

# Mortgage Banking

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
<b>MANAGEMENT AND CONTROL</b>	
The board maintains adequate policies, procedures, and internal controls for mortgage banking activities.	The lack of adequate policies and procedures increases credit, liquidity, market, and other risks.  Weak control guidelines increase the chance of poor credit decisions and unauthorized extensions of credit, as well as interest rate and price risk.
The board and management maintain and communicate a corporate culture that promotes safe, sound, and prudent practices.  Compensation programs strike a reasonable balance between generating business and ensuring quality standards are maintained.	Failure to communicate acceptable standards and behaviors may encourage impermissible or high-risk activities.  The desire to earn compensation may compromise credit quality decisions.
The board incorporates the mortgage banking operations into its strategic plan and budgeting process.	Improper planning results in the mortgage banking department reacting to external events and market forces rather than planning for expected variances.
Management effectively oversees mortgage banking activities.	Poor management oversight may lead to excessive errors, fraud, violations, and incorrectly reported financial information. These events could impair the bank's image, ability to access funding sources, and ability to originate and sell mortgages in the secondary market.
The mortgage banking area is adequately staffed.  Personnel are knowledgeable and competent for the size and nature of the mortgage banking activities.	Lack of competent management and adequate staff could result in problems with service or product delivery.  Unqualified personnel may not recognize or address changes in market conditions.
Board or management committee provides adequate oversight of interest rate risk.	Interest rate risk could negatively impact earnings, capital, and the marketability of the portfolio.
Management identifies and analyzes relevant credit and economic risks.  Management assesses the financial capacity of counterparties (brokers, dealers, correspondent lenders, private mortgage insurers, vendors, or subservicers).	Failure to identify credit and economic risks may lead to increased asset quality problems, liquidity pressures, and elevated interest rate risk.  Serviced portfolios concentrated in areas experiencing economic downturns may lead to decreased servicing revenue.  Counterparties that have financial difficulties may not be able to remit payments owed to the bank.

Standards	Associated Risks
PERFORMANCE	
Management adheres to established policies, procedures, laws, and regulations.	Excessive errors can occur, fraud and other violations of law may go undetected, and financial information may be reported incorrectly.
<p>Hedging strategies are effective.</p> <p>The bank achieves sufficient economies of scale to sustain solid profits.</p>	<p>The bank may be exposed to significant interest rate risk.</p> <p>Interest rate volatility can cause large fluctuations in warehouse funding costs and gains and losses on sales of assets.</p> <p>Profits may be minimal or non-existent without a sufficient volume of sales and servicing.</p>
Management maintains adequate liquidity levels.	Inability to meet obligations may impair earnings and possibly damage the bank's reputation in the secondary market.
Asset quality is acceptable and delinquencies are at reasonable levels	<p>The bank may not be able to sell loans or servicing rights at prevailing market rates if credit quality deteriorates.</p> <p>Poor credit quality can result in cancellations of contracts with secondary market agencies.</p> <p>Poor credit quality increases the cost of servicing the loan, particularly if servicing agreements require the servicer to undertake costly collection efforts on behalf of investors.</p>

## Mortgage Banking

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

**The following information can be reviewed as part of normal preplanning activities. Examiners should prepare and submit a separate request letter to the appropriate department manager. The request list should be tailored to request only those items relevant to the specific bank. Examiners should review prior examination workpapers to help decide what to include in the request list. Refer to the Federal Reserve Board's manual on mortgage banking activities or the OTS Secondary Market Activities Regulatory Handbook for detailed discussions regarding mortgage banking activities.**

- 1 Review the following documents:
  - 1 A Previous examination reports and related workpapers on mortgage banking.
  - 1 B Internal and external auditors' reports, government sponsored agencies' reports, and significant private investors' reports, if available.
  - 1 C Internal memoranda and management reports on the mortgage banking unit since the previous examination.
  - 1 D Briefly review information about the department's financial performance to gain a basic understanding of assets, liabilities, and profitability. Detailed financial analysis is outlined later in this module.
- 2 Review the types of products offered and targeted markets.
  - 2 A Assess whether or not there is an over-reliance on one product type or a concentration in one or two geographical areas.
  - 2 B Determine if there are any material changes in types of products, underwriting criteria, production and servicing volumes, and market focus.

### BOARD AND MANAGEMENT OVERSIGHT

- 3 Review bank policies and procedures regarding mortgage banking activities. Listed below are broad policy requirements that should be addressed for all areas. More specific policy requirements are listed under related subject headings.
  - 3 A Defined permissible mortgage banking activities.
  - 3 B Individual officer and employee responsibilities.
  - 3 C Lending limits.
  - 3 D Segregation of duties.
- 4 Determine if bank policies, procedures, and strategies of other functional areas (liquidity, funds management, etc.) consider mortgage banking activities. (Coordinate with examiners reviewing those areas.)

- 5 Determine if management adheres to policy guidelines.
- 6 Review the process for granting exceptions to policy guidelines.
- 7 Assess the quality of board reporting by reviewing a sample of board reports or packets.
  - 7 A Board reports should include or convey the following information in sufficient detail given the size and complexity of the department:
    - 7 A1 1. Operating results (profitability, efficiency, and cost information).
    2. Asset quality trends (delinquencies, charge-offs, foreclosures, collection accounts).
    3. Production volume.
    4. Inventory agings (how long loans are in the warehouse or their turnover rate).
    5. Mark-to-market analyses.
    6. Liquidity and capital needs.
    7. Industry and peer group performance statistics.
    8. Policy and operating procedure exception reports.
    9. Processing backlogs.
    10. Market values of servicing rights (including related assumptions).
    11. Internal and external audits assessing the effectiveness of control procedures.
    12. Hedging activities (products, results, and strategies).
- 8 Determine if a separate board committee for mortgage banking activities exists, and review committee minutes, if applicable, for significant information.
- 9 Determine if the experience, technical knowledge, and administrative capabilities of management are sufficient for mortgage banking operations. This assessment can be accomplished through the following activities:
  - 9 A Reviewing compliance with governing policies.
  - 9 B Reviewing performance indicators (backlogs, delinquencies, costs, profitability).
  - 9 C Assessing operating management's performance with regards to the procedures outlined in this document.
- 10 Review the mortgage banking strategic plan and planning process. (Smaller community banks may not have a formalized plan, or mortgage banking strategies may be incorporated into the bank's overall strategic plan.)
  - 10 A Determine if goals are reasonable, attainable, and complement the bank's overall business plan.
  - 10 B Determine if management considers external influences when establishing objectives and methods to achieve these objectives.
  - 10 C Determine if the bank has the infrastructure, such as sufficient personnel, data processing, expertise, and financial capacity to meet stated objectives.
- 11 Determine if management depth and succession plans are adequate to ensure continued profitability and viability of mortgage banking activities.
- 12 Review management information systems (MIS) as it relates to mortgage banking operations. (MIS can also be reviewed in conjunction with the reviews of other activities discussed in this module.)

12 A Assess whether the system has the capacity to handle existing volume and activities, as well as projected strategies and objectives.

12 B In conjunction with reviewing the board reports, determine if the MIS is capable of producing all necessary reports. The reports should accomplish the following goals:

- 12 B1 1. Identify closed loans as either held-to-maturity or held-for-sale (accounted for at LOCOM).
2. Segregate loans by product type (30-year fixed, FHA loans, 15-year conventional, etc.), identifying the dollar amount and percentage of total loans for each type.
3. Monitor the volume of loan applications throughout the origination process (applications accepted, outstanding commitments, historical fallout rates for each loan category, etc.).
4. Monitor the status of delivery commitments to investors and the effectiveness of hedges.
5. Reflect the department's daily position, including pipeline commitments, warehouse inventory, and forward sales contracts.

## AUDIT

### Internal Audit

13 Assess the effectiveness of the bank's internal audit program for identifying and controlling risk in the mortgage banking department. Determine if the audit function has the following characteristics:

13 A Independent.

13 B Allows for reporting.

13 C Sufficient in scope to cover all relevant risks.

13 D Frequent enough to ensure all high-risk areas are reviewed on a regular basis.

14 Determine if the internal audit program covers compliance with state and Federal laws and financial reporting requirements (including proper accounting techniques).

### External Audit

15 Review the most recent engagement letter to determine if mortgage banking activities are included in the audit scope.

16 Review the most recent external audit report, management letter findings, and management's response to criticisms and recommendations.

### Quality Control

17 Determine if management establishes and implements an effective quality control program. A good quality control program should ensure that all loans are originated, processed, underwritten, closed, and serviced according to the lender's and investor's standards. (Note: HUD, FHLMC, FNMA, GNMA, and most private investors require the bank to have a quality control unit that independently assesses the quality of loans originated or purchased.)

17 A Determine if the quality control program meets investor(s) guidelines. (Note: Certain investors require 10% of closed loans to be reviewed, and this review should be conducted within 90 days of closing.)

17 B Determine if the quality control program covers retail and wholesale loan production.

18 Determine if quality control findings are clearly documented and presented to the board and senior management.

19 Determine if the quality control function is independent from the production process.

## **Fraud Detection and Training**

20 Determine if procedures exist to detect and investigate suspected fraudulent activity and to issue related management reports.

20 A Evaluate the department's early warning system for detecting potential fraud.

20 B Determine if originators, processors, underwriters, and collectors are adequately trained to identify potentially fraudulent schemes and inconsistencies on borrowers and collateral.

## **PRODUCTION**

### **General**

21 Review the guidelines for the loan production area. The guidelines should address the following areas:

21 A Types of loans that will be originated or purchased.

21 B Sources from which the loans will be acquired.

21 C Underwriting standards (usually comply with secondary market guidelines).

22 Review organization charts to determine the structure of the production function. (Note: Functional units such as underwriting and quality control should be independently managed.)

23 Determine the level of and reasons for nonconforming or unsaleable loans. The following conditions should exist:

23 A These loans do not present undue risk.

23 B Management is monitoring the quality and delinquency trends of these loans.

## **Origination and Underwriting**

24 Determine the methods used to compensate originators and if originators can alter established pricing parameters. (Originators may be overly influenced by compensation without paying sufficient attention to credit quality.)

25 Review the qualifications and experience levels of underwriters.

26 Determine if originators notify management of withdrawn mortgage applications. (Notification is necessary for proper hedging strategies.)

- 27 Evaluate how management plans for peak volume (funding) periods.
- 28 Determine how management monitors originators' adherence to underwriting guidelines.
- 29 If underwriting is done in-house, determine if management establishes approval limits, develops exception procedures for loans that are rejected or suspended, and receives reports tracking loan quality for each underwriter.

## Closing

- 30 Evaluate procedures for closing loans. Determine if management requires that necessary documents are obtained before funds are released.
- 31 Evaluate management's controls over the loan funding process.
- 32 Determine the number of pools that lack final pool certification, the reasons why, and if the mortgage banking group is required to post a letter of credit.

## Wholesale Activities

- 33 Determine the types and dollar volume of loans purchased from each wholesale source. Investigate any purchases from sources not on the approved list.
- 34 Determine management's process for evaluating and monitoring the quality of loans purchased from wholesalers. The process should consider the following issues:
  - 34 A Historical default and foreclosure levels.
  - 34 B Nondelivery history.
  - 34 C HUD/FNMA/FHLMC investor status (when applicable).
  - 34 D Documentation deficiencies.
  - 34 E Financial statements.
- 35 Review how frequently the bank puts back loans purchased from wholesale sources.

## PIPELINE, WAREHOUSE, AND HEDGING

### General

- 36 Review written policies and procedures for pipeline, warehouse, and hedging activities. These policies should define the following criteria:
  - 36 A Position and earnings-at-risk limits.
  - 36 B Lower of Cost or Market valuations.
  - 36 C Permissible hedging activities.
  - 36 D Individuals authorized to engage in hedging activities.
- 37 Evaluate the effectiveness of limits, approval requirements, MIS reports, and pipeline or warehouse hedging strategies to identify, monitor, measure, and control risks.

38 Determine if appropriate separation of duties exist in the production process (originating, closing and funding, and post closing).

## Pipeline Management

*The pipeline represents applications approved, but not yet funded. There are typically two types of loans in the pipeline; rate-locked and floating-rate. The key to effective hedging of pipeline loans is predicting fallout rates of rate-locked loans (the rate at which approved, rate-locked loans will not be funded).*

39 Review pipeline reconciliation reports (should be prepared at least monthly).

40 Review the timeliness and accuracy of pipeline commitment reporting.

40A Determine if commitments are specifically identified by product type and interest rate.

40B Determine if rate-locked commitments and floating-rate commitments are separately identified and tracked. Determine the process if a rate lock expires.

40C Review management's process for expired rate lock commitments.

41 Determine if pipeline commitments are accurately disclosed on financial reports and Reports of Condition (schedule RC-L).

42 Review management's procedures for monitoring and projecting (including assumptions) fallout rates and how these rates correspond to hedging practices. (For example, if a bank anticipates 30 percent of the committed applications will not close (fallout rate), then hedging practices should be structured accordingly. Many banks use simulation models to predict fallout rates, which depend on the interest rate environment.)

43 Review the effectiveness of hedging strategies, such as forward sales or options, used to hedge risks associated with rate-locked commitments in the pipeline. (Note: Some banks may not hedge interest rate risk associated with rate-locked loans.)

## Warehouse Management

*Warehouse loans are funded loans waiting to be delivered to the secondary market.*

44 Review internal warehouse reconciliation reports (should be prepared at least monthly). Determine if warehouse loans are accurately reflected on the general ledger and in financial reports.

45 Review warehouse turnover and aging reports.

45A Research any unusual characteristics that indicate impaired marketability, such as delinquent loans or loans in the warehouse beyond normal time frames. (Note: Loans held for sale are typically newly originated credits and held in the warehouse for a short period of time; therefore, delinquencies and protracted holding periods are not normal.)

45B Review management's methods for handling warehouse loans that are ineligible for sale. (Note: If a significant volume of ineligible loans are being placed in the bank's held for investment loan portfolio, advise examiners conducting loan review.)

46 Determine if the ALLL incorporates credit risk in mortgages held for sale, including loans in the warehouse portfolios.

47 Review the effectiveness of hedging strategies used to offset the risk inherent in funded, but unsold loans. Review any assumptions used in simulation models, if applicable.

48 Determine if warehouse loans are reported correctly on the Report of Condition (schedule RC-C).

## Hedging Practices

*Most of the procedures for determining the effectiveness of hedging practices are detailed under pipeline and warehouse management, information systems, and other areas. The following procedures represent overall practices that examiners should evaluate. Coordinate with examiner(s) performing interest rate risk review.*

49 Discuss with management the degree of interest rate risk the bank is willing to accept and strategies for achieving and maintaining desired goals. (For example, depending on the current and forecasted interest rate environment and projected fallout rates, management may either over- or under-hedge pipeline and warehouse loans.)

50 Assess management's strategies for hedging loans with various characteristics, such as, ARMs or loans with interest rate caps and floors.

51 Determine if management adequately assesses counterparty risk and establishes appropriate limits.

52 Review recent profit or loss reports for the mortgage banking operation and evaluate the effectiveness of hedging strategies.

53 Determine if hedging instruments are accurately disclosed in financial reports and Reports of Condition (schedule RC-L).

## SECONDARY MARKETING

### Selling Mortgages

54 Review the marketing programs used to sell mortgages to investors. Review and assess the volume of sales under these programs.

55 Review a sample of larger investor master sales commitments and determine the amount, maturity, and terms of the commitment.

56 Determine if the bank has been able to meet mandatory sales commitments. If unable to meet commitments, proceed to the hedging activities review in the Expanded Analysis section of this module.

### Recourse Transactions

57 Review a sample of sales contracts to determine if the bank has any continuing recourse to the purchaser beyond normal representations and warranties. If the bank is selling loans with recourse, determine if the following controls exist:

57A The bank has adequate management information systems to track all recourse obligations.

57B Reserve levels are adequate for loans sold with recourse. (Refer to SFAS 125.)

57C Management properly accounts for all loans sold with recourse in Reports of Condition.

## **MORTGAGE SERVICING**

### **Portfolio Supervision**

- 58 Review the written policies and procedures for mortgage loan servicing. Determine if they adequately cover all facets of the servicing operations.
- 59 Review a sample of investor account reconcilements. Determine if the following controls are in place:
- 59A Each investor account is reconciled at least monthly.
  - 59B Outstanding items are resolved in a timely manner, and management regularly charges off stale, unreconciled items.
  - 59C A supervisor reviews and approves the reconcilements.
- 60 Review the most recent management reports in which the operating results for the servicing unit are described. (The reports should contain sufficient details and provide useful information.)
- 61 Review the most recent analysis of servicing revenues and costs for different product types. Determine if cost estimates are done on an average or incremental basis.
- 61A Assess the servicing unit's current and projected profitability. Determine if management analyzes profitability on a product-by-product basis and how this analysis is factored into strategic decisions.
  - 61B Determine if the cost analysis includes all direct and indirect servicing expenses.
- 62 Review the list of outside vendors and subservicers employed by the bank. Determine how management assesses the quality of work performed by outsiders.
- 63 Determine if complaints are appropriately resolved. Review significant complaints to ascertain if there are possible internal control deficiencies.
- 64 Determine the number and dollar volume of delinquent loans the bank has purchased from the servicing portfolio, if any.
- 65 Evaluate the asset quality of the servicing portfolio (review delinquency reports).

### **Mortgage Servicing Rights (MSR)**

- 66 Determine the extent MSRs are reviewed by the internal and external audit department. If audits are adequate and all pertinent issues are addressed (accounting, compliance with servicing contracts, fair market valuations, and assumptions), adjust examiner review accordingly.
- 67 Review management's procedures for initially recording, amortizing, and periodically re-evaluating MSRs. (Reports of Condition and Income require quarterly valuations.) The procedures should address the following areas:
- 67A Methods for assigning a relative fair value to each MSR asset, specifically, assumptions used to derive fair value.
  - 67B Methods for amortizing the book value of each MSR over its estimated life.

- 67C Systems for documentation and recordkeeping.
- 67D Requirements for on-going supervision of MSRs.
- 67E Procedures to ensure compliance with accounting and regulatory requirements, investor criteria, and internal policies.
- 67F Procedures to ensure that the market price or valuation assumptions used for the impairment analysis are current and reflect expected levels of mortgage prepayments and market discount rates. (Note: When checking impairment, ensure that the bank's test uses the current (not the original) level of servicing fees. Prepayments on the underlying loans cause the weighted average coupon (WAC) to change, which changes the level of servicing over time.)
- 67G Process to determine if adjustments should be made to the valuation allowance account as a result of impairment analysis.
- 68 Evaluate the due diligence process for bulk acquisitions of MSRs, if applicable. (Refer to SFAS 122.)
- 68A Determine if the bank performs a comprehensive due diligence review prior to purchasing a servicing portfolio.
- 68B Determine if management applies reasonable valuation assumptions, which include data on the underlying mortgages, servicing revenues and costs, prepayment speeds, and discount rates.
- 69 Verify that management is properly reporting MSRs in Schedules RC, RC-M, and RC-F in the Report of Condition.
- 70 Determine if management properly discloses MSRs as specified in SFAS 122. Disclosure requirements include the following items:
- 70A Method used to determine lower of cost or market (LOCOM) valuation.
- 70B Amount of MSRs capitalized (or purchased) during the reporting period.
- 70C Method and amount of amortization for the reporting period.
- 70D Fair value of MSRs, including valuations methods and significant assumptions.
- 70E Reasons for not estimating fair value of MSRs and mortgage loans without MSRs. (This disclosure requirement only applies to those banks that decide not to capitalize MSR.)
- 70F Risk characteristics of underlying loans for the purpose of measuring MSRs.
- 70G Activity in valuation allowances.
- 71 Determine if management adequately reserves for loans sold with recourse in the secondary market. The provision expense to establish the reserve should be deducted when calculating the value of MSRs.

## **Interest-only (I/O) Strips Receivables**

72 Determine if management separately identifies servicing assets and any related interest-only strips receivables in accordance with SFAS 125. (FDIC: Also see FIL-106-96 for additional guidance.)

72A Review the bank's method for determining if mortgage servicing fees received exceed normal servicing fees. Confirm that assumptions are documented for each transaction.

72B Review the assumptions used for determining the normal servicing fee (25 or 44 basis points are typically applied).

72C Determine if the bank deducts the normal servicing fee and the guarantee fee before determining any applicable excess servicing fee (reported as an interest-only strip receivable).

## Collections

73 Review policies and procedures for collecting delinquent loans.

73A Determine if collection efforts follow investor guidelines.

73B Determine if the bank documents all attempts to collect past due payments.

73C Determine if the bank charges off uncollectible balances in a timely manner.

## FINANCIAL ANALYSIS

### General

74 Review the mortgage department's balance sheet and income statement. Research items that are large relative to the department's operations or that pose undue financial risk for other reasons.

75 Review any senior officer compensation arrangements that are tied to the department's profitability.

### Earnings Performance

76 Assess earnings performance of the mortgage banking activities in terms of the level, composition, and trend of net income. Consider growth plans, interest rates, and the economic environment when evaluating earnings trends.

77 Incorporate ratio and industry comparisons into the earnings analysis, where appropriate. (Ratios comparing earnings to TA or equity are of limited use unless the impact of off-balance sheet servicing activities are taken into consideration.)

### Liquidity and Funding

78 Review management's determination of the mortgage banking department's liquidity needs, considering loans in the pipeline and warehouse. (Warehouse loans are a significant source of funds.)

79 Determine whether liquidity sources are adequate for current conditions and projected funding needs.

## Core Analysis

79A Evaluate financial instruments used to fund mortgage operations. These may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and long-term debt.

79B Review asset and liability management practices to determine if funding maturities approximate maturities of underlying assets.

## Capital Adequacy

80 Determine whether the bank's capital levels are adequate to meet minimum requirements set by investors whose loans are serviced. Also determine if capital is adequate to absorb operating losses and support expected growth.

81 Determine if management is treating MSR's properly for regulatory capital purposes. (FDIC: Refer to Part 325 for limitations, and see FIL-106-96 for specific guidance.)

## Other Real Estate Review

82 Reconcile ORE held in the mortgage banking operations area. Implement standard ORE review procedures if significant volume. Refer to Other Assets and Liabilities module.

## Mortgage Banking

### REPORT OF EXAMINATION PRESENTATION:

1 Discuss analysis, conclusions, and recommendations with the EIC and management prior to completing the following pages as needed:

1 A Assessments as required on the Risk Management page. (FDIC)

1 B Earnings Analysis comment.

1 C Holding Company and Affiliate page comment (if applicable).

1 D Liquidity Analysis comment.

1 E Interest Rate Risk Assessment comment.

1 F Management/Administration page comment.

## Mortgage Banking

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

### POLICIES AND PROCEDURES

1 Investigate why the policy and procedure deficiencies identified in the Core Analysis exist. (Note: The Core Analysis reveals what the deficiencies are, whereas the Expanded Analysis is focused on the circumstances causing the deficiencies and management's ability to implement corrective action.) Discuss recommendation with management. Possible reasons for policy deficiencies may include the following circumstances:

- 1 A Management overlooked these issues.
- 1 B Management is unfamiliar with prudent mortgage banking guidelines and procedures.
- 1 C Management is unwilling to create or enhance policies and procedures.

2 If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:

- 2 A Lack of awareness of policies' existence.
- 2 B Disregard for established policies.
- 2 C Misunderstanding of the intent of policy guidelines.
- 2 D Poor internal communication of revisions to policy and procedures.

3 Determine if management commits to and supports proper controls and monitoring to ensure policy guidelines are followed in the future.

### REPORTING SYSTEMS

4 Determine why management and board reports are deficient. Seek management's responses to and corrective actions taken for these deficiencies. The cause(s) of deficient reports may stem from the following circumstances:

- 4 A Inaccurate information is contained in reports and input and output has not been tested.
- 4 B The management information system is not able to generate necessary reports.
- 4 C Management's unfamiliarity with the information system's capabilities.
- 4 D Management's unfamiliarity with necessary monitoring reports.

5 Review the quality of investor reporting. Investor reporting varies depending on the servicing contracts in place, but typically the servicing bank is responsible for the following information:

- 5 A Detailed account reconciliations.
- 5 B Information on the mortgagor's name, principal balance outstanding, and escrow balance.

- 5 C Payment status and any foreclosure activity or transfers to the servicer's ORE account.

## **PROFITABILITY**

6 Investigate the causes for operating losses in the mortgage banking operations, and evaluate the future prospects for profitability.

6 A Determine if elevated operating costs or other inefficiencies are impairing profitability (inability to achieve sufficient economies of scale).

6 B Establish whether excessive borrowing activities have led to adverse changes in the cost of funds. Evaluate the impact a change in the cost of funds would have on the net interest margin.

6 C If applicable, determine the holding company's ability to provide capital support, if necessary.

6 D Determine why hedging strategies have not appropriately controlled interest rate risk (improper hedging is often a major cause of poor profitability).

## **Hedging Activities**

7 If the bank has been unable to meet mandatory commitments, determine if management purchased loans from other sources or paid investors a pair-off fee.

7 A Determine if this situation was reported to the directorate or other board committee.

7 B Determine the reasons for the inability to meet mandatory commitments (low loan demand or ineffective hedging strategies).

8 If hedging strategies are ineffective, determine if the following situations are the cause:

8 A Poor correlation of data.

8 B Unreliable data.

8 C Speculation.

9 Determine if the following controls over forward sales activities exist:

9 A Traders are prohibited from entering forward sales data into the system. (Trade tickets should be submitted to an independent person or unit for processing.)

9 B Third-party trade confirmations are received and reviewed by a separate unit.

9 C Management researches any unconfirmed trades and discrepancies.

## **Pricing Strategies**

10 Review mortgage pricing strategies:

10 A Ascertain how prices are determined.

10 B Determine if the pricing strategy is typically at, above, or below market.

10 C Assess the impact pricing strategies have on current and future profitability.

11 Determine the frequency of price changes for retail, wholesale, and broker channels by reviewing historic price sheets. Evaluate the timing of changes relative to significant market interest rate movements.

12 Determine if the secondary marketing manager determines any new product's marketability and pricing strategy, and the bank's ability to price, deliver, and service the product.

## **ACCOUNTING AND CONTROLS**

### **General**

13 If accounting and control deficiencies affecting financial reporting were identified in the Core Analysis, conduct additional procedures as outlined in this section. The following accounting pronouncements apply to mortgage banking activities:

13 A SFAS 65, Accounting for Certain Mortgage Banking Activities.

13 B SFAS 91, Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.

13 C SFAS 115, Accounting for Certain Investments in Debt and Equity Securities.

13 D SFAS 80, Accounting for Futures Contracts.

13 E SFAS 5, Accounting for Contingencies.

13 F SFAS 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

13 G SFAS 122, Accounting for Mortgage Servicing Rights, an amendment of SFAS 65.

14 Determine if assets held-for-sale are segregated from portfolio loans and reflected on the books at LOCOM as required by SFAS 65. (Note: Per SFAS 80 "Accounting for Futures Contract", the carrying value of assets held-for-sale may be adjusted to reflect the use of futures or forwards as bona fide hedges. Firm commitments (pipeline loans) may also be affected by this SFAS.)

15 Determine if transfers from the warehouse to the permanent portfolio are accounted for at LOCOM.

16 Determine if the accounting for recognizing sales of loans is proper. (Refer to the Report of Condition Glossary for "Sale of Assets". Also refer to SFAS 125.)

17 If the bank swaps loans for pass-through certificates issued by the investor (FHLMC, FNMA, etc), determine if management continues to defer origination fees and costs in accordance with SFAS 91.

### **Mortgage Servicing Rights (MSR)**

18 Review MSRs recorded as a result of retail production (originated) or purchased activities.

18 A Determine if the bank, at the time it capitalizes servicing rights, obtains commitments to resell the mortgages prior to, or within 30 days of, their purchase.

18 B Confirm that the purchase or origination cost of the loan is allocated between the MSR and the loans based on the related fair value of the servicing and the loans without servicing rights. (Only direct costs should be capitalized for retail production.)

19 Complete an in-depth review of fair market valuations for MSRs.

19 A Determine if management identifies the characteristics of the servicing portfolio, specifically the following items:

- 19 A1 1. Investors (GNMA, FNMA, FHLMC, private label).
2. Types of products (30-year fixed, 15-year fixed, ARM's, balloons).
3. Transactions made with or without recourse.
4. Geographic dispersion of borrowers.
5. Average loan size.
6. Range of interest rates.
7. Projected life and average age of loans.
8. Delinquency, foreclosure, ORE, and bankruptcy levels.
9. Loss experience.

19 B Review prepayment speed assumptions to determine if they are realistic and conform to acceptable industry standards.

19 C Determine if discount rate assumptions are realistic and in-line with industry practices.

19 D If the servicing costs exceed the contractual servicing fee, determine if the bank records a loss on the sale.

19 E Determine if changes in the servicing fee are caused by changes in the weighted-average coupon for each mortgage pool.

20 Determine if the bank amortizes capitalized MSRs over the estimated life of the underlying assets.

20 A Determine if the bank customizes amortization periods for particular products (for example, 15-year fixed, 30-year fixed, and ARMs).

20 B Determine if the bank adjusts the amortization when the actual prepayment speed is faster or slower than originally projected.

21 If the assumptions are unrealistic and examiners believe the reported MSR value is materially overstated, consider recalculating the value of MSRs. The recalculation may be accomplished by using the bank's internal model, if reliable, using realistic assumptions or by contacting Capital Markets Specialists, if necessary.

## SERVICING

### Cash Management

22 Review the procedures for receiving payments from borrowers, depositing funds into segregated custodial accounts, and remitting funds to investors.

22 A Assess the bank's system for ensuring borrowers' payments are applied accurately and investors receive payments on schedule.

22 B Determine if adequate controls exist over custodial accounts, including daily balancing, monthly reconcilements, authority for disbursements, and segregation of administrative duties.

## **Investor Accounting and Reporting**

23 Review written servicing agreements to determine investor servicing requirements, funds remittance schedules, contractual servicing fees, guarantee fees, and servicer representations and warranties.

23 A Determine if loan delinquencies have prompted the use of bank funds to meet remittance requirements.

23 B Track the flow of funds from the investor cutoff date, the remittance of funds to investors and security holders, and the recognition of servicing revenue.

## **Escrow Account Administration**

24 Review the system for ensuring the timely payment of taxes, insurance, and other obligations of the borrower.

25 Review the method for correcting shortages and surpluses in escrow accounts.

26 Review the procedures for ensuring that tax and insurance payments are made on delinquent loans.

## **Credit Quality Review**

27 Review loan delinquency reports. Select and review a sample of files for severely delinquent borrowers (particularly those over 120 days delinquent).

27 A Determine if the bank initiates foreclosure proceedings in a timely manner and properly notifies borrowers and investors.

27 B Review a sample of loans in which the foreclosure action is delayed due to forbearance agreements. Determine if the agreements are within investors' guidelines.

28 Review a sample of investor-owned ORE properties to determine if administrative and marketing practices comply with investor guidelines.

29 Determine if there are any contingencies resulting from improper administration of foreclosed properties.

# Mortgage Banking

## REPORT OF EXAMINATION PRESENTATION:

1 Discuss analysis, conclusions, and recommendations with the EIC and management prior to completing the following pages as needed:

- 1 A Those included in the Core Analysis Decision Factors section.
- 1 B Internal Routines and Control.
- 1 C Violations of Law and Regulations.
- 1 D Examination Conclusions and Comments.
- 1 E Matters Requiring Board Attention.

## Mortgage Banking

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

- 1 Determine if risks associated with mortgage banking, such as credit risk, interest rate risk, price risk, transaction risk, liquidity risk, compliance risk, and strategic risk, are a material threat to earnings and capital.
- 2 Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns. (FDIC: Field Office Supervisor, Regional Office officials.)
- 3 Discuss the possibility of administrative and enforcement actions with executive management and the board of directors.

## Mortgage Banking

### REPORT OF EXAMINATION PRESENTATION:

1 Discuss analysis, conclusions, and recommendations with the EIC and management prior to completing the following pages as needed:

1 A Those pages included in the Expanded Analysis Decision Factors section.

1 B Confidential - Supervisory Section.

## Mortgage Banking

### Core Analysis Decision Factors

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

**Do Core Analysis and Decision Factors indicate that risks are adequately managed?**

**General Comment:(If any)**

#### **Core Analysis Decision Factors**

- C.1. Are policies and procedures adequate for the mortgage banking operations?
- C.2. Does management adhere to these policies and procedures?
- C.3. Are reporting systems adequate and accurate?
- C.4. Does management properly identify and manage risks?
- C.5. Is management complying with regulations and servicing contracts?
- C.6. Does management use appropriate strategies to limit interest rate risk exposure?
- C.7. Are controls adequate?
- C.8. Is the audit function adequate?
- C.9. Are warehouse loans sold in timely manner?
- C.10. Is the mortgage banking department's financial condition acceptable?

## Mortgage Banking

### Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

**Do Expanded Analysis and Decision Factors indicate that risks are adequately managed?**

**General Comment:(If any)**

#### **Expanded Analysis Decision Factors**

E.1. Are management deficiencies immaterial to mortgage banking operations?

E.2. Are deficiencies immaterial to the bank's financial condition?

Does interest rate risk pose minimal threat to earnings?

Will mortgage banking operations continue to augment earnings and capital?

Are liquidity needs manageable?

Are accounting deficiencies immaterial?

Are quality control deficiencies immaterial?

Are asset quality problems minimal?