

Securitization

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
MANAGEMENT AND CONTROL	
The board approves comprehensive policies and procedures that contain risk limits and direct activities for each role assumed in the securitization process.	Management exercises authority that should rest with the board or engages in activities that expose the institution to excessive risk.
The policy addresses identifying, measuring, monitoring, and controlling risk.	Management may engage in securitization activities without understanding the potential risks.
The board periodically reviews and revises securitization-related policies.	As circumstances change, the board's policies may not provide effective guidance to management and personnel.
The strategic plan includes liquidity objectives, performance objectives, and procedures for maintaining capital levels commensurate to the risks involved.	The institution does not consider the impact of securitization activities in its strategic planning process and does not maintain capital and liquidity levels commensurate to the risks involved.
Management and personnel have sufficient expertise and market knowledge to securitize assets.	Management does not understand the risks associated with asset securitization and exposes the bank to unexpected risks.
Management establishes reasonable securitization strategies to achieve the board's goals.	Management may expose the institution to risks that the board did not approve.
Management establishes a contingency plan that identifies alternative funding sources in the event of a withdrawal from the securitization market or the reduction in credit availability.	The institution is forced to sell assets at a discount to obtain funding and capital levels erode.
Reports to the board and senior management provide adequate information to monitor securitization activities.	<p>The board is unaware of the types and levels of securitization risks.</p> <p>Risks are not appropriately identified, measured, monitored, or controlled.</p> <p>The likelihood and impact of an early amortization event are not assessed.</p> <p>Improper board monitoring leads to write downs of earnings and capital.</p>
The board, or a designated committee, reviews all policy exceptions.	The board is unaware that management does not comply with policy parameters.
A sufficient independent review of securitization activities is conducted and results are reported to the board on a timely basis.	Weaknesses in identifying, measuring, monitoring, and controlling risks are not detected.
Management performs a risk assessment to determine if the risks involved are consistent with	Securitization activities are inconsistent with overall strategic and financial objectives and hinder

Standards	Associated Risks
the institution's overall strategic and financial objectives.	management's efforts toward attaining these objectives.
PERFORMANCE	
The institution adheres to applicable laws, regulations, reporting requirements, and accounting standards.	Violations can result in costly penalties and increased risk exposure. Inaccurate financial statements can be prepared.
Management maintains effective operational and internal controls.	Ineffective internal controls may lead to increased expenses and significant losses.
Credit reviews include assets sold in securitizations, if the institution retains an economic interest.	Adverse trends in the credit quality of securitized assets are not promptly detected or managed.
Hedging programs are effective.	Ineffective hedge positions negatively impact earnings and capital.
The bank maintains adequate liquidity to fulfill its role as a third-party in securitization activities.	Unplanned funding needs or the inability to acquire needed funds negatively impact earnings and capital. Market reputation is damaged.
Management performs stress tests or sensitivity analyses of securitized asset pools at least quarterly.	Management is unable to accurately predict loan pool performance and loss exposure under extreme economic and market conditions.
Retained interests are properly valued in financial statements.	Assets, earnings, and capital are misstated.

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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 appropriately identified, measured, monitored, and controlled?

Core Answer: General Comment:(If any)

Core Analysis Decision Factors

- C.1. Are policies, procedures, and risk limits adequate?
- C.2. Are internal controls adequate?
- C.3. Are the audit or independent review functions adequate?
- C.4. Are information and communication systems adequate and accurate?
- C.5. Are risks from securitization activities appropriately identified and measured?
- C.6. Are retained interests properly valued?
- C.7. Do the board and senior management effectively oversee securitization activities?

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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?

Expanded Answer: General Comment:(If any)

Expanded Analysis Decision Factors

E.1. Are the deficiencies immaterial to securitization activities?

E.2. Are the deficiencies immaterial to the institution's overall condition?

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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.

Refer to the Interagency Guidance On Asset Securitization Activities when completing this module. The following notes are for FDIC personnel only: Examiners may contact their Regional Capital Markets and Securities Specialist, or the Securities Capital Markets, and Trust Branch for assistance in completing any section of this module. Refer to the FDIC's Credit Card Securitization Activities Manual for supplemental guidance when examining banks that securitize credit card receivables. Scope: This module applies to activities of institutions that meet any of the following criteria: 1) originate or purchase loans for sale as part of a securitization, 2) retain financial interests in securitized assets, or 3) act as a third party for securitization transactions, such as credit enhancer or liquidity provider. This module does not include procedures for servicing activities.

PRELIMINARY REVIEW

- 1 Review prior examination reports and file correspondence for an overview of any previously identified securitization activity concerns.
- 2 Review interim internal and external audit reports and independent reviews for any securitization activity concerns.
- 3 Review 10-K and 10-Q reports for information concerning the institution's securitization activities.
- 4 Review performance information that is publicly available from rating agencies (e.g., Fitch IBCA.com) for both the subject institution's pools and comparable pools.
- 5 Review board or committee minutes and internal management reports for evidence of oversight, responsibility, and any identified securitization activity concerns.
- 6 Review securitization activity since last examination and identify trends in the following:
 - 6A Securitization volume.
 - 6B Deal structure.
 - 6C Collateral type.
- 7 Review the institution or third party valuation report of retained interests.
- 8 Discuss with management the securitization philosophy and determine if it is consistent with the bank's strategic plan and other board approved policies.

POLICIES, PROCEDURES, AND RISK LIMITS

- 9 Determine if securitization policies and procedures are adequate and established risk limits are appropriate. The written policies and procedures should address:
 - 9A. Permissible securitization activities.

9B Authority and responsibility over:

9B1 Transaction approvals and cancellations.

9B2 Deal negotiation and execution.

9B3 Counterparty approvals.

9B4 Transaction monitoring.

9B5 Pricing approvals.

9B6 Personnel supervision.

9B7 Risk management.

9B8 Reporting and approving policy exceptions.

9C Underwriting standards for loans originated or purchased for securitization.

9D Servicing standards, including criteria for selecting a third-party servicer.

9E Exposure limits for retained interests as a percentage of Tier 1 capital.

9F Standards for repurchasing distressed loans from the securitized credit pool that are consistent with contractual recourse obligations.

9G Hedging activities.

9H Legal counsel review of contracts or agreements.

9I Consistently applied accounting methodology.

9J Regulatory reporting requirements.

9K Valuation methods for retained interests, including procedures for review and approval of the underlying assumptions.

9L Management reporting process.

INTERNAL CONTROLS

Note: When any of the following procedures have been conducted by the institution's independent review program, use all reliable, current work products for the examination.

10 Determine if sufficient operational separation and rotation of duties exist.

11 Determine if proper safeguards are in place regarding access to and use of records.

12 Determine if loan servicing statements and trustee reports for each securitization are routinely reconciled.

13 Determine if deviations from policy parameters are handled in accordance with board approved policies.

14 When the bank retains recourse in a securitization, determine whether internal controls are in place to ensure recourse payments to the trust do not exceed the bank's contractual obligation.

AUDIT OR INDEPENDENT REVIEW

15 Determine that the independence and scope of the audit or independent review is sufficient to identify policy, risk management, internal control, and compliance deficiencies. The scope should include the following:

15A An assessment of the valuation process, including the appropriateness of the underlying assumptions.

15B An assessment of the appropriateness of the modeling process and validation mechanisms.

15C When a third party services loans, including a subsidiary or an affiliate, independent verification of the existence of the loans to determine if balances reconcile to internal records.

15D Verification of compliance with deal covenants.

15E Conformance with the Pooling and Servicing Agreement.

15F Adequacy of information systems to process data accurately.

15G Accuracy of information systems, regulatory, and public reporting.

15H Compliance with policy guidelines.

15I A review of monthly reconciliations of loans held-for-sale.

15J Proper accounting treatment for loans held-for-sale.

15K Proper accounting treatment for loans transferred from the loans held-for-sale account to the institution's general loan account.

15L Proper accounting treatment for original booking, subsequent valuations, and regulatory reporting of retained interests.

16 Determine if both regular and unscheduled reviews are performed.

17 Determine that results are reported to the board or designated committee on a timely basis.

18 Determine if management's responses to recent audits or independent reviews are reasonable.

INFORMATION AND COMMUNICATION SYSTEMS

19 Determine if internal management reports provide sufficient information for management's decisions and for monitoring the results of those decisions. If the institution maintains an economic interest in the securitized assets, reports should address the following:

19A Performance of assets in securitized pools.

19B Deal summaries for completed, in process, and prospective securitization transactions. Deal summaries should include collateral type, dollar volume of loans sold, maturity, credit

enhancement and subordination features, financial covenants, rights of repurchase, and counterparty exposures.

19C Vintage analysis for each pool using monthly data.

19D Static pool cash collection analysis.

19E A monthly statement of covenant compliance.

19F Quarterly or more frequent sensitivity analyses or stress tests.

19G Exposure by counterparty and function (e.g., loan originator, credit enhancement provider, servicer).

19H Profitability analysis by securitization and function (e.g., originator, provider of direct credit substitute).

19I Liquidity usage and expected funding requirements.

20 Determine if securitization activity information is effectively communicated to the lending, credit review, funds management, and risk management areas.

RISK IDENTIFICATION AND MEASUREMENT

21 Review the following ratios to determine credit quality and to determine if underwriting standards for securitized and held-for-sale loans are the same as for those retained in the loan portfolio.

21A Noncurrent Loans to Gross Loans.

21B Total Past Due Loans to Gross Loans.

21C Net Losses to Average Total Loans.

22 Review the institution's standards for approving originators and assess the method of determining the quality of prospective asset purchases.

23 Review aging reports for loans in the held-for-sale account. For loans that are housed in this account longer than the average holding period, determine the cause and the prospects for disposal.

24 If a significant volume of unmarketable loans is transferred from the held-for-sale loan account to the general loan account, determine the cause of these transfers and the impact upon credit quality.

25 If the institution retains an economic interest in the securitized assets, determine that management monitors the delinquency, defaults, and losses of assets sold.

26 Determine that management reviews financial audits or other documentation to analyze the condition of any third party credit enhancement provider, including a subsidiary or an affiliate, involved in the institution's securitizations.

Note: Refer to the Related Organizations Module to determine compliance with Sections 23A and B of the Federal Reserve Act.

27 Assess the financial impact on the institution if management takes action to prevent early amortization or a rating downgrade.

- 28 If the institution retains an economic interest in the securitized assets, determine that management monitors the prepayment performance of assets sold.
- 29 Determine if the bank's retained interest is subject to basis risk due to differences between indices on the underlying loans and the bond classes. Assess how this risk is managed.
- 30 Determine if the by-products of securitizations (e.g., retained interests and held-for-sale loans) are properly reflected in the bank's Interest Rate Risk model.
- 31 Review management's statements of covenant compliance and determine the probability that the institution's marketplace reputation will be damaged.
- 32 Determine if management has an adequate plan of action that addresses the following items:
- 32A Preventing early amortization, a rating downgrade, or other adverse consequences to the bondholder.
 - 32B Minimizing the impact on capital, interest rate risk, earnings, and liquidity if the bank chooses to take action to protect the bondholders.
 - 32C Restoring marketplace reputation if early amortization, a rating downgrade, or other adverse consequences to the bondholder actually occurs.
- 33 Determine that management has an adequate contingency plan for liquidity if the institution is unable to access the securitization market due to market disruption or other restrictions.
- 34 If a third party servicer is used, including a subsidiary or an affiliate, determine that management reviews operational audits or other documentation to analyze the operating soundness of this entity.
- 35 Determine that the institution can fund its third party activities and that these contingent liabilities are considered in the bank's funding plans.
- 36 Determine that the authority to provide direct credit substitutes (e.g., financial standby letters of credit) is subject to the approval of the credit department.
- 37 Determine that exposures arising from direct credit substitutes are analyzed during the internal credit review process.
- 38 Review the institution's written agreement to provide back-up liquidity and determine the institution's obligations to fund, rights to withhold, and advances.

VALUATION OF RETAINED INTERESTS

- 39 Review the contractual documents, including the loan purchase and sale agreements and offering circulars, to validate that the institution is legally entitled to receive the cash flows from the securitization that have been booked as a retained interest. These cash flows may include excess principal and interest payments from the collateral and release of reserve funds.
- 40 Determine if management stratifies securitized assets by homogeneous loan characteristics when making valuation assumptions.
- 41 Determine the reasonableness of prepayment, loss, and discount rate assumptions used to value retained interests.

- 41A Review management's documentation supporting the appropriateness of the assumptions.
- 41B Determine that management reviews and updates the reasonableness of assumptions regularly based on current and projected market conditions. These reviews should be performed at least quarterly.
- 42 Review supporting cash flow documentation to determine the following:
 - 42A The amount of interest paid to the senior bond classes matches the stated coupon rate for each bond class.
 - 42B Cash flows are distributed to bond classes and the retained interest according to the terms of the prospectus, offering circular, or pooling and servicing agreement.
 - 42C The deal redemption or cleanup provision is accurately reflected in the cash flows to the retained interest holder.
- 43 If a third party values the retained interest(s), review management's documentation and evaluate the due diligence performed for determining the qualifications of the third party's personnel.

BOARD AND SENIOR MANAGEMENT OVERSIGHT

- 44 Review management's risk assessment analysis that determines whether risks involved are consistent with the institution's overall strategic and financial objectives. The analysis should include the following:
 - 44A An evaluation of the cost of securitizing assets compared to the cost of alternative funding sources.
 - 44B An assessment of the initial cost and projected return of the transaction.
 - 44C A determination as to the ongoing costs and risks related to a transaction.
- 45 Determine if the board reviews and approves securitization policies at least annually or when changes in securitization activities occur.
- 46 Determine that management complies with laws and accounting standards.
 - 46A Determine that management appropriately applies the minimum risk-based capital standards to securitization transactions that involve recourse, including low-level recourse.
 - 46B If the institution securitizes assets and retains an interest that serves as a credit enhancement supporting the transferred assets, determine that management reflects these transactions as assets sold with recourse in schedules RC-L and RC-R of the Consolidated Reports of Income and Condition.
 - 46C Determine that the securitization and the retained interests are accounted for consistent with SFAS 125 and other appropriate accounting standards.
 - 46D Confirm that loans to be securitized (held-for-sale loans) are valued at the lower of cost or market value according to SFAS 65.
- 47 Determine if historical performance indicates adequate board and senior management oversight.

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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.

INTERNAL CONTROLS

- 1 Reconcile the dollar volume of loans serviced by a third party, including a subsidiary or an affiliate, that are either on-balance sheet or that have been sold in a securitization.
 - 1A Independently verify that the amount of loans being serviced ties to the institution's records and the supporting cash flow documentation for valuing the retained interests.
 - 1B For on-balance sheet loans, verify that the dollar volume of loans on the servicing statements ties to the dollar volume of loans on the institution's records.
 - 1C For securitized loans, verify that the dollar volume of loans on the servicing statements ties to the dollar volume of loans on the supporting cash flow documentation for valuing the retained interests.
- 2 Review monthly held-for-sale loan account reconciliations.

RISK IDENTIFICATION AND MEASUREMENT

- 3 If there are material differences in the credit quality of the securitized and on-balance sheet assets, investigate the reasons(s) for the performance disparity by comparing the following characteristics of the securitized and on-balance sheet assets.
 - 3A Loan-to-value ratio.
 - 3B FICO or other credit score.
 - 3C Loan characteristics (e.g., WAC, WAM, variable vs. fixed rate).

VALUATION AND CLASSIFICATION OF RETAINED INTERESTS

- 4 Perform an in-depth analysis of the assumptions used to value retained interests.
 - 4A Review the methodology for prepayment, loss, and discount rate assumptions and verify their calculations.
 - 4B Compare the prepayment and loss assumptions used in valuing the retained interests to actual performance of the underlying collateral. If the underlying collateral does not have sufficient performance history, compare assumptions to those of deals with substantially similar underlying assets.
 - 4C Compare the discount rate used in valuing the retained interests to the discount rate that other market participants use to value retained interests with substantially similar underlying assets.
 - 4D Determine that the discount rate is applied to the actual excess interest that the trust distributes to the retained interest (cash-out method). The discount rate should not be applied to the excess interest that the trust receives (cash-in method).

4E Determine if the following items are properly reflected in the cash flow to the holder of the retained interests:

4E1. Fees (e.g., trustee, servicer, insurer).

4E2. Release of or additions to a reserve or overcollateralization account.

4E3. Payments from delinquent loans that are not in default.

4E4. Recoveries.

4E5. Insurance coverage of losses (e.g., FHA guaranteed).

4E6. Credit losses.

5 Using the discount rate assumption, verify the present value calculation of the expected future cash flows to the retained interest.

6 If the assumptions used to value the retained interests lack objectively verifiable support or fail to meet the supervisory standards set forth in the Interagency Guidance on Asset Securitization Activities, the retained interests should be classified Loss and disallowed for regulatory capital purposes.

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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 Assess the impact of securitization activity deficiencies on the bank's overall condition.
- 2 Determine the effect that credit, interest rate, liquidity, and reputation risk exposures have on the institution's safety and soundness.
- 3 Evaluate the effect that planned securitization activities may have on capital, asset quality, earnings, liquidity, and sensitivity to market risk.
- 4 Gauge management's willingness and ability to correct deficiencies.
- 5 Determine if formal or informal administrative actions are warranted, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns. (FDIC Only: Field Office Supervisor, Regional Office)
- 6 Investigate potential recommendations for civil money penalties.