicable), and the parent company's senior management and board of directors to determine whether management and directors are adequately informed regarding the financial risks associated with MSAs, amortization methods and hedging techniques, and the degree of risk inherent in the company's strategic focus and business mix with respect to the projected volume of MSAs.

3070.0.7 INTERCOMPANY TRANSACTIONS

A mortgage banking company that is organized as a nonbank subsidiary of a bank holding company often sells assets to, receives funding from, or services loans for its bank affiliates. Given the trend toward managing mortgage banking activities as a line function rather than by legal entity, such intercompany transactions have become an area of heightened supervisory concern.

In general, sections 23A and 23B of the Federal Reserve Act are designed to prevent a bank from being disadvantaged through the purchase of low-quality assets from an affiliate, the pressure to fund the majority of an affiliate's working-capital needs, and intercompany transactions that either inadequately compensate the bank or are not conducted on an arms-length basis.

3070.0.7.1 Section 23A of the Federal Reserve Act

Section 23A was enacted as part of the Banking Act of 1933 (the Glass-Steagall Act) for state member banks and later extended to all federally insured banks.[18] Section 23A defines companies that control or are under common control with the bank as affiliates of the bank. For example, the term ''affiliates'' includes bank holding companies and their subsidiaries as well as banks and nonbanking companies that are under common individual control.[19] The two primary aspects of section 23A—quantitative restrictions and collateral requirements—are discussed next.

3070.0.7.1.1 Quantitative Restrictions

The quantitative restrictions imposed by section 23A generally limit the aggregate amount of so-called ''covered transactions'' to 10 percent of the bank's capital and surplus for transactions with a given affiliate, and 20 percent of the bank's capital and surplus for transactions with all of its affiliates.[20] Covered transactions include—

- a loan or extension of credit by a bank to an affiliate, such as a warehouse line of credit provided to the affiliate;
- the purchase of or investment in securities such as a privately issued MBS issued by an affiliate;
- the purchase of assets from an affiliate, such as a loan purchased either as an accommodation to a bank customer or for the bank's asset/liability management purposes;
- the acceptance by a bank of securities issued by an affiliate as collateral for a loan or extension of credit by the bank to any person or company (Securities might include either the stock of a publicly held affiliate or the stock from one of its officer's own business enterprises.); or

18. As originally enacted, the Banking Act of 1933 covered only member banks. In 1966, Congress amended section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. 1828(j), to extend the coverage of section 23A to include insured nonmember banks. As a result, section 23A now applies to all federally insured banks. (12 U.S.C. 371c)

19. Nonbank subsidiaries of banks, as opposed to nonbank subsidiaries of bank holding companies, are not affiliates for purposes of section 23A, unless the Board of Governors of the Federal Reserve System determines otherwise. Banks that are part of a chain banking organization are subject to the restrictions of section 23A.

20. For section 23A purposes, the definition for capital and surplus includes the allowance for loan and lease losses.

- the issuance by a bank of a guaranty, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate (A letter of credit might be posted by the bank to cover an excessive number of GNMA pools that lack final pool certification.).

The examiner should determine the bank's method for identifying covered transactions and applying the quantitative limits for section 23A purposes. If a covered transaction is found that exceeds these quantitative limits, either on an individual or an aggregate basis, an apparent violation of section 23A has occurred. All such apparent violations of law should be discussed with management and cited in the report.

Particular attention should be paid to intercompany asset transfers and funding arrangements to determine whether they constitute covered transactions under section 23A. In Interpretation 250.250 (12 C.F.R. 250.250)[21] the Board determined that a member bank's purchase, without recourse, and at face value, of a mortgage note, or a participation therein, from a mortgage banking subsidiary of the parent bank holding company, which had no financial interest in the underlying asset on which it had granted credit through the note, did not involve a ''loan'' or ''extension of credit''[22] from the member bank to the seller of the mortgage note within the meaning of section 23A if—

- the member bank's commitment to purchase the loan or participation therein was obtained by the affiliate within the context of a proposed transaction or series of proposed transactions in anticipation of the affiliate's commitment to make such loan(s),
- the commitment to purchase the loan was based on the bank's independent credit evaluation of the creditworthiness of the mortgagor(s),[23] and
- there could be no blanket advance commitment by the member bank to purchase a stipulated amount of loans that bore no reference to specific proposed transactions. Accordingly, the nonbank affiliate must have adequate and independent working capital to fund its operations.

The Board stated that if the bank followed these procedures, then the bank would be taking advantage of an individual investment opportunity and thus should be exempt from section 23A. However, the Board was concerned that the bank should not be allowed to set up a business relationship with any affiliate which could create the opportunity for the bank, at some time in the future, to engage in unsafe transactions because the bank felt impelled by an improper incentive to alleviate the working-capital needs of the affiliate. Accordingly, the bank's transactions with the affiliate should not be of such a volume as to create pressure on the bank to relax its sound credit judgment concerning the individual loans involved and thereby result in an inappropriate risk to the soundness of the bank.

3070.0.7.1.2 Collateral Requirements

In addition to the quantitative restrictions, certain covered transactions between a bank and an affiliate must also be secured at the time of the transaction by collateral having a certain market value. Unless otherwise exempted, covered transactions that must be adequately secured include loans or extensions of credit, guaranties, acceptances, and letters of credit issued on behalf of the affiliate.

Collateralization requirements range from 100 percent to 130 percent depending on the type of collateral used. Acceptable forms of collateral include U.S. government or U.S. government–guaranteed obligations, instruments that are acceptable at the Federal Reserve's discount window, bank deposits that are segregated into accounts specifically earmarked for this purpose, other debt instruments, stock, leases, or other real or personal property. According to an August 31, 1987, Board interpretation (at FRRS 3–1164.3), mortgage-servicing rights do not constitute a permissible form of collateral for purposes of section 23A because of (1) their inherent volatility, making it difficult to accurately value the rights, and (2) the need to secure permission to transfer servicing rights from the legal owner of the underlying mortgage.[24]

21. See also *Federal Reserve Regulatory Service*, 3–1133.
22. Under section 23A, as amended by the Garn–St Germain Act in 1982, a member bank's purchase of a loan from its nonbank affiliate that was made to an unaffiliated party is now considered a purchase of an asset from the affiliate unless it is excepted under interpretation 250.250.
23. Dual employees may not be used to satisfy the independent credit evaluation requirement.
24. Item (2) refers to the bank's ability to sell the mortgage-servicing rights if the affiliate defaults on its loan.

An example of a covered transaction that is subject to both the quantitative restrictions and the collateral requirements of section 23A would be an overdraft in the mortgage company's checking account with an affiliate bank, which is considered an extension of credit. A line of credit by a bank to a nonbank affiliate also constitutes a covered transaction. It is important to remember that the full value of the line, not just the portion drawn down, must satisfy the quantitative and the collateral requirements of section 23A at all times. The examiner should review checking accounts and funding arrangements to ensure that the appropriate level and type of collateral is maintained. Collateral values should be monitored regularly so that depreciated or matured collateral is replaced as needed.

3070.0.7.1.3 Prohibited Transactions

In addition to the quantitative and collateral requirements, section 23A also prohibits certain affiliate transactions altogether. Most importantly, a bank and its subsidiaries may not purchase a low-quality asset (generally a classified or past-due asset) from an affiliate or accept a low-quality asset as collateral for a loan. Section 23A also requires that all covered transactions be conducted on terms that are consistent with safe and sound banking practices.

3070.0.7.1.4 Exemptions from Section 23A of the FRA

As mentioned previously, several types of intercompany transactions are exempted from the requirements of section 23A. For example, transactions between banks in which 80 percent or more of each bank's stock is owned by the same bank holding company (so-called "sister banks") are exempt from most provisions of section 23A.[25] Other transactions that are exempt include the following:

- deposits received from the affiliate during the ordinary course of business (checks in the process of collection)
- immediate credit given to an affiliate for uncollected items received in the ordinary course of business
- loans, extensions of credit, guaranties, acceptances, or letters of credit issued on behalf of the affiliate that are fully secured by obligations issued or guaranteed by the U.S. government or a segregated earmarked account in the bank
- the purchase of assets having a readily and identifiable market price at the time of purchase
- transactions that are deemed to be in the public interest and consistent with the purposes of the act

Internal controls should be in place to ensure that all transactions are adequately reviewed. Documentation should be maintained for intercompany transactions that are exempted from the requirements of section 23A.

3070.0.7.2 Section 23B of the Federal Reserve Act

The Competitive Equality Banking Act of 1987 amended the Federal Reserve Act to add a new provision, known as section 23B. In general, section 23B provides that covered transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If no comparable transactions exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonaffiliated companies. A bank is also generally prohibited from purchasing as a fiduciary securities or assets from an affiliate except under specified circumstances. Finally, a bank and its affiliate may not advertise or enter into an agreement that suggests the bank is in any way responsible for the obligations of the affiliate.

Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A. However, section 23B excludes banks from the term "affiliate." Therefore, transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B.

25. Foreign banks do not qualify as sister banks for section 23A purposes. These transactions are still subject to the prohibition against the purchase of low-quality assets and to the requirement that covered transactions be on terms and conditions that are consistent with safe and sound banking practices. It should also be noted that federal savings banks do qualify for the sister-bank exemption if all banks in the corporate chain have met their fully phased-in capital guidelines, as provided for in the Home Owner's Loan Act.

3070.0.7.3 Management and Service Fees

The Federal Reserve System's 1979 policy statement on diversion of bank income practices is intended to prevent excessive or unjustifiable management or service fees, as well as any other unwarranted payments or practices that, by diverting bank resources to the parent company or a nonbank affiliate, may have an adverse financial impact on a subsidiary (paying) bank (see section 2020.6). Diversion of income practices with respect to a mortgage banking company might potentially include, but are not limited to—

- servicing fees, or other payments assessed by the mortgage banking company and paid by the bank that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the nonbank subsidiary in its role as servicer and/or seller;
- balances maintained by the bank primarily in support of mortgage banking company borrowings without appropriate compensation to the bank;
- prepayment of fees to the mortgage banking company for services not yet rendered;
- nonreimbursed origination fees, marketing costs, or other expenses incurred by the bank that primarily support the mortgage banking company's activities; and
- loan repurchase agreements between the bank and the mortgage banking company while the mortgage banking company is processing loans in the mortgage pipeline.

Purchase and funding agreements should adequately itemize and document the types of services provided and the basis for fees. Billing statements and other documentation should clearly evidence that fees actually charged and paid are reasonable and consistent with regulatory policy requirements as described.

3070.0.7.4 Tie-In Considerations of the BHC Act

Section 106 of the BHC Act Amendments of 1970 contains five restrictions intended to prohibit anticompetitive behavior by banks: two prohibit tying arrangements; two prohibit reciprocity arrangements; and one prohibits exclusive dealing arrangements.[26] The tying restrictions, which have the greatest effect on industry practices, prohibit a bank from restricting the availability or varying the consideration for one product or service (the *tying product*) on the condition that a customer purchase another product or service offered by the bank or by any of its affiliates (the *tied product*).

Section 106 was adopted in 1970 when Congress expanded the authority of the Board to approve proposals by bank holding companies to engage in nonbanking activities. The provisions of section 106 were based on congressional concern that banks' unique role in the economy, in particular their power to extend credit, would allow them to create a competitive advantage for their affiliates in the new, nonbanking markets that they were being allowed to enter.[27] Congress therefore imposed special limitations on tying by banks—restrictions beyond those imposed by the antitrust laws. Section 106 is a broader prohibition; unlike the antitrust laws, a plaintiff in action under section 106 need not show that (1) the seller has market power in the market for the tying product, (2) the tying arrangement has had an anticompetitive effect in the market for the tied product, or (3) the tying arrangement has had a substantial effect on interstate commerce.

Section 106 applies only when a *bank* offers the tying product.[28] The Board has authority to grant exceptions to section 106, which it has used to allow banking organizations to package their products when doing so would benefit the organization and its customers without anticompetitive effects.

3070.0.7.4.1 Section 225.7(d) of Regulation Y

The Board originally extended section 106, which covers tying arrangements by *banks* only, to cover nonbank affiliates and bank holding companies. The Board rescinded this extension of the statute effective April 21, 1997. Thus, unless subject to another exemption, section 106 *prohibits*—

- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from the bank; and

26. 12 U.S.C. 1972.
27. See S. Rep. No. 1084, 91st Cong., 2d Sess. (1970).
28. See 1997 FRB 275.

- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from an affiliate of the bank.

Section 106 and the Board's regulation allow—

- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from an affiliated bank; and
- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from a nonbank affiliate.

These distinctions make sense if one keeps in mind the concern of the statute: banks (*not* nonbanks) have special power over credit and, thus, are able to induce or coerce their customers into purchasing products that they would otherwise prefer not to purchase or to purchase from someone else.[29]

3070.0.7.4.2 Interaffiliate Tying Arrangements Treated the Same as Intrabank Arrangements

Section 106 contains an explicit exception (the *statutory traditional bank product exception*) that permits a bank to tie any product or service to a loan, discount, deposit, or trust service offered by that bank.[30] For example, a bank could condition the use of its messenger service on a customer's maintaining a deposit account at the bank. Although the statutory traditional bank product exception appears to have been effective in preserving traditional relationships between a customer and bank, the exception is limited in an important way—it does not extend to transactions involving products offered by affiliates.

The Board has adopted a *regulatory traditional bank product exception* that extends the statutory exception to transactions involving affiliates.[31] Although the Board has previously limited the scope of this extension, interaffiliate arrangements are now exempt to the same extent as intrabank arrangements.[32]

3070.0.7.4.3 Foreign Transactions Under Section 106

The Board has adopted a "safe harbor" from the anti-tying rules for transactions with corporate customers that are incorporated or otherwise organized and that have their principal place of business outside the United States, or with individuals who are citizens of a foreign country and are not resident in the United States. However, the safe harbor would not protect tying arrangements in which the customer is a U.S.-incorporated division of a foreign company. Furthermore, the safe harbor would not shelter a transaction from other antitrust laws if they were otherwise applicable.[33]

3070.0.7.4.4 Technical Change

The Board also has adopted a definition of "bank" for purposes of the anti-tying rules. The definition clarifies that any exemptions afforded to banks generally also would be applicable to credit card and other limited-purpose institutions and to U.S. branches and agencies of foreign banks.[34]

3070.0.7.5 Inspection Objective

1. To evaluate transactions between a mortgage banking company organized as a direct subsidiary of a bank holding company and affiliated banks for compliance with federal laws and regulations, and related policy guidance.

3070.0.7.6 Inspection Procedures

1. Review management's method for monitoring and identifying section 23A and 23B covered transactions and applying the quantitative limitations. Determine whether—

   a. all covered transactions have been identified;

   b. quantitative limits are calculated correctly;

   c. covered transactions, including any overdrafts and lines of credit, meet both the

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29. The Board's rule also includes a limited prohibition on tying arrangements involving electronic benefit transfer services (12 C.F.R. 225.7(d)).
30. 12 U.S.C. 1972(1)(A).
31. See 12 C.F.R. 225.7(b)(1).
32. A similar action was taken for interaffiliate reciprocity arrangements, in which section 106 permits a bank to condition the availability of a product or service on the customer's providing to the bank some product or service "related to and usually provided in connection with" a loan, discount, deposit, or trust service (12 U.S.C. 1972(1)(C)).
33. See 12 C.F.R. 225.7(b)(3).
34. See 12 C.F.R. 225.7(e).

quantitative limits and collateral requirements of section 23A; and

d. adequate collateral values have been maintained over the life of the covered transactions (For example, collateral is maintained for the full amount of any credit lines with the bank, and any depreciated or matured collateral has been replaced as required.).

2. Review purchase and funding contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine that—

a. asset purchases by the bank are either within the quantitative limits of section 23A or meet the exemption requirements of C.F.R. section 250.250,

b. all purchases are at fair market value and consistent with market terms as required by section 23B,

c. no low-quality assets were transferred to the bank since the previous inspection,

d. the method of compensating the bank for balances maintained and net interest income earned on warehouse loans or lines is reasonable and based on market terms.

3. Review servicing contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine—

a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?);

b. the nature of all services provided; and

c. billing arrangements, the frequency of billing, the method of computation, and the basis for such fees.

4. Review the bank holding company's policy statement on the prohibition of tie-in arrangements, the adequacy of training provided to employees, and whether its respective subsidiaries are in full compliance with internal policy.

3070.0.8 REGULATION Y COMPLIANCE

During the course of the on-site inspection, the examiner is expected to conduct sufficient tests and inquiries to determine whether the company is in compliance with Regulation Y and the act. Such tests and inquiries would include a listing of company offices which can be compared with the approved offices, comparisons of credit-related insurance policies and rate schedules against stipulated public benefits cited in Board orders, and reviews of various activities for technical compliance.

While not specifically detailed in this guidance, the examiner may find it necessary to conduct a review of the company's ledgers and accounts that is sufficient to disclose possible impermissible activities and potential violations of law. The audit function, both internal and external, should not be solely relied on for this disclosure because the auditor's program may emphasize other areas of concern. As a nonbank subsidiary of a bank holding company, reference should be made to part 225 of the Code of Federal Regulations (such as section 225.28(b) of Regulation Y) and other relevant sections thereof.

Concurrent with the review of assets for credit quality, the examiner should undertake a review of asset-related activities for compliance with the subsidiary's approval orders. In mortgage banking firms, it is possible that the company is engaging unknowingly in certain impermissible activities, such as those described by 12 C.F.R. 225.126 (i.e., real estate brokerage, land development, real estate syndication, and property management) and those deemed impermissible by Board order (see sections 3000.0.4 and 3700.0 to 3700.12). The Board of Governors has ruled (1972 FRB 429) that the purchase and development of land for sale to third parties constitutes land development by a nonbank subsidiary. However, the completion of a foreclosed property to facilitate the recovery of funds advanced under the loan appears to be permissible, provided that the additional work brings the project underway at foreclosure up to a saleable condition. The Board has also ruled that property management for third parties is impermissible (1972 FRB 652). However, property management as a fiduciary, for operating premises of affiliates, or for properties acquired for debts previously contracted (DPC) is permissible. In addition to the other impermissible activities, engaging in real estate joint ventures has also been ruled impermissible. If such impermissible activities are found, they represent violations and should be appropriately treated. The servicing agreements should be reviewed to determine that no additional liabilities, real or contingent, are imposed on the company beyond its responsibilities as a servicing agent.

The usual source of growth in the servicing portfolio is the company's own origination activity. However, it is not uncommon for a company to supplement this growth with bulk purchases of serviced mortgages from other companies. Under certain circumstances, usually relating to the relative percentage of the seller's portfolio, these transactions may not comply with 12 C.F.R. 225.132. Since these transactions may represent the effective acquisition of a going concern subject to prior approval by the Federal Reserve System, ''servicing portfolio'' acquisitions should be reviewed for compliance.

Section 225.22(d)(1) of Regulation Y provides an exemption from required Board approval for DPC property acquired in good faith and divested within two years of acquisition. The Board may permit additional extensions that can result in the property being held by a bank holding company for a total of 10 years, if the property has value and marketability characteristics similar to real estate. In conjunction with the review of real estate owned, the examiner should determine if any subsidiary holds title to any property that should have been disposed of within the time limits of Regulation Y, the book value of which has been reduced to zero and the property is not disclosed on the balance sheet. See section 3030.0 ''Acquisition of DPC Shares or Assets," for additional information on DPC property acquired.

3070.0.9 ON-SITE INSPECTION OF MORTGAGE BANKING SUBSIDIARIES

Scheduling of on-site inspections of mortgage banking nonbank subsidiaries of bank holding companies should be done in accordance with the Board policy for frequency and scope of inspections, beginning at section 5000.0.2. After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by nonaccrual and delinquency reports, the level of risk exposure to the organization (see section 4030.2), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected that would require a visit, even though a satisfactory condition had been determined during the previous inspection. Mortgage subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected. All significant mortgage banking subsidiaries should be fully inspected at least once every three years.

3070.0.10 Laws, Regulations, Interpretations, and Orders

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Loans to affiliates section 23A of the FRA	371c			
Restrictions on transactions with affiliates	371c			
Purchase of affiliate's notes from a third party			3–1131	
Activities not closely related to banking		225.126	4–184	
Acquisition of assets		225.132	4–175.1	
Purchase by member bank of loans originated by a mortgage banking firm		250.250	3–1133	
Mortgage companies acquired under sections 4(c)(1) or 4(c)(8) of the act		225.122	4–196	
Activities closely related to banking		225.123	4–176	
Investments in community welfare projects		225.127	4–178	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3070.0.11 APPENDIX A—FIRST DAY LETTER

FEDERAL RESERVE BANK
OF BOSTON

P. O. BOX 2076
BOSTON, MASSACHUSETTS 02106-2076

June 15, 19x9

Mr. John Doe
President
XYZ Mortgage Bank Corporation
Boston, Massachusetts 02107

Dear Mr. Doe:

In conjunction with the inspection of the XYZ Bank Holding Company, we plan to begin an inspection of XYZ Mortgage Bank Corporation on July 15, 19x9. To facilitate this inspection, please provide a copy of or make available the following information relative to your organization's mortgage banking activities. Information should be as of xx/xx/xx and should be delivered to the examiner-in-charge as soon as it is available. Whenever possible, standardized management reports should be provided. Please include the name and telephone extension of the appropriate persons to contact, by department, if additional information is necessary.

Board Oversight and Management

1. Provide a listing of the mortgage banking company's board of directors that includes each individual's name, place of employment, title and position, age, management responsibilities (if any), and the length of time he or she has served on the board.
2. List significant management and board committees and have minutes from these meetings available for examiner review. Provide a copy of standardized reports that are provided before each meeting.
3. Provide an organizational chart that highlights individuals who are responsible for the following functional areas: production, warehousing and funding, marketing, servicing, finance, mortgage-servicing asset (MSA) valuations, internal audit, quality control, loan review, compliance, and legal. Include biographies and salary information.
4. Describe any organizational changes that have taken place at the mortgage banking company since xx/xx/xx, including any mergers, acquisitions, or consolidation of mortgage banking activities. Describe any management changes at or above the senior vice president level and provide details on management's new responsibilities.
5. Provide a copy of standardized management reports that are used to monitor compliance with established policies, operating procedures, and controls within each functional area.
6. Provide a copy of the mortgage banking company's most recent operating budget and its long-term strategic plan. Evaluate how interest-rate movements, competition, and other external factors have affected product mix, staffing levels, and the allocation of capital.
7. Describe the internal control environment and the internal control programs that are in place within the mortgage banking company. Have available for examiner review the following reports that were conducted since xx/xx/xx:
   a. internal and external audits
   b. loan reviews

c. internal control and compliance audits completed by or on behalf of agencies such as HUD, FHA, GNMA, FannieMae, FHLMC, state agencies, and private investors

Also have available management's response to each report and the most recent copy of any management reports that monitor the status of outstanding issues or problems.

8. Provide an organization chart for the *internal audit* department. Indicate the scope and frequency of internal audits for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make internal audit workpapers available for examiner review.
9. Provide an organization chart for the *loan review* department. Indicate the scope and frequency of loan reviews for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make loan review workpapers available for examiner review.
10. Provide details on the nature and scope of the quality control program for loans originated and/or serviced for investors. Include an organization chart for the unit(s) involved in such activities, details on any outsourcing programs used since the previous inspection, copies of quality control reports submitted to senior management, and management responses.
11. Describe the method for ensuring compliance with state and federal laws and regulations. Make available for examiner review the procedures manual, work programs, and workpapers compiled by the person/department responsible for compliance.
12. Describe the insurance coverage in effect for the mortgage banking company and its officers and the date it was last reviewed by the board of directors.
13. Recap all mortgage banking–related legal claims/lawsuits in excess of $1 million. Indicate the nature of any legal reserve that is maintained and the method used to assess reserve adequacy.
14. Describe the system for logging, tracking, and responding to customer complaints. The customer complaint file should be made available for examiner review while on-site.
15. Provide a copy of the disaster recovery plan and describe safeguards in place to protect loan documents and data processing input records.

Production and Correspondent Lending Data

16. Provide detailed organization charts for departments within the company which relate to the production function (i.e., retail originations, wholesale purchases, processing, underwriting, closing, shipping).
17. Provide information on the total number and dollar amount of loans generated by the following sources during the two most recent fiscal years and the interim year-to-date period. For purchased loans, please specify the method of purchase (i.e., bulk versus flow), program name, and amount subject to recourse back to either the seller or the investor):

    a. originated by the mortgage banking company

    b. purchased from affiliates

    c. purchased from nonaffiliated third parties
18. Provide written policies and procedures manuals that describe traditional and nontraditional mortgage products, underwriting standards, closing and funding procedures, exception reporting practices, management and employee compensation methods, and training programs for loan production personnel. State methods used to establish ongoing compliance with written policies and procedures and provide copies of relevant management exception reports.
19. Describe the credit approval process used for in-house originations. Include information on rate commitment options extended to the borrower, the average length of the commitment period,

controls that are in place to monitor fallout caused by processing backlogs, and procedures for expired commitments.

20. Provide details on the correspondent lending program, including a list of approved institutions and copies of the most recent loan-quality reports. Describe the credit review process before purchase and any controls that are in place to protect the mortgage banking company against future losses on loans purchased from affiliates and from correspondents.

21. Determine whether rate-locks are provided to correspondents on best effort production programs. What methods are used to verify reported loan fallout?

22. Provide information on the average income and cost per origination and compare with industry standards. Describe the method of accounting used for origination fees and other related noninterest income and expenses.

23. If the mortgage banking company is a subsidiary of a state member bank or sells loans to a bank affiliate that is subject to Regulation O, furnish a list of extensions of credit to ''an executive officer, director, or principal shareholder'' (as defined in section 215.2 of Regulation O) of—

    a. the state member bank;

    b. a bank holding company of which the state member bank is a subsidiary;

    c. any other subsidiary of that bank holding company;

    d. a company controlled by an insider, as defined by Regulation O; and

    e. a political or campaign committee that benefits or is controlled by an insider as defined by Regulation O.

    For all such extensions of credit, include the amount, date the loan(s) was originated or renewed, interest rate, collateral requirements, total amount of loans outstanding to that individual or company, and date of approval by the board of directors. Also include the aggregate amount of loans outstanding to all such insiders as of the inspection date in relation to the bank's unimpaired capital and unimpaired surplus as defined in Regulation O. (See subsection 2050.0.3.2.)

Marketing and Hedging Data

24. Provide detailed organization charts for departments within the company that relate to the marketing and hedging functions. Describe management's roles and responsibilities with respect to the sale of loans in the secondary market, asset securitization, funding, liquidity risk management, interest-rate risk management, and interaction with the asset/liability management function at the parent company.

25. Provide a copy of written policies and procedures used to hedge interest-rate risk associated with the pipeline and closed-loan warehouse. Describe any parameters and limits that are in place and provide a list of securities dealers with whom management is authorized to conduct business.

26. Provide management reports on pipeline and closed-loan (warehouse) inventory volume, mix, yield, age, and turnover as of the inspection date. Describe the method used to project fallout and any models that are used to determine the sensitivity of the pipeline to interest-rate fluctuations.

27. Indicate the methods used to securitize loans for sale in the secondary market, including the use of third-party guaranties and other forms of credit enhancement. Are securities generally sold or retained on the balance sheet?

28. Provide information on the number and volume of securities that lacked final pool certification as of the inspection date. State whether this volume is in compliance with investor guidelines. If

applicable, indicate whether the requirements for obtaining a letter of credit or other guaranty have been satisfied.

Servicing Data

29. Provide a detailed organization chart for the servicing department.
30. List subservicers and vendors who are employed to perform servicing functions. Briefly describe the nature of the services provided.
31. Indicate whether any contracts with subservicers and/or vendors have been terminated for cause since the prior inspection.
32. Provide the monthly servicing management reports since the prior inspection, including the number of loans serviced, dollar volume, and composition of the servicing portfolio in terms of product mix, average loan size, weighted average coupon rates, weighted average maturities, geographic location, and delinquencies and foreclosures.
33. Provide a list of investors for whom servicing was performed as of the most recent quarter-end. Identify any recourse or repurchase provisions and/or forbearance requirements.
34. State whether any investors have terminated servicing contracts with the mortgage company and/or its affiliates for cause since the prior inspection, or if any are likely to be terminated in the near future.
35. Provide a list of all major bulk purchases and sales of servicing since the prior inspection. Identify the terms of each sale and any resulting gains or losses.
36. Provide a list and aging of all outstanding advances to investors as of the date of inspection.
37. Provide access to the servicing policies and procedures manual. Indicate the frequency with which manuals are updated. How does management ensure that subservicers and vendors comply with these same policies and procedures?
38. Provide a servicing-fee schedule (in basis points) for conventional, government, and nontraditional loans serviced for third parties.
39. Provide copies of management reports used to track portfolio runoff.
40. Provide a loan delinquency report segmented into 30, 60, 90, 120, and 180 foreclosure categories. Indicate the volume and number of loans in each segment by loan type. Also include information on the number and dollar volume of delinquent loans that were purchased out of investor pools.
41. Detail the number and dollar volume of other real estate (ORE) parcels segregated by company-owned and investor-owned. Provide a list of loans in foreclosure for which action has been delayed, if applicable.
42. Provide access to the customers’ complaint file so that examiners can review it while on-site.

Financial Data

43. Provide copies of the Report of Condition and Income and/or Y-series report that was filed by the mortgage banking company for the two previous fiscal years and the most recent interim period.
44. Provide an internally prepared balance sheet and income statement that reconcile with the most recent Report of Condition and Income and/or Federal Reserve Board Y-series report.

45. Provide the latest published financial statements, if applicable, including the annual report, SEC 10K, 10Qs, and any press releases.
46. Provide copies of the accounting policies pertaining to mortgage loans, securities, and other assets held for sale and held for investment. Also provide copies of management reports that monitor compliance with SFAS No. 115 (securities), the current SFAS No. 65 (loans), SFAS No. 125 (mortgage-servicing assets), and internal policies as of the close of business of the most recent quarter.
47. Provide details on all formal and informal funding mechanisms, including but not limited to repurchase agreements, commercial paper programs, and debt issuance facilities. Indicate the counterparties, where applicable; the amount uncommitted; and the amount outstanding under each facility as of the close of the most recent quarter. Provide copies of all formal and informal written agreements.
48. Provide copies of credit agreements for all funding lines from affiliated and nonaffiliated institutions. Describe methods used to monitor the credit quality of all funding sources. The following information should be included:
    a. lending bank (include copies of confirmation letters)
    b. total credit line
    c. amount in use as of the inspection date
    d. amount available for use and by whom
    e. expiration date
    f. compensating balance and/or fee arrangements
    g. purpose
    h. whether the credit lines are contractual obligations of the lenders
    i. reciprocity arrangements, if any
    j. collateral requirements
    k. legal opinions evidencing compliance with sections 23A and 23B of the Federal Reserve Act, as amended
49. Provide copies of any contingency planning documents that outline alternative courses of action should the condition of traditional funding sources deteriorate.
50. Provide a copy of any standardized financial presentations made to the executive management team and to the board of directors.
51. Provide a copy of standardized management reports used to measure and track the quality of originated, purchased, and serviced assets. Include an aging report that identifies loans that are past due 30, 60, 90, 120, and 180 or more days and indicate whether such loans are *held for sale, held for investment,* or *serviced for investors*.
52. Provide a copy of internal policies that apply to loans held for investment. Indicate the date each loan that was on the books as of the most recent quarter-end was transferred to this account, its amortized cost, market value, and any write-downs or adjustments to yield at the date of transfer. Indicate the person responsible for reviewing these loans for collectibility, the frequency of such reviews, and any adjustments or write-downs taken over the past year.
53. Provide detail pertaining to the transfer or sale of assets between the nonbank mortgage banking company and affiliated entities since the last inspection and that supports the FR Y-8 Reports. Also provide related documentation evidencing methods for asset valuation and credit-quality determination.
54. Provide detail on the allowance for loan and lease losses, contra asset valuation allowances, and

other reserve accounts as of xx/xx/xx (fiscal) and xx/xx/xx (interim). For each account in use, provide a copy of the most recent analysis and a description of the applicable loan and other losses provisions reserving methodology.

55. Provide a copy of the company's policy with respect to real estate appraisals.
56. Provide a copy of management reports that are used for liquidity, funding, and asset/liability management. If these activities are coordinated with affiliate bank or parent bank holding company personnel, provide copies of the information that is routinely provided.
57. Indicate the method for assessing capital adequacy at the mortgage company level. Provide a copy of the company's capital and dividend policies, as well as a list of dividends paid to shareholders during the two previous fiscal years and the most recent interim period. Are any changes in the level of dividends planned or anticipated?

Mortgage-Servicing Assets

58. Provide an organization chart highlighting those areas and individuals responsible for the recording, measurement, and impairment testing for originated and purchased mortgage-servicing rights (MSAs).
59. Provide an inventory listing of all MSAs as of the close of business of the most recent quarter.
60. Discuss the various loan-origination and -purchase programs that give rise to MSAs; the method for calculating and communicating the price paid to correspondents and brokers for service release premiums; whether MSAs are recorded on table-funded loans; and the details on any bulk purchases since the previous inspection, including the price paid and yield realized.
61. Discuss the various loan-sale programs that give rise to MSAs, the method for calculating and recording the initial value of MSAs.
62. Provide a copy of detailed written policies and procedures regarding the initial recording, amortization, and periodic revaluation and impairment testing for MSAs. Indicate the management and/or board committee responsible for approving such policies and the date of last approval.
63. Provide detailed information on any valuation models used for MSA revaluations and a copy of the output as of the most recent quarter-end. Indicate whether such revaluations are performed in-house or by an outside vendor and the frequency of such revaluations.
64. Reconcile fair market values of MSAs to their respective book values as of the most recent quarter-end. Provide a copy of management reports and related journal entries used to record amortization adjustments and/or write-downs.
65. Provide copies of worksheets used to calculate the amount of MSAs included in Tier 1 capital for regulatory reporting purposes as of the most recent quarter-end.
66. Furnish copies of any management reports or presentations to the board of directors or a committee thereof regarding the risk characteristics of MSAs, business risk analysis, and methods used to hedge the interest-rate and prepayment-rate risks associated with capitalized MSAs.
67. Provide an organization chart highlighting those areas and individuals responsible for hedging the interest-rate and prepayment-rate risk associated with MSAs.
68. Provide information on any financial instruments used to hedge interest-rate and prepayment-risk associated with MSAs. Include a detailed prospectus on any customized hedge products that are purchased from investment bankers and a statement from either internal or external accountants on whether such instruments qualify for hedge accounting treatment under SFAS No. 80.

69. Provide a copy of management reports that identify the number of contracts or instruments used, their current market value, and the degree of correlation between the hedge instrument and the underlying MSAs being hedged. Such reports should demonstrate the effectiveness of the hedge under varying market conditions.

70. Provide information on the number and dollar volume of servicing rights sold during the most recent fiscal year and interim period.

71. If mortgage-servicing assets are sold, provide information on the number and dollar volume sold during the most recent fiscal year and interim period.

Intercompany Transactions

72. Provide an organizational chart on a legal-entity basis that includes the bank holding company and all directly held bank and nonbank affiliates.

73. If the mortgage banking company is a direct nonbank subsidiary of the bank holding company, describe the method for identifying transactions that constitute ‘‘covered transactions’’ under sections 23A and 23B of the Federal Reserve Act, as well as the method for applying quantitative limits for section 23A and 23B purposes.

74. Provide a current listing of collateral that is maintained for covered transactions. Indicate whether collateral is maintained for the full amount of any credit lines with the bank and whether any depreciated or matured collateral has been replaced since the previous review.

75. Provide copies of any purchase and funding contracts between the mortgage banking company and affiliated bank(s). Please address whether any or all of the following conditions are met and/or provide written support, where applicable:

    a. asset purchases by the bank have been reviewed by management and are either within the quantitative limits of section 23A or meet the exemption requirements of section 250.250

    b. all purchases are at fair market value and consistent with market terms as required by section 23B

    c. no low-quality assets were transferred to a bank affiliate since the previous inspection

    d. the method of compensating bank affiliates for balances maintained by the parent company or its nonbank subsidiaries and the net interest income earned on warehouse loans or lines is reasonable and based on market terms

76. Provide copies of any servicing contracts between the mortgage banking company and affiliate bank(s). If not so stated, indicate the following information:

    a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?)

    b. the nature of all services provided

    c. billing arrangements, the frequency of billing, the method of computation and the basis for such fees

    d. the date of last review and approval by the mortgage banking company’s board of directors

77. Provide a copy of the bank holding company’s policy statement on the prohibition of tie-in arrangements, a description of training that is provided to employees in this area, and an attestation as to whether the nonbank subsidiary is in full compliance with internal policy.

78. If the mortgage banking company charges management or other fees, describe the nature of the

fees, the method of computation for such fees, and the settlement procedures. Include a listing of fees charged for the prior two fiscal years and the most recent interim period.

79. Provide a copy of the bank holding company's intercompany tax allocation policy. Indicate the amount and timing of intercompany tax payments and credits received during the two previous fiscal years and the most recent interim period. If credits are due, please indicate the amount owed to the subsidiary and the date the intercompany receivable originated.

Sincerely yours,

Vice President,
Federal Reserve Bank of Boston

3070.0.12 APPENDIX B—ACCOUNTING LITERATURE

The following is a list of generally accepted accounting principles (GAAP) governing the mortgage banking industry that are in the form of accounting standards and interpretations. Accounting standards may change over time. Current accounting literature should be reviewed with management during each inspection.

Statements of Financial Accounting Standards (SFAS)

SFAS No. 5, ‘‘Accounting for Contingencies’’

SFAS No. 65, ‘‘Accounting for Certain Mortgage Banking Activities,’’ as amended

SFAS No. 77, ‘‘Reporting by Transferors for Transfers of Receivables with Recourse’’

SFAS No. 80, ‘‘Accounting for Futures Transactions’’

SFAS No. 91, ‘‘Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases’’

SFAS No. 115, ‘‘Accounting for Certain Investments in Debt and Equity Securities’’

SFAS No. 125, ‘‘Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities’’

FASB Technical Bulletin

Technical Bulletin No. 87-3, ‘‘Accounting for Mortgage Servicing Fees and Rights’’

Emerging Issues Task Force (EITF)

Issue No. 85-13, ‘‘Sale of Mortgage Service Rights on Mortgages Owned by Others’’

Issue No. 85-26, ‘‘Measurement of Servicing Fee under FASB Statement No. 65—When a Loan Is Sold with Servicing Retained’’

Issue No. 85-28, ‘‘Consolidation Issues Relating to Collateralized Mortgage Obligations’’

Issue No. 86-38, ‘‘Implications of Mortgage Prepayments on Amortization of Servicing Rights’’

Issue No. 86-39, ‘‘Gains from the Sale of Mortgage Loans with Servicing Rights Retained’’

Issue No. 87-25, ‘‘Sale of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement’’

Issue No. 87-34, ‘‘Sale of Mortgage Servicing Rights with a Subservicing Agreement’’

Issue No. 88-11, ‘‘Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold’’

Issue No. 89-4, ‘‘Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate’’

Issue No. 89-5, ‘‘Sale of Mortgage Loan Servicing Rights’’

Issue No. 90-21, ‘‘Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement’’

Issue No. 92-10, ‘‘Loan Acquisitions Involving Table Funding Arrangements’’

3070.0.13 APPENDIX C—REGULATORY GUIDANCE

The following is a list of sections in this manual that examiners may find particularly useful in the review of mortgage banking activities. Regulatory guidance also evolves over time. This list is not all inclusive.

2010.0.1	Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks
2020.0–.7	Intercompany Transactions
2050.0	Extensions of Credit to BHC Officials
2060.0–.6	Management Information Systems
2065.2	Determining an Adequate Level for the Allowance for Loan and Lease Losses
2080.05	Bank Holding Company Funding and Liquidity
2080.0–.3	BHC Funding Practices
2125.0	Trading Activities of Banking Organizations
2126.0	Nontrading Activities of Banking Organizations
2126.1	Investment Securities and End-User Derivatives Activities
2128.02	Asset Securitization
2130.0	Futures, Forward, and Option Contracts
2150.0	Repurchase Transactions
3070.0	Section 4(c)(8)—Mortgage Banking
3080.0	Section 4(c)(8)—Servicing Loans
4000 sections	Financial Analysis
4030.0.2	Nonbanks (Analysis of Financial Condition and Risk Assessment)
4070.0	BHC Rating System

3073.0.1 EXPANDED STUDENT-LOAN-SERVICING ACTIVITIES

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of Regulation Y to expand the student-loan-servicing activities of its nonbank subsidiary. The activities would consist of—

1. providing student-loan authorities (the authority) with regular reports that include information in the aggregate and by individual lenders concerning the volume of loans being serviced for the authority and the volume of loans outstanding;
2. preparing projections for approval by the authority of student loans to be purchased and commitments to be issued in the future, based on the volume of loans being serviced and commitments outstanding, consistent with the amount of funds available to the authority as the result of its sale of bonds;
3. advising eligible lenders, borrowers, and other interested parties of the authority's student-loan-purchase program, including the criteria used by the authority in purchasing student loans and the extent to which the authority will be purchasing loans in the future based on the availability of funds; and
4. meeting regularly with the authority to advise it of the nonbank subsidiary's efforts in connection with the student-loan activities.

Under no circumstances would the nonbank subsidiary be authorized to bind the authority or its bank trustee to commit to purchase or actually to purchase student loans from eligible lenders.

The proposed activities were regarded as being equivalent to the activities of a mortgage banking subsidiary of a bank holding company, authorized under section 225.28(b)(1) of Regulation Y, with respect to acquiring and servicing mortgage loans for institutional investors or in connection with the secondary-mortgage market. The activities proposed and currently conducted by the applicant, to the extent that they were different from the services performed by any institution that services loans for others, were perceived as being different only in that they related to servicing student loans for a governmental authority. Banks and their nonbank subsidiaries generally provide comprehensive loan-acquisition and -servicing "packages" for investors in mortgage and other loans. The bank holding company's nonbank subsidiary was the nation's largest servicer of student loans, and was thus particularly well equipped to perform the proposed expanded services.

In addition to determining that the proposed activities were closely related to banking to approve the application, the Board had to conclude that the proposed activities would produce benefits to the public that would outweigh any possible adverse effects, such as unsound banking practices, unfair competition, conflicts of interests, or undue concentration of resources. The Board made that conclusion in addition to determining that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act was favorable. Accordingly, the application was approved on July 1, 1985 (1985 FRB 725).

Section 4(c)(8) of the BHC Act (Servicing Loans) Section 3080.0

A bank holding company or its subsidiary may engage in the activity of servicing loans or other extensions of credit for either affiliated companies or for persons or institutions not affiliated with the holding company. The service will often be carried on as an additional activity of a credit-extending subsidiary, such as a mortgage company, where the loan serviced was originated by the subsidiary and subsequently sold to an investor. A servicing company provides the collection vehicle through receipt and disbursement of funds for investors who may not possess the resources to accomplish the activity. The purpose of servicing is to keep a sound loan in good standing for a passive investor. The servicing company's remuneration is usually based upon a percentage of the outstanding balance of the loan.

The traditional servicing arrangement arises from the normal business of a mortgage company. The company grants extensions of credit to qualified borrowers and subsequently packages and sells these loans, normally without recourse, to individuals or institutional investors who contract the collection of the credit to the mortgage company. The company may also purchase mortgages or other extensions of credit in the open market with the intention of reselling the credit and retaining the servicing or can simply purchase servicing portfolios (12 C.F.R. 225.132). The collection itself is basically a bookkeeping function.

Servicing loans for others is relatively risk-free to the company when the credits are sold without recourse to investors. A credit which has been sold with recourse represents an unusual circumstance and should, therefore, be reviewed in detail. The serviced loans will generally be high quality mortgages which are in turn purchased from the company by passive investors desiring a fixed rate of return on their funds. The risk to a servicing company lies in its portfolio of unsold loans, or its "warehouse." The risk is two-fold: (1) the loan may not be of high enough quality to attract an investor so that the servicing company will have to continue to carry the credit for its own account, and (2) the loan was made at an interest rate which is below current market rates. In the latter case, the servicing company must either sell the loan at a discount or continue to hold the credit for its own account. In either case, the loan is treated as an asset of the company and involves credit risk.

The inspection of a servicing company, or a servicing department of a credit-extending subsidiary, should focus on adequacy of documentation and controls, and on the quality and marketability of the warehoused loans. The examiner should obtain a past due report for the portfolio and note in the inspection report significant credits which are past due together with the period of delinquency, the type of loan, and the asset classification, if any. The nature of the servicing business is such that the number of past dues should be small because loans are only warehoused for a short period of time until they can be sold to an investor. As a rule, a past due loan or a current loan which has been warehoused for more than several months is indicative of some problem with the credit. Each loan should be evaluated to determine the reason it has not been sold.

During periods of rising long-term interest rates, the warehouse portfolio becomes subject to the risk that a loan may not be marketable, except at a discount, because of its relatively low yield. This affects both the servicer's income and liquidity.

In the case of the parent company acting as a servicer, the inspection should also determine whether the activity is being carried on under the proper exemption. A bank holding company may act as a servicer under section 4(c)(8) of the Act or under the provisions of sections 4(a)(2) and/or 4(c)(1) of the Act. If carried on under Section 4(a)(2) of the BHC Act, the holding company is limited to servicing loans only for its own account or its banking and nonbanking subsidiaries. If carried under Section 4(c)(1)(C) of the BHC Act, the bank holding company is limited to servicing loans only for its own account or its banking subsidiaries.

Finally, the income of the company should be subject to scrutiny. A servicing company should be a profitable business. The servicer receives a fee based upon a percentage of the outstanding balance of the loan. In the early years of the payback period, the fee should significantly exceed the cost of the service, and because much of the portfolio will be refinanced either prior to its maturity or prepaid, the fee income should be sufficient to cover the servicer's cost plus profit. The reason for poor earnings in this activity is generally either inefficiency in the collection area, failure to attain the breakeven point of servicing volume, or the inability to turnover the warehouse portfolio often enough to maintain new fee generation. In the event that the servicer is unprofitable, the examiner should determine the reasons and clearly set them forth in the inspection report.

The servicing arrangement is of a fiduciary nature and as such it gives rise to certain contingent liabilities. In the situation where the servicer is not fully and properly discharging its servicing responsibilities in accordance with the servicing agreement, the holder of the serviced notes might bring legal claims against the servicer. The inspection process should direct attention to this area including a review of the servicing agreement and verification that the servicer is fulfilling its obligations. Management should be reminded of the significant loss exposure which can result from improper attention to its fiduciary responsibilities.

3080.0.1 INSPECTION OBJECTIVES

1. To determine that internal controls are adequate to administer effectively the servicing of the loan portfolio.

2. To determine the level of exposure to credit risk of loans held for the firm's own account.

3. To determine if the firm's earnings are sufficient so as not to be a burden on the parent or subsidiary bank.

3080.0.2 INSPECTION PROCEDURES

1. Review the balance sheet to determine the volume of credits held for the firm's own account and evaluate their asset quality.

2. Review internal controls and evaluate their adequacy.

3. Review earnings and appraise the impact on the parent and bank subsidiaries.

4. Review servicing agreements and evaluate the potential or contingent risks to which the firm is exposed in the event of failure by a borrower to service its loan properly.

5. Determine whether mortgage servicing rights are recorded as an asset and whether they are being amortized over the average life of the loans being serviced.

A bank holding company may engage under contract with a third party in the management, servicing, and collection[1] of the types of assets that an insured depository institution may originate and own. The company cannot engage in real property management or real estate brokerage services as part of these services. See Regulation Y, section 225.28(b)(2)(vi). Provided below are some initial historical examples of Board orders that involve asset-management services related to this nonbanking activity. The commitments and conditions provided for within the Board orders should not be considered to be currently applicable.

3084.0.1 ASSET-MANAGEMENT SERVICES TO CERTAIN GOVERNMENTAL AGENCIES AND UNAFFILIATED FINANCIAL INSTITUTIONS WITH TROUBLED ASSETS

Three bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in providing asset-management services to the Resolution Trust Corporation and the Federal Deposit Insurance Corporation, and generally to unaffiliated financial institutions with troubled assets. The applicants committed to conduct these activities under the same terms and conditions as set out in 1988 FRB 771.

The commitments and conditions of this order required that (1) the asset-management activities would be provided to the banks and savings associations, (2) the applicant would obtain the Board's approval before providing asset-management services for pools of assets that were not originated or held by financial institutions and their affiliates, (3) the applicant would cause its asset-management subsidiary to establish procedures to preserve the confidentiality of information obtained in the course of providing asset-management services, and (4) neither the applicant nor its management subsidiary would take title to the assets managed by the asset-management subsidiary.

The applications of these holding companies were approved by a Board order on December 24, 1990 (1991 FRB 124). Two additional orders about providing asset-management services were approved on March 25, 1991 (1991 FRB 331 and 334).

3084.0.2 ASSET-MANAGEMENT SERVICES FOR ASSETS ORIGINATED BY NONFINANCIAL INSTITUTIONS

Two bank holding companies (the applicants) applied jointly for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in collection-agency activities pursuant to Regulation Y through a joint venture. The Board concluded that the collection activities were permissible.

The bank holding companies also applied for the Board's approval to engage in asset-management, asset-servicing, and collection activities through a nonbank of the joint venture located in New Jersey. The subsidiary would provide asset-management services to the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). It would also provide these services to unaffiliated third-party investors that purchase pools of assets assembled by the RTC or the FDIC. Under the proposal, neither the applicants nor this nonbank subsidiary would acquire an ownership interest in the assets that they manage or in the institutions for which they provide the asset-management services. The applicants further committed that they would not provide real property management or real estate brokerage services as part of the proposed activities.

The Board previously determined that, within certain parameters, providing asset-management services for assets originated by financial institutions (banks, savings associations, and credit unions) and their bank holding company affiliates is an activity closely related to banking (see 1991 FRB 331, 334 and section 3600.15.3). The applicants proposed to conduct all asset-management activities subject to the same conditions as in the Board orders previously cited.

The applicants proposed to engage in asset-management activities for assets originated by nonfinancial institutions as well as by financial institutions. These assets include real estate, consumer, and other loans; equipment leases; and extensions of credit. Assets of nonfinancial institutions include pension funds, leasing com-

1. Asset-management services include acting as agent in the liquidation or sale of loans and collateral for loans, including real estate and other assets acquired through foreclosure or in satisfaction of debts previously contracted.

panies, finance companies, and investment companies formed to engage in asset-management activities. The managed assets would be limited to the types of assets that financial institutions have the authority to originate. The Board concluded that the applicants would have the expertise to engage in managing these types of assets, regardless of the originating entity. The Board also determined that the proposal was consistent with the asset-management proposals approved in its prior orders. The Board concluded that the applicants' proposed activities are closely related to banking and approved the order on December 21, 1992. (1993 FRB 131)