



Comptroller of the Currency
Administrator of National Banks

RESCINDED

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Mortgage Banking

Comptroller's Handbook

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Background

Depository institutions have traditionally originated residential mortgage loans to hold in their loan portfolios, and mortgage banking is a natural extension of this traditional origination process. Although it can include loan origination, mortgage banking goes beyond this basic activity. A bank that only originates and holds mortgage loans in its loan portfolio has not engaged in mortgage banking as defined here. Those activities are discussed elsewhere in the *Comptroller's Handbook*.

Mortgage banking generally involves loan originations, purchases, and sales through the secondary mortgage market. A mortgage bank can retain or sell loans it originates and retain or sell the servicing on those loans. Through mortgage banking, national banks can and do participate in any or a combination of these activities. Banks can also participate in mortgage banking activities by purchasing rather than originating loans.

The mortgage banking industry is highly competitive and involves many firms and intense competition. Firms engaged in mortgage banking vary in size from very small, local firms to exceptionally large, nationwide operations. Commercial banks and their subsidiaries and affiliates make up a large and growing proportion of the mortgage banking industry.

Mortgage banking activities generate fee income and provide cross-selling opportunities that enhance a bank's retail banking franchise. The general shift from traditional lending to mortgage banking activities has taken place in the context of a more recent general shift by commercial banks from interest income activities to non-interest, fee generating activities.

Primary and Secondary Mortgage Markets

The key economic function of a mortgage lender is to provide funds for the purchase or refinancing of residential properties. This function takes place in the **primary** mortgage market where mortgage lenders originate mortgages by lending funds directly to homeowners. This market contrasts with the **secondary** mortgage market. In the secondary mortgage market, lenders and investors buy and sell loans that were originated directly by lenders in the primary mortgage market. Lenders and investors also sell and purchase securities in the secondary market that are collateralized by groups of pooled mortgage loans.

Banks that use the secondary market to sell loans they originate do so to gain flexibility in managing their long-term interest rate exposures. They also use it to increase their liquidity and expand their opportunities to earn fee-generated income.

The secondary mortgage market came about largely because of various public policy measures and programs aimed at promoting more widespread home ownership. Those efforts go as far back as the 1930s. Several government-run and government-sponsored programs have played an important part in fostering home ownership, and are still important in the market today. The Federal Housing Administration (FHA), for example, encourages private mortgage lending by providing insurance against default. The Federal National Mortgage Association (FNMA or Fannie Mae) supports conventional, FHA and Veteran's Administration (VA) mortgages by operating programs to purchase loans and turn them into securities to sell to investors. (For a more complete description of government-run and government-sponsored programs, see Appendix.)

Most of the loans mortgage banks sell are originated under government-sponsored programs. These loans can be sold directly or converted into securities collateralized by mortgages. Mortgage banks also sell mortgages and

mortgage-backed securities to private investors. Mortgage-backed securities, in particular, have attracted more investors into the market by providing a better blend of risk profiles than individual loans.

Fundamentals of Mortgage Banking

When a bank originates a mortgage loan, it is creating two commodities, a loan and the right to service the loan. The secondary market values and trades each of these commodities daily. Mortgage bankers create economic value by producing these assets at a cost that is less than their market value.

Given the cyclical nature of mortgage banking and the trend to greater industry consolidation, banks must maximize efficiencies and economies of scale to compete effectively. Mortgage banking operations can realize efficiencies by using systems and technology that enhance loan processing or servicing activities. The largest mortgage servicing operations invest heavily in technology to manage and process large volumes of individual mortgages with differing payments, taxes, insurance, disbursements, etc. They also operate complex telephone systems to handle customer service, collections, and foreclosures. This highly developed infrastructure enables mortgage banks to effectively handle large and rapidly growing portfolios.

Mortgage banking operations also need effective information systems to identify the value created and cost incurred to produce different mortgage products. This is especially critical for banks that retain servicing rights. To optimize earnings on servicing assets, mortgage banks must have cost-efficient servicing operations and effective, integrated information systems.

Risks Associated with Mortgage Banking

For purposes of the OCC's discussion of risk, examiners assess banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: *Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction, Compliance, Strategic, and Reputation*. These categories are not mutually exclusive; any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

The applicable risks associated with mortgage banking are: **credit risk, interest rate risk, price risk, transaction risk, liquidity risk, compliance risk, strategic risk, and reputation risk**. These are discussed more fully in the following paragraphs.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or to otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuers, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

In mortgage banking, credit risk arises in a number of ways. For example, if the quality of loans produced or serviced deteriorates, the bank will not be able to sell the loans at prevailing market prices. Purchasers of these assets will discount their bid prices or avoid acquisition if credit problems exist. Poor credit quality can also result in the loss of favorable terms or the possible cancellation of contracts with secondary market agencies.

For banks that service loans for others, credit risk directly affects the market value and profitability of a bank's mortgage servicing portfolio. Most servicing agreements require servicers to remit principal and interest payments to investors

and keep property taxes and hazard insurance premiums current even when they have not received payments from past due borrowers. These agreements also require the bank to undertake costly collection efforts on behalf of investors.

A bank is also exposed to credit risk when it services loans for investors on a contractual recourse basis and retains risk of loss arising from borrower default. When a customer defaults on a loan under a recourse arrangement, the bank is responsible for all credit loss because it must repurchase the loan serviced.

A related form of credit risk involves concentration risk. Concentration risk can occur if a servicing portfolio is composed of loans in a geographic area that is experiencing an economic downturn or if a portfolio is composed of nonstandard product types.

A mortgage bank can be exposed to counterparty credit risk if a counterparty fails to meet its obligation, for example because of financial difficulties. Counterparties associated with mortgage banking activities include broker/dealers, correspondent lenders, private mortgage insurers, vendors, subservicers, and loan closing agents. If a counterparty becomes financially unstable or experiences operational difficulties, the bank may be unable to collect receivables owed to it or may be forced to seek services elsewhere. Because of its exposure to the financial performance of counterparties, a bank should monitor counterparties' actions on a regular basis and should perform appropriate analysis of their financial stability.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. The economic perspective focuses on the value of the bank in today's interest rate environment and the sensitivity of that value to changes in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-related options embedded in bank products (options risk). The evaluation of interest rate risk must consider the impact of complex, illiquid hedging strategies or products, and also the potential impact on fee income which is sensitive to changes in interest rates. In those situations where trading is separately managed this refers to structural positions and not trading positions.

Changes in interest rates pose significant risks to mortgage banking activities in several ways. Accordingly, effective risk management practices and oversight by the Asset/Liability Committee, or a similar committee, are essential elements of a well-managed mortgage banking operation. These practices are described below in the Management and Overall Supervision section of the Introduction.

Higher interest rates can reduce homebuyers' willingness or ability to finance a real estate loan and, thereby, can adversely affect a bank that needs a minimum level of loan originations to remain profitable. Rising interest rates, however, can increase the cash flows expected from the servicing rights portfolio and, thus, increase both projected income and the value of the servicing rights. Falling interest rates normally result in faster loan prepayments, which can reduce cash flows expected from the rights and the value of the bank's servicing portfolio.

Price Risk

Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodities markets.

Price risk focuses on the changes in market factors (e.g., interest rates, market liquidity, and volatilities) that affect the value of traded instruments. Rising interest rates reduce the value of warehouse loans and pipeline commitments, and can cause market losses if not adequately hedged.

Falling interest rates may cause borrowers to seek more favorable terms and withdraw loan applications before the loans close. If customers withdraw their applications, a bank may be unable to originate enough loans to meet its forward sales commitments. Because of this kind of “fallout,” a bank may have to purchase additional loans in the secondary market at prices higher than anticipated. Alternatively, a bank may choose to liquidate its commitment to sell and deliver mortgages by paying a fee to the counterparty, commonly called a pair-off arrangement. (For definition of these terms, see **pair-off arrangement** and **pair-off fee** in the Glossary.)

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

To be successful, a mortgage banking operation must be able to originate, sell, and service large volumes of loans efficiently. Transaction risks that are not controlled can cause the company substantial losses.

To manage transaction risk, a mortgage banking operation should employ competent management and staff, maintain effective internal controls, and use comprehensive management information systems. To limit transaction risk, a bank's information and recordkeeping systems must be able to accurately and efficiently process large volumes of data. Because of the large number of documents involved and the high volume of transactions, detailed subsidiary ledgers must support all general ledger accounts. Similarly, accounts should be reconciled at least monthly and be supported by effective supervisory controls.

Excessive levels of missing collateral documents are another source of transaction risk. If the bank has a large number of undocumented loans in its servicing portfolio, purchasers will not be willing to pay as high a price for the portfolio. To limit this risk, management should establish and maintain control systems that properly identify and manage this exposure.

Mortgage servicers are exposed to considerable transaction risk when they perform escrow administration and document custodian activities. As the escrow account administrator, the servicer must protect borrowers' funds and make timely payments on their behalf to taxing authorities, hazard insurance providers, and other parties. The servicer also must ensure that escrow accounts are maintained within legal limits. As document custodian, the institution must obtain, track, and safekeep loan documentation for investors.

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

In mortgage banking, credit and transaction risk weaknesses can cause liquidity problems if the bank fails to underwrite or service loans in a manner that meets investors' requirements. As a result, the bank may not be able to sell mortgage inventory or servicing rights to generate funds. Additionally, investors may require the bank to repurchase loans sold to the investor which the bank inappropriately underwrote or serviced.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

A bank that originates and/or services mortgages is responsible for complying with applicable federal and state laws. For example, when a bank or its agent fails to comply with laws requiring servicers to pay interest on a borrower's escrow account balance, the bank may become involved in, and possibly incur losses from, litigation. In addition, failure to comply with disclosure requirements, such as those imposed under the Truth-in-Lending Act, could make the bank a target of class-action litigation.

Mortgage banking managers must be aware of fair lending requirements and implement effective procedures and controls to help them identify practices that could result in discriminatory treatment of any class of borrowers. For example, selectively increasing the price of a mortgage loan above the bank's established rate to certain customers ("overages") may have the effect of discriminating against those customers. This practice, left undetected and not properly controlled, may raise the possibility of litigation or regulatory action. (For a more complete discussion of fair lending, see the "Community Bank Consumer Compliance" booklet.)

Strategic Risk

Strategic risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

In mortgage banking activities, strategic risk can expose the bank to financial losses caused by changes in the quantity or quality of products, services, operating controls, management supervision, hedging decisions, acquisitions, competition, and technology. If these risks are not adequately understood, measured, and controlled, they may result in high earnings volatility and significant capital pressures. A bank's strategic direction is often difficult to reverse on a short-term basis, and changes usually result in significant costs.

To limit strategic risk, management should understand the economic dynamics and market conditions of the industry, including the cost structure and profitability of each major segment of mortgage banking operations, to ensure initiatives are based upon sound information. Management should consider this information before offering new products and services, altering its pricing strategies, encouraging growth, or pursuing acquisitions. Additionally, management should ensure a proper balance exists between the mortgage company's willingness to accept risk and its supporting resources and controls. The structure and managerial talent of the organization must support its strategies and degree of innovation.

Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services, or continue servicing existing relationships. This risk can expose the institution

to litigation, financial loss, or damage to its reputation. Reputation risk exposure is present throughout the organization and is why banks have the responsibility to exercise an abundance of caution in dealing with its customers and community. This risk is present in activities such as asset management and agency transactions.

An operational breakdown or general weakness in any part of its mortgage banking activities can harm a bank's reputation. For example, a mortgage bank that services loans for third party investors bears operational and administrative responsibilities to act prudently on behalf of investors and borrowers. Misrepresentations, breaches of duty, administrative lapses, and conflicts of interest can result in lawsuits, financial loss, and/or damage to the company's reputation. In addition, a bank that originates and sells loans into the secondary market should follow effective underwriting and documentation standards to protect its reputation in the market to support future loan sales.

Statutory and Regulatory Authority

Twelve USC 371 provides the statutory authority for a national bank to engage in mortgage banking activities. It permits national banks to make, arrange, purchase, or sell loans or extensions of credit secured by liens or interests in real estate. Twelve CFR 34 clarifies the types of collateral that qualify as real estate. Finally, 12 CFR 7.7379 permits a national bank, either directly or through a subsidiary, to act as agent in the warehousing and servicing of mortgage loans.

Capital Requirements

Banks that engage in mortgage banking activities must comply with the OCC's risk-based capital and leverage ratio requirements that apply to those activities. (For a more complete discussion of OCC capital requirements, see the Capital and Dividends section of the *Comptroller's Handbook*.)

In addition to the OCC's requirements, the Federal Home Loan Mortgage Corporation (FHLMC), FNMA, and Government National Mortgage Association (GNMA) require banks, nonbanks, and individuals conducting business with them to maintain a minimum level of capital. Failure to satisfy any agency's minimum capital requirement may result in the bank losing the right to securitize, sell, and service mortgages for that agency. Since the capital requirements are different for each agency, examiners should determine if the bank or its mortgage banking subsidiary meets the capital requirements of each agency with which it has a relationship.

Management and Overall Supervision

The success of a mortgage banking enterprise depends on strong information systems, efficient processing, effective delivery systems, knowledgeable staff, and competent management. Weaknesses in any of these critical areas could diminish the bank's ability to respond quickly to changing market conditions and potentially jeopardize the organization's financial condition.

The activities that comprise mortgage banking are interdependent. The efficiency and profitability of a mortgage banking operation hinges on how well a bank manages these activities on a departmental and institutional basis.

Because mortgage banking encompasses numerous activities that pose significant risks, the bank should have effective policies and strong internal controls governing each operational area. Effective policies and internal controls enable the bank to adhere to its established strategic objectives and to institutionalize effective risk management practices. Policies also can help ensure that the bank benefits through efficiencies gained from standard operating procedures. Further, policies provide mortgage banking personnel with a consistent message about appropriate underwriting standards needed to ensure that loans made are eligible for sale into the secondary market.

The requirement for effective policies and internal controls does not alter a bank's designation as noncomplex. The OCC, however, requires banks to have written mortgage banking policies unless the risk in their activity is so small that it is considered *de minimis*.

An effective risk management program is a key component of management's supervision. The board of directors and senior management should define the mortgage banking operation's business strategies, permissible activities, lines of authority, operational responsibilities, and acceptable risk levels.

In developing a strategic plan, management should assess current and prospective market conditions and industry competition. It is essential that a sufficient long-term resource commitment exists to endure the cyclical downturns endemic in this industry. If the company intends to be a niche player, management should clearly delineate its targeted market segment and develop appropriate business strategies.

A mortgage banking operation's business plan should include specific financial objectives. The plan should be consistent with the bank's overall strategic plan and describe strategies management intends to pursue when acquiring, selling, and servicing mortgage banking assets. The plan should also provide for adequate financial, human, technological, and physical resources to support the operation's activities.

The strategic planning process should include an assessment of the servicing time necessary to recapture production costs and achieve required returns. An understanding of this basic information is also critical to decisions to purchase servicing rights, and should be incorporated into servicing hedging strategies.

Comprehensive management information systems (MIS) are essential to a successful mortgage banking operation. The bank's systems should provide accurate, up-to-date information on all functional areas and should support the preparation of accurate financial statements. The MIS reports should be designed so that management can identify and evaluate operating results and monitor primary sources of risk. Management also should establish and maintain systems for monitoring compliance with laws, regulations, and investor requirements.

Internal and External Audit

Because of the variety of risks inherent in mortgage banking activities, internal auditors should review all aspects of mortgage banking operations as part of the bank's ongoing audit program. Audits should assess compliance with bank policies or practices, investor criteria, federal and state laws, and regulatory issuances and guidelines. Internal audit staff should be independent and knowledgeable about mortgage banking activities. They should report audit findings and policy deviations directly to the board of directors or to the audit committee of the board.

Examiners should assess the scope of internal and external audit coverage. They should also review audit findings and the effectiveness of management's actions to correct deficiencies.

Activities Associated with Mortgage Banking

Mortgage banking involves four major areas of activities: loan production, pipeline and warehouse management, secondary marketing, and servicing. Each of these activities is normally performed in a separate unit or department of the bank or mortgage banking company.

- The **loan production** unit originates, processes, underwrites, and closes mortgage loans.
- The **pipeline and warehouse management** unit manages price risk from loan commitments and loans held-for-sale.
- The **secondary marketing** unit develops, prices, and sells loan products and delivers loans to permanent investors.
- The **servicing** unit (sometimes referred to as loan administration) collects monthly payments from borrowers; remits payments to the permanent investor or security holder; handles contacts with borrowers about delinquencies, assumptions, and escrow accounts; and pays real estate tax and insurance premiums as they become due.

These activities commonly result in the creation of two unique assets: **mortgage servicing rights** (purchased and originated) and **excess servicing fee receivables (ESFR)**. Evaluating the valuation techniques and accounting principles associated with these assets is a key component of the examination of a mortgage banking operation.

Loan Production

A bank involved in mortgage loan production should have policies and effective practices and procedures governing loan production activities. At a minimum, those guidelines should address:

- Types of loans the bank will originate or purchase.
- Sources from which the loans will be acquired.
- Basic underwriting standards.

Types of Mortgage Loans

Mortgage banking operations deal primarily with two types of mortgage loans: government loans and conventional loans.

Government loans, which are either insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans' Administration (VA), carry maximum mortgage amounts and have strict underwriting standards. These mortgages are commonly sold into pools that back GNMA securities.

Conventional loans are those not directly insured or guaranteed by the U.S. government. Conventional loans are further divided into **conforming** and **nonconforming mortgages**. Conforming loans may be sold to the FHLMC or FNMA (commonly referred to as government-sponsored enterprises or GSEs) which, in turn, securitize, package, and sell these loans to investors in the secondary market. Conforming loans comply with agency loan size limitations, amortization periods, and underwriting guidelines. FHLMC and FNMA securities are not backed by the full faith and credit of the U.S. government. There is a widespread perception, however, that they carry an implicit government guarantee.

Nonconforming loans are not eligible for purchase by a GSE, but can be sold in the secondary market as whole loans, or can be pooled, securitized, and sold as private-label mortgage-backed securities. The most common type of nonconforming loan is a “jumbo loan” which carries a principal amount in excess of the ceiling established by the GSEs.

Other nonconforming loans are largely nontraditional mortgage products created in response to customer preference, the interest rate environment, inflated or deflated property values, or competition. Examples of these loans include mortgages with starting interest rates below market (“teaser rate”) that later increase; low/no documentation loans; graduated payment mortgages; negative amortization loans; reverse annuity mortgages; and no-equity mortgages. Since nonconforming loans do not carry standardized features, the size of the market for these loans is considerably less than that for conforming conventional loans. These products may pose unique credit and price risks, and should be supervised accordingly.

When a borrower lacks sufficient equity to meet downpayment requirements, he or she may purchase private mortgage insurance (PMI) to meet GSE and private investors’ underwriting guidelines. The borrower purchases mortgage insurance for FHA loans through the federal government. Private companies offer mortgage insurance products for conventional loans. For conventional loans, mortgage insurance is generally required for loans with initial loan-to-value ratios of more than 80 percent.

Sources of Mortgage Loans

Banks commonly create mortgage production through both retail (internal) and wholesale (external) sources.

Retail sources for mortgage loans include bank-generated loan applications, brokered loans, and contacts with real estate agents and home builders. Loans must be closed in the bank’s name to be considered retail originations. Although originating retail loans allows a bank to maintain tighter controls over its products and affords the opportunity to cross-sell other bank products, the volume of loans generated in this manner may not consistently cover a bank’s related fixed overhead costs. A bank that engages in mortgage banking, therefore, may supplement its retail loan production volume with additional mortgages purchased from wholesale sources.

Wholesale sources for loans include loans purchased from bank correspondents or other third-party sellers. These mortgages close in the third party’s name and are subsequently sold to the bank.

Banks commonly underwrite loans obtained through correspondents. In some cases, the bank delegates the underwriting function to the correspondent. When this is the case, bank management should have systems to ensure the correspondent is well-managed, financially sound, and providing high quality mortgages that meet prescribed underwriting guidelines. The quality of loans underwritten by correspondents should be closely monitored through post-purchase reviews, tests performed by the quality control unit, and portfolio management activities. Monitoring the quality of loans originated by the bank’s correspondent enables bank management to know if individual correspondents are producing the quality of loans the bank expects. If credit or documentation problems are discovered, the bank should take appropriate action, which could include terminating its relationship with the correspondent.

The wholesale production of mortgage loans allows banks to expand volume without increasing related fixed costs. The wholesale business is highly competitive, however. As a result, there may be periods during the business cycle when it is difficult for a bank to obtain required loan volume at an attractive price. In addition, wholesale mortgages have increased potential for fraud if proper control systems are not in place.

Underwriting Standards

To ensure loans made are eligible for sale to the secondary market, most lenders apply underwriting and documentation standards that conform to those specified by the GSEs or private label issuers. Although they will vary by loan type, common underwriting procedures include:

- Reviewing appraisals for completeness, accuracy, and quality.
- Evaluating the repayment ability of the borrower based on income, financial resources, employment, and credit history.
- Determining if the borrower has sufficient funds to close.
- Determining if the property will be owner-occupied.
- Checking the accuracy of all calculations and disclosures.
- Identifying any special loan requirements.
- Ensuring adherence to appropriate fair lending requirements.

Production Process

Mortgage loan production normally consists of four phases: origination, processing, underwriting, and closing. The head of production should be responsible for supervising each of these areas and ensuring adherence to internal and external requirements. In addition, that officer should be responsible for portfolio management.

Origination

Originators are the sales staff of the mortgage banking unit. Their primary role is the solicitation of applications from prospective borrowers. Normally, a significant portion of originators' compensation takes the form of commissions. Therefore, originators should not have authority to set or dominate the company's loan pricing decisions, because the potential conflict can create unacceptable reputation, market, and credit risks.

Banks use many different ways to originate loans. In addition to face-to-face customer contacts, many banks have telemarketing and direct mailing units that provide additional ways to solicit applications.

Processing

The employees of the processing unit, processors, verify information supplied by a mortgage applicant, such as income, employment, and downpayment sources. This unit is responsible for obtaining an appraisal of the financed property and acquiring preliminary title insurance. The processing unit should use an automated processing system or a system of checklists to ensure all required steps are completed and to maintain controls over loan documentation.

Processors must prepare files in a complete manner before the files are delivered to the underwriting unit. If a credit package is incomplete, the underwriting process will be temporarily suspended, causing the bank to suffer unnecessary delays and expense.

Underwriting

The underwriting unit's major function is to approve or deny loan applications. Underwriters determine if a prospective borrower qualifies for the requested mortgage, and whether income and collateral coverage meet bank and investor requirements. This unit is responsible for reviewing appraisals for completeness, accuracy, and quality; evaluating a borrower's ability to close and repay the loan; determining if the property will be owner-occupied; checking the accuracy of all calculations and disclosures; identifying any special loan requirements; and ensuring adherence to fair lending

requirements.

Closing

After a loan is approved by the underwriting unit, the closing unit ensures the loan is properly closed and settled and the bank has all required documentation. Closings may be performed by an internal loan closing unit or by title companies or attorneys acting as agents for the bank. The individual who performs the closing, whether bank employee or agent, should obtain all required documents before disbursing the loan proceeds. Obtaining all front-end documents, (e.g., note, preliminary title insurance, mortgage assignment(s), insurance/guaranty certificate), is the responsibility of the closing function. In addition, the loan closer should maintain control over the closing package and submit it to the mortgage company generally within three business days of closing.

The closing unit should perform a post-closing review of each loan file after closing, generally within ten days of closing. This review ensures that the bank or its agent closed each loan according to the underwriter's instructions and that all documents were properly executed. Missing or inaccurate front-end documents identified in the post-closing review should be tracked and obtained. The unit should prepare reports that track these exceptions by the responsible loan closers.

Portfolio Management

The credit quality of loans that a mortgage bank originates affects the overall value of the mortgage servicing rights and the bank's cost of servicing those loans. Because poor credit quality lowers the value of servicing rights and increases the underlying cost of performing servicing functions, it is essential that a mortgage bank effectively monitor the quality of loans it originates.

One common technique mortgage banks use to monitor loan quality is vintage analysis, which tracks delinquency, foreclosure, and loss ratios of similar products over comparable time periods. The objective of vintage analysis is to identify sources of credit quality problems early so that corrective measures can be taken. Because mortgages do not reach peak delinquency levels until they have seasoned 30 to 48 months, tracking the payment performance of seasoned loans over their entire term provides important information. That information allows the bank to evaluate the quality of the unseasoned mortgages over comparable time periods and to forecast the impact that aging will have on credit quality ratios.

Mortgage bank management also should track key financial information initially received from the borrower and perform statistical analysis of borrower performance over time. This information can be used to monitor trends and provide insights into delinquency and foreclosure levels for each major product type. Original loan-to-value ratios, and housing and total debt coverage ratios are examples of essential financial statistics. Management also should review sales and repurchase data on mortgage production to assess the quality of that activity.

Production Quality Control

The Department of Housing and Urban Development (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. Quality control reviews may be performed internally or contracted to an outside vendor. The quality control function tests a sample of closed loans to verify that underwriting and closing procedures comply with bank policies or practices, government regulations, and the requirements of investors and private mortgage insurers. The unit confirms property appraisal data and borrower employment and income information. It also performs fraud prevention, detection, and investigation functions.

The quality control unit should be independent of the production function. Management of quality control should not report to an individual directly involved in the production of loans. The unit also may report to the audit committee of the board, the mortgage company president, or the chief financial officer.

The quality control unit should sample each month's new production according to the investor's sampling requirements. For the quality control reviews to be acceptable to HUD, FHLMC, FNMA, and GNMA, the sample must be skewed toward higher risk loans (e.g., those with high loan-to-value ratios). The quality control unit also should review loans that investors require the bank to repurchase, those that become delinquent within the first six months, and those which may involve fraudulent actions against the bank.

Reports issued by the quality control unit should be distributed to appropriate levels of management. The reports should summarize the work performed and overall conclusions regarding the quality of loan production and provide loan-specific findings. Quality control reports should normally be issued within 90 days of loan closing to help ensure the underlying causes of deficiencies are resolved in a timely manner. The quality control unit should require written responses to significant deficiencies from management of the responsible unit. Examiners should review several quality control reports to determine the effectiveness of management's actions to correct noted problems.

To ensure fraud referrals are promptly investigated, the quality control unit should designate an individual or group of individuals responsible for detailing potential fraud exposure for the bank. This individual or group should be responsible for submitting criminal referrals to regulatory and law enforcement agencies as required by law, and for providing fraud detection and prevention training to the sales staff, processors, underwriters, and collectors.

Allowance for Loan and Lease Losses and Recourse Reserves

Banks involved in mortgage banking activities are required to establish three accounting reserves. The allowance for loan and lease losses and recourse reserve are discussed here. The foreclosure reserve is discussed later, under the Servicing section of this introduction. Each of the reserves should be separately established and analyzed for adequacy and not commingled.

A bank's **allowance for loan and lease losses** (ALLL) should adequately cover inherent loss in mortgages owned by the bank. This includes loans in both the permanent portfolio and warehouse account.

The bank's allowance policy, provision methodology, documentation, and quarterly evaluation of reserve adequacy should comply with the requirements discussed in the "Allowance for Loan and Lease Losses" booklet of the *Comptroller's Handbook*.

Banks may sell residential mortgage loans with recourse to FNMA and FHLMC and receive sales treatment consistent with generally acceptable accounting principles (GAAP). To record these transactions as sales, the bank must identify the expected losses on the mortgages with recourse and establish a **recourse reserve** to cover the losses identified. By establishing an appropriate recourse reserve, the bank can report the transactions as sales on its quarterly Report of Condition and Income (call report) without regard to the recourse provision. (For more information on this accounting practice, see FAS 77.) Although these assets receive sales treatment for call report purposes, they generally are still counted in risk-weighted assets in computing the bank's risk-based capital ratio. A bank must count these assets for calculating risk-based capital unless it has not retained any significant risk of loss and the recourse reserve recorded under FAS 77 is equal to the bank's maximum exposure. (See 12 CFR 3, Appendix A, Section 3, footnote 14.)

The accounting treatment for sales of private-label mortgage-backed securities and nonconforming conventional mortgages depends on the amount of risk retained. The bank must account for the transaction as a financing (i.e., borrowing) on the quarterly call report if its recourse exposure exceeds its total expected loss. Only when the amount

of contractual recourse is less than or equal to the expected loss may the transaction be accounted for as a sale.

Banks report most other loan sales on the quarterly Report of Condition and Income as a financing if the bank retains any risk of loss.

Pipeline, Warehouse, and Hedging

Pipeline commitments have additional uncertainty because they are not closed loans. A mortgage commitment is said to be in the "pipeline" when an application is taken from a prospective borrower. Commitments remain in the pipeline throughout the processing and underwriting period. When the loan is closed, it is placed on the bank's books in a warehouse account where it remains until sold and delivered to an investor. Conversely, loans that the bank plans to retain should be transferred to the permanent loan portfolio after loan closing.

The loan commitment represents an option granted to the customer. While commitments give customers the right to receive the stated loan terms, they are not obligated to close the loan. Changes in interest rates can significantly influence the customer's desire to execute this option.

Warehouse loans are closed mortgages awaiting sale to a secondary market investor. Uncertainty regarding the delivery of a warehouse loan to an investor is limited to a determination of whether the loan meets investor underwriting, documentation, and operational guidelines. As a result, 100 percent of warehouse loans are normally sold forward into the secondary market.

Hedging the price risk associated with loans awaiting sale and with commitments to fund loans is a key component of a successful mortgage banking operation. The overall objective of this function should be to manage the operation's price risk and minimize market losses, not to speculate on the direction of interest rate movements. While some market risk positions are inevitable, they should always comply with board approved value-at-risk limits.

Pipeline Management

When a consumer submits a loan application, a mortgage bank normally grants the consumer the option of "locking in" the rate at which the loan will close in the future. The lock-in period commonly runs for up to 60 days without a fee. If the consumer decides not to lock-in at the current established rate, the loan is said to be "floating." Locked in pipeline commitments subject the bank to price risk, while floating rate commitments do not.

Interest rate fluctuations affect mortgage pipeline activities. Changes in rates influence the volume of loan applications that the bank closes, the value of the pipeline commitments, and the value of commitments to sell mortgages in the secondary market.

If interest rates decline when a prospective borrower's application is being processed, the applicant may decide to obtain a lower rate loan elsewhere before the loan can be closed. For this reason, interest rate declines result in an increased number of loans that do not close. Loans in the pipeline that do not close are called "fallout." The percentage of mortgages that do not make it to closing is called the "fallout percentage."

If the amount of fallout is so great that a bank is unable to meet its outstanding delivery commitments to investors, the bank may have to purchase needed loans in the secondary market at unfavorable prices or pay "pair-off fees" to liquidate its forward sale contract by a contract to commit to sell in the future with an investor. These pair-off fees equal the impact of the market movement on the price of the loans covered under the contract.

If, on the other hand, interest rates rise, fallout declines because customers have greater financial incentive to exercise their option and close the loan. When this occurs, a bank risks not having sold forward a sufficient dollar volume of mortgages. The interest rates on unhedged mortgages will be below market interest rates, causing the bank to incur a loss when it sells the loans.

Effective supervision of pipeline activities depends on accurate, detailed management information systems. Systems and pipeline modeling weaknesses, poor data quality, or inaccurate analysis could adversely impact business decisions and results. Reports should provide management with information needed to determine an appropriate strategy for offsetting (hedging) the bank's risk.

Reporting systems should monitor the volume of loan applications that will continue through the various aspects of the origination process, become marketable loans, and be delivered to investors. The reports also should monitor the status of delivery commitments to investors, the effectiveness of hedges, and historical fallout rates for each specific loan category (e.g., 8 percent, 30-year fixed rate FHA loans or 7.50 percent, 15-year conventional loans). The bank also may use a pipeline hedge model to estimate fallout volumes under various interest rate scenarios.

Management also should develop prudent risk management policies and procedures, including earnings-at-risk parameters to guard against adverse financial results. (For appropriate risk management practices, see BC-277, Risk Management of Financial Derivatives.) Residual bank's hedging practices should be quantified and reported to senior management regularly.

Hedging the Pipeline Against Fallout

There are several approaches to protect, or hedge, the bank from fallout or unforeseen problems in the pipeline. The most common hedging technique is to sell forward the percentage of the pipeline that the bank expects to close. For example, if a bank anticipates 30 percent of applications to fall out, it will sell forward an amount equal to 70 percent of the mortgage applications in the pipeline. If the bank has estimated correctly and closes 70 percent of the loans, the pipeline is completely hedged. If the bank closes more or less than the 70 percent, however, it is exposed to price risk.

Many banks use a combination of forward sales and options to offset price risk. For example, if the bank anticipates closing 80 percent of the loans in the pipeline under the best of circumstances but only 60 percent under a worst-case scenario, it could sell forward an amount equal to 60 percent of the pipeline and purchase options to sell loans in the market on 20 percent of the pipeline. This method hedges the pipeline as long as 60 to 80 percent of the loans close. Using options to hedge pipeline risk is effective, but also more expensive than solely using forward sale contracts.

Warehouse Management

A mortgage bank normally holds a loan in the warehouse account for no more than 90 days. These loans are typically already committed for delivery to an investor. Loans remaining in the warehouse for a longer period may indicate salability or documentation problems. Unsalable mortgages should be transferred out of the warehouse and into the bank's permanent loan portfolio. This transfer must be recorded at the lower of cost or market value (LOCOM).

The warehouse needs to be reconciled on an ongoing basis. Normally, monthly reconciliations are sufficient and provide a means of detecting funding or delivery errors.

Hedging the Warehouse

Warehouse loans that are not adequately covered by forward sales commitments or other hedges expose the bank to price risk. If interest rates rise, the bank may have to sell the loans at a loss. For this reason, banks should hedge

warehouse loans if the loans pose more than nominal risk exposure.

Accounting for Pipeline Commitments and Warehouse Loans

Pipeline commitments and mortgages in the warehouse are classified as “held-for-sale” and, as stipulated in Statement of Financial Accounting Standards (SFAS) No. 65, should be accounted for at LOCOM. Warehouse loans should be reflected on the balance sheet separately from the bank’s permanent portfolio of loans. Warehouse loans are reported on the quarterly Report of Condition on schedule RC-C. Pipeline commitments should be accurately reported as a contingent liability on schedule RC-L, line 1e B other unused commitments.

Secondary Marketing

A bank’s secondary marketing department, working with production management, is responsible for developing, pricing, selling, documenting, and delivering mortgage products to investors. A bank must consistently demonstrate reliable performance in underwriting, documenting, packaging, and delivering quality mortgage products to remain in good standing with secondary market participants. Poor performance of loans sold could lead to unfavorable prices for future sales or terminated relationships.

Product Development

As discussed earlier, mortgage loans sold to government-sponsored agencies must meet each agency’s specific underwriting and eligibility guidelines. FHA and VA loans are eligible for sale into GNMA securities. Conforming conventional loans (and certain FHA and VA loans) may be sold into FNMA and FHLMC securities. Nonconforming (jumbo) conventional mortgages and mortgages which do not meet agency underwriting guidelines may be sold through private label securities or to private investors.

The secondary marketing department should ensure that the loan products the bank intends to sell meet the guidelines established by investors. Before offering a new type of loan, the secondary marketing department should determine its marketability and consider the bank’s ability to price, deliver, and service the product. The bank’s legal counsel and compliance personnel also should review new products to determine if they comply with applicable laws and regulations.

Mortgage Pricing

Mortgage pricing is closely tied to the mortgage-backed securities market. The servicing option and remittance cycle also influence the price.

Price quotes for FNMA, FHLMC, and GNMA mortgage-backed securities are readily available on automated security screens at most secondary marketing departments. Because of guarantee fees and normal servicing fees, mortgages are typically sold into securities with pass-through rates 0.5 percent below the mortgage note rate. If the security price for a 60-day forward 8.00 percent, 30-year FNMA is 99, the bank must charge its customer one discount point for an 8.50 percent, 30-year mortgage, to be priced at the market.

During periods of aggressive competition, banks occasionally offer their mortgage products below applicable security prices at a marketing loss (e.g., an 8.50 percent mortgage with no discount points). Alternatively, banks sometimes price their mortgage products at a premium to the market (e.g., an 8.50 percent mortgage with two discount points).

Management should give appropriate consideration to mortgage pricing to ensure it is consistent with the company’s

strategic plan and earnings objectives. Although secondary marketing personnel should establish prices with input from the head of production, originators should not be allowed to overly influence or dominate pricing decisions.

Recourse Options

A bank can choose to service loans for investors on either a recourse or non-recourse basis. Servicing with recourse allows the bank to increase the price at which it sells loans. Management should ensure that the bank is adequately compensated for the credit risk retained.

Loans are serviced for FNMA under either "regular" or "special" servicing options. With FNMA "regular" servicing, the bank retains all risk of loss from mortgagor default. With FNMA "special" servicing, the bank only retains exposure for normal representations and warranties (i.e., ensuring that the mortgage was properly underwritten according to established guidelines). FHLMC offers similar servicing options. GNMA servicing carries no contractual recourse; however, in the event of mortgagor default, the servicer has exposure for principal loss (VA no bid), interest loss (FHA), and other nonreimbursable expenses incurred as part of the collection process.

Regulatory accounting permits sales treatment for FNMA and FHLMC mortgages sold with recourse. If the bank retains recourse on any other transactions, regulatory accounting prohibits sales treatment unless the expected loss exceeds the bank's exposure. The bank must establish appropriate reserves for all recourse exposure. (Additional information can be found earlier, under the Allowance for Loans and Lease Losses and Recourse Reserves section.)

Guarantee Fee, Float, and Remittance Cycle

The amount of guarantee fees the bank pays agency and private guarantors is negotiable. Guarantee fees are based on the amount of risk assumed by the bank and the timing of cash flows (remittance cycle) paid to the investor. The longer the guarantor holds the mortgage payments, the smaller the guarantee fee necessary to compensate them. Investors have different requirements for accounting cutoff dates, payment schedules, and remittance dates.

FNMA and FHLMC allow the seller (bank) to either "buy up" or "buy down" the guarantee fee. These options provide the bank the flexibility for increasing or decreasing the amount of excess servicing. If the bank buys up the guarantee fee (i.e., pays a higher fee to FNMA or FHLMC), it increases the amount of cash it receives in exchange for a smaller excess servicing fee when the mortgages are sold. When the bank buys down the guarantee fee, it receives less cash from the sale in exchange for a larger excess servicing fee over the life of the underlying loans.

Selling Mortgages

A bank can sell mortgages in the secondary market as an individual (whole) loan or as part of a pool of loans. Pools are usually made up of loans with similar characteristics, such as product type, underwriting terms, interest rate, original or remaining maturity, and payment frequency. Banks that originate a substantial number of mortgage loans normally pool them to sell because it produces a higher price and reduces transaction costs.

Loans also may be "swapped" for pass-through certificates issued by investors (i.e., FHLMC). In this transaction, the bank gives up a portion of the interest income on the loan (generally 0.25 percent) in return for a more liquid asset and more favorable risk-based capital treatment. The bank retains servicing of the loans which back the certificate. Banks that engage in the swap program must follow generally accepted accounting principles and recognize loan origination fees and direct origination costs over the life of the loan, as prescribed by SFAS No. 91. (See SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating and Acquiring Loans.")

A bank's relationship with an investor is usually based on a commitment from the investor to purchase a specific dollar volume of loans. A "master sales commitment" details the dollar amount and/or maturity of the obligation. This document also describes investor-mandated underwriting standards as well as delivery and mortgage servicing requirements.

Frequently, master sales commitments require mandatory delivery of loans. This contractually obligates the bank to deliver a specific dollar volume of mortgages to the investor. If the bank is unable to deliver the required volume within the specified commitment period, it must either purchase loans from other sources to deliver or pay the investor a pair-off fee.

Sales commitments also may involve "best efforts" (optional) delivery. Under such commitments, the bank is not contractually obligated to deliver a specific dollar volume of loans to the investor. Mandatory delivery contracts normally produce higher selling prices for the loans than best efforts contracts but contain more uncertainty and risk.

Documentation and Delivery

To fulfill its delivery responsibilities, the banks must obtain all mortgage documents for its investors. Front-end documents are obtained before, or at, closing. Post-closing documents such as mortgages, assignments, and title policies must be recorded by local authorities or issued by the title company. Post-closing documents may normally be received up to 120 days after closing.

A good tracking system for document collection activities is necessary to ensure an effective process. The system should identify the customer by name, the document missing, and the number of days since loan closing. The bank should diligently follow up on and obtain these documents. Failure to obtain mortgage documents in a timely manner can result in unnecessary financial and legal exposure for a bank.

A bank that sells mortgages into GNMA securities must obtain a third party certification that all loan documents are on file. A bank's affiliate or subsidiary company is eligible to certify the pools; however, in this arrangement GNMA requires the bank to have a separate trust department. The file custodian issues the final pool certification after verification that all documentation is complete. If one loan in the pool is missing a single document, the entire pool may not receive final certification.

GNMA has established tolerance levels for the final certification, transfer, and recertification of mortgage pools. Examiners should be sure to reference current GNMA pool certification requirements. If the seller exceeds the established limit, GNMA can require the seller to post a letter of credit to protect GNMA against potential loss. FNMA and FHLMC do not have a specific monetary penalty in place, but do require an appropriate document collection process.

Sales contracts with private investors or purchasers of servicing normally require all documents to be obtained. Common contract provisions include requirements that the seller repurchase defective mortgages, the buyer's ability to hold back sales proceeds, and indemnification of the buyer from losses resulting from missing documents.

Servicing

Servicing revenue is a primary source of income for many banks engaged in mortgage banking. To be successful, the servicer must comply with investor requirements and applicable laws, have strong internal controls, and manage costs. A servicing agreement between the bank and each investor describes the investor's requirements for servicing its assets and the manner in which the servicer will be compensated. Ultimately, if a bank fails to appropriately service an investor's portfolio, the servicing rights could be revoked without compensation.

In addition to the contractual servicing fee paid by each investor, mortgage banks are compensated for their servicing activities through: (1) income resulting from borrower/investor payment float; (2) ancillary income from late fees, commissions on optional insurance policies (credit life, accidental death, and disability), and miscellaneous fees; and (3) benefits of compensating balances from custodial funds.

Effective cost management is essential for servicers. Management should understand the company's cost to service each major type of loan in order to assess product profitability. By understanding its servicing profitability, management is better able to make informed strategic decisions regarding the portfolio. Detailed information systems capable of measuring and analyzing servicing costs are an essential part of this process.

Servicing Functions

Loan servicing involves several areas of responsibility:

- Cash management.
- Investor accounting and reporting.
- Document custodianship.
- Escrow account administration.
- Collection.
- Other real estate owned (OREO).
- Loan setup and payoff.
- Customer service.
- Other servicing arrangements.

Cash management consists of collecting borrowers' mortgage payments and depositing those funds into custodial accounts. The principal and interest portion of each payment is separated from the portion set aside for escrow items. These custodial accounts require daily balancing and monthly reconciliation, control over disbursements, segregation of administrative duties, and the deposit of funds into appropriate financial institutions.

Investor accounting and reporting consists of performing various recordkeeping functions on behalf of investors. Strong internal control systems must be in place to ensure accurate accounting and reporting. The bank should reconcile each investor account monthly. Outstanding reconciling items generally should be resolved within 30 days. The bank should review the aging of unreconciled items on a regular basis and charge off uncollectible balances.

Servicers process borrowers' loan payments and remit principal and interest to investors according to the specified remittance schedule. Most commonly, the schedule of borrowers' payments (whether actually made or not) determines the remittance schedule to the investor. In other cases, investors are not paid until the servicer actually receives payments from the homeowners.

Investor accounting responsibilities vary according to the type of servicing program. As an example, with GNMA I servicing, the servicer remits principal and interest to individual security holders and is responsible for maintaining a current list of all security holders. With GNMA II, FNMA, and FHLMC servicing programs, the servicer forwards remittances to a central paying agent who remits payments to the security holders based upon a specified schedule.

Some investors allow the servicer to purchase a loan from the pool when the loan reaches a certain level of delinquency as outlined in the seller/servicer agreement. This allows the servicer to reduce the costs of remitting principal and interest payments on behalf of a past-due borrower. To maintain the government agency guarantee or insurance, however, the servicer must continue to follow the agency's servicing guidelines.

Conversely, the bank should establish controls to prevent the purchase or removal of a loan from the pool before allowed by investor-established time frames. Premature purchase or removal of a loan harms investors by inappropriately reducing the outstanding balance of their portfolio.

Servicing adjustable-rate mortgage loans requires special operating controls. In particular, the bank should ensure interest rate adjustments are properly performed and documented, and that customers are notified in accordance with investor guidelines.

A servicer's investor reporting responsibilities involve preparing monthly reports to investors on principal and interest collections, delinquency rates, foreclosure actions, property inspections, chargeoffs, and OREO. Servicers also report information to consumer credit bureaus on the past-due status of a homeowner's loan.

Document custodianship consists of adequately safekeeping loan documents. Original documents should be stored in a secured and protected area such as a fireproof vault. Copies of critical documents (i.e., a certified copy of the note) should be maintained in a separate location. Servicers also should maintain an inventory log of documents held in safekeeping. The log should identify documents which have been removed and by whom. Some investors require the servicer to employ a third-party custodian to safeguard loan documents. In such cases, the servicer is responsible for timely delivery of documents to the custodian.

Escrow account administration consists of collecting and holding borrower funds in escrow to pay real estate taxes, hazard insurance premiums, and property assessments. The escrow account administration unit sets up the account, credits the account for the tax and insurance funds received as part of the borrower's monthly mortgage payment, makes timely payments of a borrower's obligations, analyzes the account balance in relation to anticipated payments annually, and reports the account balance to the borrower annually. If a borrower's escrow account has a surplus or shortage, the unit makes a lump-sum reimbursement or charge to the borrower, or adjusts the amount of the homeowner's monthly mortgage payment accordingly.

A servicer may collect and hold escrow funds on behalf of each borrower only up to the limits established by 12 U.S.C. 2609, the Real Estate Settlement Procedures Act (RESPA), i.e., up to the amount required to make expected payments over the next 12 months plus an additional one-sixth of that amount. This limit applies to funds collected at closing as well as those collected throughout the life of the loan. State laws may also prescribe escrow account balance limits and, in some cases, require the servicer to pay interest on escrow balances.

Collection consists of obtaining payment on delinquent loans by sending written delinquency notices to borrowers, making telephone calls and arranging face-to-face contacts, conducting property inspections, and executing foreclosure actions.

The collection unit should closely follow investor requirements on the timing and manner of collection activities. Collection personnel should document each step in the collection process including actions taken, the date of each action, success in contacting the borrower, and the commitment received from the overdue borrower.

Collection activities must comply with the Fair Debt Collection Practices Act (15 U.S.C. 1692). Among other things, this law defines from whom a debt collector may gather information on a consumer, the type of information that may be collected, and the acceptable forms of communicating with the consumer and other parties. The servicer must also follow state laws pertaining to collection and foreclosure actions.

In some cases a collection unit may enter into a short-term forbearance arrangement with a delinquent borrower before beginning a foreclosure action. For example, a servicer may permit the borrower to defer payments, follow an

alternative repayment plan, or execute a deed-in-lieu of foreclosure. Management should have information systems adequate to analyze forbearance activities. The collections unit also should soundly derive and thoroughly document the reason for each forbearance arrangement and obtain investor approval, if necessary.

A servicer advances funds and incurs costs on behalf of investors during the collection process and during the time foreclosed property is administered as other real estate owned. An account receivable is normally established to account for these investor advances. The investor subsequently reimburses the servicer for much of the funds advanced and costs incurred. The servicer will still likely incur some of the costs associated with collecting a delinquent loan, even for mortgages serviced with no contractual recourse. One example of this arises in a VA “no-bid” action. If the loss expected to be recognized by the VA following a foreclosure is greater than the amount of the VA guarantee, the VA may elect to pay the full amount of its guarantee to the servicer and transfer title to the property. The servicer is left to administer and dispose of the property, commonly at a substantial loss. Other noteworthy collection costs include nonreimbursed interest advances on FHA loans and expenses above those considered normal and customary by investors.

The bank should establish a “foreclosure reserve” to provide for uncollectible investor advances. Using historical collection and disposal costs for each major product type as a guide, the foreclosure reserve should adequately cover expected losses. Chargeoffs, recoveries, and provision expenses should be recognized through the foreclosure reserve.

Other real estate owned (OREO) administration consists of managing and disposing of foreclosed properties. Some mortgage servicing agreements require the servicer to take legal title to OREO; for example, loans sold with recourse or a VA no-bid loan. In these cases, the investor transfers property title to the servicer following the foreclosure action. If the bank has or will obtain legal title to the property, management must follow the terms and conditions under which a national bank may hold real estate and other real estate owned, as specified in 12 U.S.C. 29 and 12 CFR 34. When the bank bears primary loss exposure for a serviced loan, management must follow the instructions for preparation of the Report of Condition regarding loan loss recognition and OREO reporting.

Servicing agreements may also include provisions involving OREO that merely require the servicer to perform administrative duties as agent for the investor. For example, the servicer may be required to secure and protect the property, conduct inspections on a regular basis, obtain a current appraisal, and market the property.

Loan setup and payoff consists of inputting information into the automated servicing system and processing loan payoffs. The loan setup unit inputs information regarding the borrower, the type of loan and repayment terms, and the investor. Appropriate servicing of the loan requires the setup unit to input data accurately and in a timely manner (normally within 15 days of loan closing, or moderately longer for acquired loans). The setup unit, or some other related unit, normally sends the borrower a letter which introduces the company's services and includes the first payment coupon. This “welcome letter” helps to establish positive customer relations and to reduce the volume of loans with “first payment default” (which may cause an investor to refuse the loan). Given the large volume of inputs, loan setup is an expensive process for many servicers. Commonly, the cost of loan setup exceeds all or most of the first year's servicing revenue.

The payoff unit is responsible for processing loan payoffs, including recording the mortgage satisfaction and returning the original note to the borrower. Failure to process the mortgage satisfaction in accordance with state laws may result in monetary fines.

If a loan pays in full during the month, some investors require the servicer to remit a full month's interest even though the borrower only paid interest through the payoff date. This interest expense can significantly impact servicing costs in periods of high payoffs. The examiner should assess the bank's efforts to minimize this interest expense.

Customer service creates and maintains a positive relationship with borrowers. The customer service unit researches and answers customer questions. Customer service commonly tracks customer complaints and ensures they are satisfactorily addressed. Customer service efforts are especially important before and after servicing portfolio purchases or sales, or during periods of high business activity.

Other servicing arrangements that are important to mortgage servicing include data processing systems and outside vendors and subservicers. To assist in tracking servicing-related information, the servicer should employ an adequate data processing system. A bank servicer should have thorough controls and audit coverage in place to ensure the integrity of the information.

A servicer may employ outside vendors and subservicers to perform various servicing tasks such as making real estate tax and insurance payments, performing lock-box services, conducting property inspections, and performing custodial duties for loan documents. In such situations, management should regularly assess the quality of each vendor's work and annually evaluate the vendor's financial strength.

Servicing Quality Control

Banks are encouraged to have a quality control function that independently reviews the work performed by each servicing function. The quality control unit should test a representative sample of transactions, report its findings to appropriate levels of management, and require written responses for significant findings.

Mortgage Servicing Assets

Mortgage banking activities commonly result in the creation of mortgage servicing rights (purchased and originated) and excess servicing fee receivables (ESFR) assets. Purchased mortgage servicing rights (PMSR) and originated mortgage servicing rights (OMSR) represent the cost of acquiring the rights to service loans for others.

The Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 122 (SFAS 122) allowing originated mortgage servicing rights (OMSR) as assets on a bank's balance sheet. Previously, banks could not record OMSR as an asset. Efforts are currently underway to consider revising current regulatory capital and reporting treatment of OMSR. Once a final decision is made on regulatory treatment for OMSR, these procedures will be revised to incorporate any changes.

Mortgage Servicing Rights

Methods of Acquiring PMSR and OMSR Assets

A bank may build a mortgage servicing portfolio by purchasing the right to service a group of loans for an investor. A bank can purchase the right to service mortgages and create PMSR in any of three ways: bulk acquisitions, production flow activities, or business combinations. OMSR can be acquired through the bank's retail loan production activities. Both originated and purchased mortgage servicing rights are reported on the bank's quarterly Report of Condition on schedule RC-M.

In a **bulk acquisition** transaction, a mortgage bank purchases the servicing rights only, leaving ownership of the underlying mortgages or securities to the investor. A bank may capitalize the cost of purchasing these servicing rights, but the amount capitalized should not exceed the assets' purchase price or fair value.

Before proceeding with each bulk acquisition, the bank should conduct a due diligence review of the servicing portfolio it is considering acquiring. The review should document and analyze all of the characteristics of the portfolio. In addition, the reviewer's analysis of the economic value of the servicing rights should be documented in writing, including the valuation assumptions used. The bank should keep records of due diligence reviews for every purchased portfolio.

Production flow activities are transactions in which the bank purchases both newly underwritten mortgage loans and the rights to service those loans. The bank must allocate the purchase price between loans and acquired servicing rights if it has a definitive plan to sell (or securitize) the loans at the time of the purchase transaction. To qualify as a definitive plan, the bank must have formally committed to sell (or securitize) the loans before it completes the purchase, obtain a commitment to sell the mortgages to an investor within a reasonable time frame after the purchase (usually within 30 days), or, before the purchase date, make a commitment to deliver the mortgage loans for securitization. The plan to sell (or securitize) the loans should include estimates of the purchase price and selling price of the mortgages.

If the bank does not have a definitive plan to sell or securitize the mortgages, PMSR cannot be booked at the purchase date. Instead, the cost of acquiring the servicing rights is included as part of the overall cost of purchasing the mortgages.

In a **business combination**, the bank records PMSR and OMSR formerly held by the entity acquired. If the business combination is a purchase transaction, the purchasing bank should record as PMSR the existing mortgage servicing rights of the acquired bank at fair value. The purchasing bank also must book the fair value of uncanceled servicing rights associated with mortgages that the acquired bank originated and sold. When determining the fair value of PMSR, the purchasing bank should consider the market prices currently being paid for servicing rights similar to those acquired.

If market prices are unavailable, SFAS 65, as amended by SFAS 122, requires the purchasing bank to use alternative methods to value the servicing rights (i.e., a discounted cash flow method using a market value discount rate, option-pricing models, matrix pricing, option-adjusted spread models, and other fundamental analysis). When using the discounted cash flow method, the purchasing bank should estimate the net servicing income it expects to earn over the predicted life of the underlying mortgages. In arriving at the projected net servicing income, the purchasing bank should deduct all related expenses that are predicted to occur over the same period. The purchasing bank should then discount the estimated future net income stream using a market yield to arrive at the fair value of the servicing rights. PMSR cannot be recorded for more than its purchase price or present value.

If the business combination is accounted for as a pooling of interests, the purchasing bank may not book PMSR on the loans the acquired bank originated and sold, but did not capitalize. Under accounting rules for pooling of interest, the assets and liabilities of the two banks are merely added together at their current book values. The purchasing bank cannot make adjustments to reflect fair value of the acquired assets.

Retail Production consists of activities in which the bank, through its branch network or production units, originates new mortgage loans that close in the bank's name or the name of one of its subsidiaries. If the bank has a definitive plan to sell (or securitize) the loans at the time they are originated, it must capitalize a portion of the origination cost that relates to the originated servicing rights (OMSR). The amount capitalized should be based on the relative fair values of the mortgage loans and the servicing rights. Costs other than direct loan origination costs must be charged to expense when incurred; therefore, only direct loan origination costs are deferred as part of the cost of the loans. When the loans are purchased, however, the cost may include both the seller's indirect and direct costs. Thus, all other things being the same, the costs capitalized for retail originated loans generally are less than the those for purchased loans and the gain generally will be greater.

If the bank intends to hold the mortgages in its loan portfolio, the entire origination cost is allocated to the mortgage loans

and no cost is allocated to mortgage servicing rights.

Documentation and Recordkeeping

A bank should have adequate recordkeeping systems in place to monitor its origination and production flow activities as well as its bulk acquisitions. These records should support and account for the value assigned to each PMSR and OMSR asset when it was initially booked. The system should also monitor prepayment and other changes in valuation on an ongoing basis.

A bank should maintain a file for each bulk acquisition. Each file should document the bank's original expectations for the life of the net revenue stream and the valuation assumptions used to capitalize those net cash flows.

Records for production flow activities should detail dates and prices for purchases, sales commitments, and ultimate sales. The bank should document losses and gains recognized. For retail acquisitions (originations), the bank should maintain records supporting fair value allocations and related assumptions.

When a bank records PMSR as a result of a business combination purchase transaction, the acquiring bank should document the methodology used to compute the fair value of the acquired servicing assets. For a pooling of interests, the acquiring bank should document the book value of the acquired bank's existing mortgage servicing rights as of the pooling date. The acquiring bank also should document the assumptions the it used to arrive at that value.

Valuation and Amortization

The value of a servicing asset is based on its expected future cash flows. To value servicing rights, a bank estimates the net servicing income it will earn from the servicing activities, and discounts that income stream to its present value using a discount rate that reflects the riskiness (i.e., uncertainty) of the cash flows.

Most mortgage loans are repaid well before contractual maturity, as homeowners move, refinance, or simply pay the loan ahead of schedule. To estimate the income it will receive from servicing the loans, however, a bank must project the level of servicing fees it can expect from the loan pool as individual loans prepay over time. The prepayment speed is a key component in a valuation model, and represents the annual rate at which borrowers are forecast to prepay their mortgage loan principal. Common prepayment speed measures used by the industry include Public Securities Association (PSA), Conditional Prepayment Rate (CPR), and Single Monthly Mortality (SMM). (For definitions of these terms, see the Glossary.)

A prepayment model provides an estimate of contractual income from loan servicing. Total servicing income includes:

- Contractual income.
- Earnings on escrow deposits.
- Float resulting from timing differences between borrower payments and investor remittance.
- Late fees.
- Ancillary income.

Servicing expense items should incorporate direct servicing costs and appropriate allocations of other costs. Estimated future servicing costs may be determined based on additional (or incremental) costs that the bank will incur as a result of adding additional loans to its servicing portfolio.

Once a bank has estimated the net servicing income (expected servicing income less expected servicing expenses) it will receive for servicing the pool, it must discount these cash flows to their present value by using a market discount

rate appropriate for mortgage servicing rights (MSRs). The discount rate used should equal the required rate of return for an asset with similar risk. It should consider an investor's required return for assets with similar cash flow risks, such as mortgage-backed interest-only strips for similar underlying mortgages. The discount rate also should consider the risk premium for the uncertainties specifically associated with servicing operations (e.g., possible changes in future servicing costs, ancillary income, and earnings on escrow accounts). The fair value of the servicing rights is the present value (using an appropriate market discount rate) of the expected net servicing income.

When valuing mortgage servicing rights, banks should use a prepayment speed based on long-term prepayment estimates for the underlying mortgages. Prepayment speeds should be realistic and substantiated by independent sources. (Examples of independent sources are Bloomberg, Telerate, and Knight Ridder.) Banks with substantial servicing assets should track their own prepayment experience for different pools and types of mortgages to validate prepayment assumptions they use in valuation models. If a bank's servicing portfolio consistently experiences prepayment rates that differ from industry experience for similar pools, because of regional or other factors, the bank may use customized prepayment speeds. If the bank uses customized prepayment speeds, those speeds must be both well supported and properly documented.

If a bank's estimate of fair values is not based on appropriate market discount rates and realistic prepayment speeds, MSR values will not be supportable. If a slower than expected prepayment speed, or an inappropriately low discount rate, is used, the capitalized book value of the MSR assets will be inflated. Employing a faster prepayment speed and/or a higher than market discount rate will have the opposite effect.

Initial Recordation of Servicing

A bank that purchases or originates mortgage loans with a definitive plan to sell or securitize the loans, and retain the servicing rights, must allocate the cost of the mortgage loans between the loans and the servicing rights. The allocated cost must be based on the relative fair value at the date of purchase or origination, if it is practicable to estimate those fair values. The allocation shall be based on the assumption that a normal servicing fee will be retained and the remaining cash flows will be sold or securitized.

For example, if the cost to purchase or originate a loan is \$99,000, and the fair value of the loan (without the servicing rights) and the servicing rights are \$98,000 and \$2,000 respectively (total \$100,000), then 98 percent of the cost is allocated to the loan and 2 percent is allocated to the servicing rights. Therefore, the loan and rights would be valued at \$97,020 and \$1,980 respectively, as shown below:

Loan	\$97,020	(\$99,000 x .98)
Servicing rights	\$1,980	(\$99,000 x .02)

A bank that does not have a definitive plan to sell or securitize at the time of purchase or origination, but later sells or securitizes the mortgage loans and retains the servicing, must capitalize the servicing at the date of sale (or securitization). The cost allocated to servicing, however, must be based on relative fair values of the loans and servicing rights at the date of sale or securitization.

When allocating the costs, a bank must consider quoted market prices or market prices currently available for servicing similar to that purchased or originated. If similar servicing pools are not available, a bank may use alternative methods, such as a discounted cash flow method (described above) or other appropriate methodology, to estimate the fair value.

When estimating fair value, a bank should consider the expected life of the anticipated future servicing revenue stream, not the contractual maturity of the loans being serviced. Because loans prepay, the life of the revenue stream will be

less than the contractual maturity of the serviced mortgages. A bank should incorporate assumptions that buyers would use in their estimate of future servicing income and expense.

Amortization of MSRs

Banks must amortize PMSR and OMSR in proportion to, and over the period of, the net servicing income. For example, if the bank expects to receive 10 percent of its estimated net servicing income in the first year, 10 percent of the purchase price of the servicing rights should be amortized in the first year.

For each pool of serviced loans, net servicing income will be greatest in the earlier years of the mortgages and will decline as borrowers pay down the principal on their loans. Because of this, a bank should use an accelerated amortization method for PMSR and OMSR. As indicated in the instructions for the Report of Condition, the maximum period for amortizing PMSR and OMSR is 15 years. If unexpected changes in net servicing income occur, or are expected to occur because of prepayments or other changes, the bank must adjust its amortization rate accordingly.

Impairment Analysis

Banks should assess the characteristics of the underlying mortgage loans and choose one or more of the appropriate predominate risk characteristics (e.g., loan type, such as the various conventional or government-guaranteed or insured mortgage loans, adjustable-rate or fixed-rate mortgage loans; size of loan; note rate; date of origination; term; and geographical location) to stratify (group) the costs of PMSR and OMSR. PMSR and OMSR may be combined for purposes of developing appropriate risk strata. Banks may apply previous accounting policies for stratifying mortgage servicing rights that were capitalized prior to the adoption of SFAS 122.

Each quarter, a bank must evaluate its servicing portfolio for declines in value (impairment). Impairment should be measured by stratum on a fair value basis. Banks record impairment by establishing a valuation reserve for each stratum in which the combined book value of the mortgage servicing rights (PMSR and OMSR) exceeds fair value.

To the extent possible, banks should base the quarterly valuation on market quotes from active markets. If market prices are unavailable, the bank should use the best information available in the circumstances including, for example, prices of similar assets, discounted cash flow calculations, and various other fair value valuation techniques.

Estimates of fair value of each stratum selected should incorporate market participants' assumptions including market (current) discount rates, prepayment speeds, and valuation assumptions unique to each underlying loan pool. Loan pools that have similar risk characteristics can be combined to measure fair values within each stratum. Unanticipated prepayments, a change in future expected prepayments, loan delinquencies, defaults, and certain other events may affect the fair value of any particular stratum.

To appropriately assess impairment, banks generally will need to perform a detailed analysis of the loan pools that underlie each stratum. The detailed analysis may include assessments based on product, term, interest rate, and other relevant characteristics (e.g., FNMA, 15-year, weighted average coupon 9.50 percent).

To determine impairment of a particular stratum, banks may combine the unimpaired servicing pools with impaired pools within each stratum. If the impairment analysis reveals that current book value of a stratum (net of amortization) is greater than fair value, the bank must increase the valuation allowance for that stratum by the difference. The fair value of mortgage servicing rights that have not been capitalized shall not be used in the evaluation of impairment.

When determining if the value of a stratum is impaired, a bank may not offset losses in one impaired stratum against

gains (if any) in another. Valuation allowances for an individual stratum may be reduced or eliminated if values recover; however, it is never appropriate to write up the unamortized book value of a stratum on a bank's books.

Management should document their quarterly reviews for impairment. The documentation for each stratum should include, at a minimum, the original and current book values of the servicing rights, dates acquired, the original and current balances of the underlying mortgages, loan characteristics (e.g., GNMA, 30-year, weighted average coupon 10 percent, 200 PSA), and the remaining absolute and discounted net cash flows. The bank should maintain this information for individual bulk acquisitions as well as for business combinations. For origination and production flow activities, the bank, at a minimum, should maintain this information by product type and by month. Documentation of the quarterly analysis for impairment also should include a summary rollforward of the activity in the valuation allowances for each individual stratum during the period, including any additions charged, reductions credited to operations, and direct write downs charged against the allowance.

Excess Servicing Fee Receivables

Excess servicing fee receivables (ESFR) represent the present value of servicing revenue above the contractual servicing rate (normal servicing fee). ESFR can be recorded for mortgages originated by the bank and for those obtained through production flow activities and subsequently sold.

Recording ESFR

The interest rate paid by a borrower on a mortgage loan ordinarily is greater than the rate "passed through" to the owner of the loans (the pass-through rate). If the rate paid by the borrower minus the pass-through rate is positive and exceeds the sum of the normal servicing fee plus the applicable guarantee fee, a bank can capitalize an ESFR asset. For example, consider a 30-year, fixed rate, conventional loan. If the loan rate is 9 percent, the pass through rate is 8.5 percent, the normal servicing fee is 0.25 percent (25 basis points), and the guarantee fee is 0.21 percent (21 basis points), then the excess servicing fee is 0.04 percent (4 basis points). The ESFR asset is reported on the bank's quarterly Report of Condition on schedule RC-F, line 3.

According to SFAS 65 and regulatory accounting rules, if the actual servicing fee is less than the normal servicing fee, the sales price of the loans associated with a particular ESFR asset must be adjusted to provide for the recognition of a normal servicing fee in each subsequent year. The amount of the adjustment is the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been specified. (The amount of this adjustment is the present value of the future excess servicing-related cash flows described in the preceding paragraph.) In addition, if normal servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing shall be accrued at that date.

The ESFR asset results in a larger gain or smaller loss on the sale of loans. This is in addition to any cash gain or loss from the sale. The recognized gain cannot exceed the gain that would have been realized for the same sale with servicing released. In addition, if the applicable guarantee fee and normal servicing fee exceed the interest rate difference between the weighted average coupon (WAC) and the pass-through rate, the bank must record a loss.

Documentation and Recordkeeping

A bank should have recordkeeping systems that support and account for the initial and ongoing values assigned to ESFR assets. For each sale of ESFR-related mortgages, the bank should maintain a file that documents the assumptions used to value and record the corresponding ESFR asset.

In addition, the bank should have a system that tracks actual payment experience for individual mortgage pools. The

system should also contain information on the original and current principal balance for each pool; original and current book values of ESFR assets; and the discount rate, prepayment speed, and excess servicing fee used to calculate the present value of the excess servicing fee receivable for each pool. The bank should use this information when preparing the quarterly ESFR impairment analysis. The current servicing fee can change over time if mortgages with different note rates are sold into the same security.

Because ESFR assets represent earnings and capital to the bank when they are recognized, overly optimistic or unreasonable assumptions could result in overstated earnings and capital. A bank should have satisfactory policies, procedures, and control systems in place to ensure that ESFR are realistically valued and that the book value is based upon prudent assumptions.

Valuation and Amortization

The initial book value of each ESFR asset should be based upon cash flow calculations that use the expected lives of the underlying mortgages—not the contractual maturity of the loans. This is because prepayments will shorten the contractual maturities of the underlying mortgages. In addition, normal amortization of loan principal and prepayments will cause this cash flow to steadily decrease over time.

A bank should use a market rate to discount the expected cash flow stream related to each ESFR asset in order to determine its present value. The discount rate should be an appropriate long-term rate that considers the risks associated with ESFR. As a **guideline** to determine if the discount rate for an ESFR asset is appropriate, examiners should remember that risks associated with ESFR correspond to those of mortgage-backed interest-only securities. These ESFR assets frequently have required returns approximately 200 basis points in excess of the underlying mortgage interest rate. Higher or lower discount rates may be appropriate, but should also be adequately supported. The bank's cost of funds rate, a Treasury security rate, or the mortgage note rate are not appropriate discount rates because these rates do not reflect the underlying risk of the ESFR asset.

If cash flow calculations are not based on appropriate long-term rates, ESFR book values will not be supportable. If a slower than expected prepayment speed or an inappropriately low discount rate is used, the capitalized book value of the ESFR asset will be inflated. Employing a faster prepayment speed and/or a higher-than-market discount rate has the opposite effect on book value, e.g., it underestimates the value of the asset. Banks should use prepayment speeds which are realistic and supportable.

A bank should use either the interest method or the level yield method to amortize the ESFR associated with each loan pool. As was the case with the initial book value calculations, the amortization period for each ESFR asset should be based on the projected lives of the underlying mortgages, not the contractual maturities of the loans. At a minimum, the bank should establish different amortization periods for distinctly different mortgage products (for example, 15-year fixed, 30-year fixed, and adjustable-rate mortgages).

The following is a formula for determining ESFR:

$$\text{Principal Balance of Mortgage Pool} \times \text{Excess Servicing Fee} \times \text{Conversion Factor} = \text{ESFR}$$

The excess servicing fee is the servicing fee remaining after subtracting the pass-through rate, guarantee fee, and the normal servicing fee from the weighted average note rate of the mortgage pool. The conversion factor is a representation of the prepayment speed, discount rate, and contractual maturity of the mortgages. It quantifies the present value equivalent number of years of cash flow. The bank's conversion factor can be compared to FNMA and FHLMC guarantee fee buy-up and buy-down schedules to evaluate its reasonableness.

Impairment Analysis

Management must conduct a pool-by-pool review of the value of ESFR at least quarterly and adjust the book value of the ESFR asset, if necessary. The bank should thoroughly document each impairment review.

If unanticipated prepayments, changes in expected future prepayments, or other events occur that reduce the amount of expected future excess servicing fee income, a bank must write down the asset by the amount by which the asset's book value exceeds the discounted amount of future excess servicing fee income. In the future, if changes in prepayment speeds are considered permanent, the bank should also increase the amortization rate for these assets. The discount rate used in the impairment analysis should be the rate used when the asset was created. The discount rate should remain constant throughout the life of the asset.

When the true prepayment experience for a pool of loans is slower than original estimates, the value of ESFR assets associated with that pool will exceed its book value. Although a bank may not write up the book value of these ESFR assets, it can slow down the amortization rate.

Hedging Mortgage Servicing Assets

A bank should operate under a comprehensive interest rate risk management policy approved by its board of directors. At a minimum, the policy should address hedging objectives, acceptable hedge instruments, accounting treatment, position limits, loss (earnings-at-risk) limits, personnel authorized to engage in hedging activities, and required MIS reports. The board and senior management should receive periodic reports summarizing the bank's hedging activities.

Risk Management

Servicing rights provide high returns for a bank if properly priced, but contain substantial risk. An effective risk management program can reduce the volatility of returns.

Falling interest rates can quickly result in negative returns. During periods of falling interest rates, prepayments accelerate and reduce the value of originated and purchased mortgage servicing rights. Protecting this revenue stream through effective hedging is essential for the bank's uninterrupted success. Insurance can protect the bank against losses.

During periods of rising interest rates, servicing rights on fixed-rate products will increase in value. Their appreciation will compensate for the cost of insurance (hedging).

Risk management policies should address risks associated with prepayments. Since the value of mortgage servicing assets declines as prepayment speeds on the underlying loans increase, a bank with significant holdings of these assets should, at a minimum, have a method for protecting against catastrophic losses that could result from unexpected prepayments. Responsible parties should be able to demonstrate to senior bank management, regulators, and accountants how the bank analyzes, limits, and hedges this prepayment exposure. Failure to adequately identify and appropriately limit the bank's prepayment risk may be viewed as an unsafe and unsound banking practice.

To substantiate the validity of hedge positions, management also should regularly perform documented analyses of how closely the hedge instrument and the asset being hedged have correlated. Examiners should determine if the bank's hedging activities have exposed it to basis risk. Basis risk occurs when the value of the hedge instrument does not move in perfect tandem with the item being hedged. Any disparity can result in different movements in the market

value of each. For example, using Treasury-based products to hedge mortgage servicing assets can create basis risk. Examiners should review how management establishes hedge ratios and monitors basis risk.

Hedge Products

Common hedge products currently used to protect servicing values include interest rate floors and caps, principle only strips (POs), and Treasury bond call options. Other more exotic hedge products include prepayment swaps (sometimes referred to as interest-only swaps) and cash-flow swaps. Cash-flow swaps can either be principal caps or revenue caps (also called interest caps).

The purpose of each type of hedge product is to lessen the effects of unanticipated prepayments on the bank's income statement. Each type of hedge uses the concepts of a "reference portfolio" and a "strike" prepayment speed. The reference portfolio is a synthetic portfolio of actual mortgage-backed securities. The prepayment rate of the mortgage loans backing the securities in the reference portfolio is used to calculate hedge cash flows. For this reason, it is important that the loans underlying the securities in the reference portfolio are similar in type, maturity, coupon, and, ideally, geographic distribution to the mortgages in the servicing portfolio being hedged. The strike prepayment speed is selected by the hedge purchaser, who assumes the risk for prepayments occurring at less than the strike speed. The lower the strike prepayment speed, the higher the cost of the hedge.

The **prepayment swap** is a symmetrical hedge. If the prepayment speed accelerates, the bank receives payment from the hedge dealer; if prepayments slow down, the bank makes payments to the dealer. In a faster prepayment environment, the prepayment swap is designed to create increasing hedge-related cash flow to the bank as the cash flow of the servicing portfolio is declining. In a lower-than-projected prepayment climate, the bank forfeits some of the increase in servicing portfolio value that accrues from declining prepayments.

A **principal cap** preserves the book value of the servicing portfolio and, thereby, stabilizes the yield on the servicing asset. A principal cap is an asymmetrical hedge: the bank receives payments if prepayment speeds accelerate, but does not make payments if they diminish. The bank's potential loss on the hedge is limited to the fixed premium paid the dealer.

A **revenue cap** is also an asymmetrical hedge. Its objective is to stabilize the revenue stream of the servicing asset over the life of the hedge.

Whether management uses the hedges described above, other new products likely to enter the market, or instruments devised internally, examiners should analyze closely the appropriateness, correlation, and effectiveness of hedging strategies. Regardless of the approach, the overall objective should be effective risk management. The bank should view hedging activities as insurance to protect against losses, not as a source of profits.

Glossary

Accelerated amortization. An accounting technique in which the larger portion of the asset's book value is written off in the early years of the asset's expected life.

Accelerated remittance cycle (ARC). An option whereby an entity selling and/or servicing mortgages to/for the Federal Home Loan Mortgage Corporation reduces the guarantee fee it pays by paying principal and interest payments early and shortening the monthly remittance delay.

Accident and health premium. A payment by a borrower to ensure that mortgage payments continue to be paid if the borrower becomes disabled or ill.

Acquisition cost. In a Federal Housing Administration transaction, the price the borrower pays for the property plus any closing, repair, and financing costs (except discounts in other than a refinancing transaction). Acquisition costs do not include prepaid discounts in a purchase transaction, mortgage insurance premiums, or similar add-on costs.

Adjustable-rate mortgage (ARM) also called a **variable-rate mortgage (VRM).** A mortgage loan that allows a lender to adjust periodically the interest rate in accordance with a specified index agreed to at the inception of the loan.

Amortization. The process of paying off a loan by gradually reducing the balance through a series of installment payments, or the process of writing off mortgage servicing assets on a bank's balance sheet.

Annual mortgage statement. A report, prepared by the lender or servicing agent, for a mortgagor that states the amount of taxes, insurance, and interest that were paid during the year, and the outstanding principal balance.

Balloon mortgage. A mortgage for which the periodic installments of principal and interest do not fully amortize the loan. The balance of the mortgage is due in a lump sum (balloon payment) at the end of the term.

Best efforts. See **Optional delivery commitment.**

Bulk acquisition. Purchase of the servicing rights associated with a group of mortgages. Ownership of the underlying mortgages is not affected by the transaction. See also **Purchased mortgage servicing rights.**

Buy-down guarantee. See **Guarantee fee buy-down.**

Buy-down mortgage. A mortgage in which a lender accepts a below-market interest rate in return for an interest rate subsidy paid as additional discount points by the builder, seller, or buyer.

Buy-up guarantee. See **Guarantee fee buy-up.**

Cap (interest rate). In an adjustable-rate mortgage, a limit on the amount the interest rate may increase per period and/or over the life of the loan. See also **Floor.**

Capitalize. Converting a series of anticipated cash flows into present value by discounting them at an established rate of return.

Capitalized value. The present value of a set of future cash flows.

Certificate of reasonable value (CRV). A document issued by the Veterans Administration (VA) that establishes a maximum value and loan amount for a VA-guaranteed mortgage.

Closing. Consummation of a mortgage transaction at which the note and other legal documents are signed and the loan proceeds are disbursed.

Closing costs. Fees paid to effect the closing of a mortgage. Common closing costs include origination fees, discount points, title insurance fees, survey fees, appraisal fees, and attorney's fees.

Closing statement. A financial disclosure giving an account of all funds received and expected at closing, including escrow deposits for taxes, hazard insurance, and mortgage insurance. All federally insured or guaranteed and most conventionally financed loans use a uniform closing statement called the HUD-1.

Commitment (lender/borrower). An agreement, often in writing, between a lender and a borrower to lend money at a future date or for a specified time period subject to specified conditions.

Commitment (seller/investor). A written agreement between a seller of loans and an investor to sell and buy mortgages under specified terms for a specified period of time.

Commitment fee (lender/borrower). A fee paid by a potential borrower to the potential lender for the lender's promise to lend money at a specified date in the future, or for a specified period of time and under specified terms.

Commitment fee (seller/investor). A fee paid by the loan seller to the investor in return for the investor's promise to purchase a loan or a package of loans at an agreed-upon price at a future date.

Computerized loan origination system (CLO). An electronic system that furnishes subscribers with the latest data on available loan programs at a variety of lending institutions. Some CLOs offer mortgage information services and can pre-qualify borrowers, process loan applications, underwrite loans, and make a commitment of funds.

Conditional prepayment rate (CPR). A standard of measurement of the projected annual rate of prepayment for a mortgage loan or pool of loans. Although the standard CPR is 6 percent per year, it can be quoted at any percentage. For example, a 10.5 percent CPR assumes that 10.5 percent of the outstanding balance of a mortgage pool will prepay each year. *See also* **Public Securities Administration prepayment model** and **Single monthly mortality**.

Conforming mortgage. A mortgage loan that meets all requirements (loan type, amount, and age) for purchase by the Federal Home Loan Mortgage Corporation or Federal National Mortgage Association.

Conventional mortgage. A mortgage loan that is not government-guaranteed or government-insured. There are two types of conventional loans, conforming and nonconforming. *See also* **Conforming mortgage** and **Nonconforming mortgage**.

Convertible mortgage. An adjustable-rate mortgage that may be converted to a fixed-rate mortgage at one or more specified times over its term.

Correspondent. A mortgage banker that originates mortgage loans that are sold to other mortgage bankers.

Direct endorsement (DE). A Department of Housing and Urban Development (HUD) program that enables an eligible lender to process and close single-family applications for Federal Housing Administration-insured loans without HUD's prior review.

Discount rate. The time value of money can be interpreted as the rate at which individuals are willing to trade present for future consumption, or the opportunity cost of capital. Mathematically, the discount rate represents the rate at which future dollars are converted into present value. This rate can be used to calculate the present value of future cash flow streams generated by mortgage servicing rights.

Escrow. The portion of the borrower's monthly payments held by the servicer to pay taxes, insurance, mortgage insurance (if required), and other related expenses as they become due. In some parts of the U.S., escrows are also called impounds or reserves.

Escrow analysis. The periodic review of escrow accounts to determine if current monthly deposits will provide sufficient funds to pay taxes, insurance, and related expenses when due.

Excess servicing fee. The interest rate spread between the weighted average coupon rate (WAC) of a mortgage loan pool and the pass-through interest rate after deducting the servicing fee and the guarantee fee. For example, when the WAC is 9.00 percent for the pool, the pass-through rate is 8.50 percent, the servicing fee is 0.25 percent, and the guarantee fee is 0.21 percent, the excess servicing fee is 0.04 percent.

Excess servicing fee receivable (ESFR). The present value of the projected future cash flows generated by the excess servicing fee. This calculation requires application of a discount rate and must reflect the expected prepayment rate of the underlying loan.

Fallout. Loans in the pipeline not expected to close.

Federal Home Loan Mortgage Corporation (FHLMC) also called **Freddie Mac.** A stockholder-owned corporation created by Congress in the Emergency Home Finance Act of 1970 (12 U.S.C. 1451). Freddie Mac operates mortgage purchase and securitization programs to support the secondary market in mortgages on residential property.

Federal Housing Administration (FHA). A federal agency of the Department of Housing and Urban Development (HUD) established in 1934 under the National Housing Act. The FHA supports the secondary market in mortgages on residential property by providing mortgage insurance for certain residential mortgages.

Federal National Mortgage Association (FNMA) also called **Fannie Mae.** A stockholder-owned corporation created by Congress in a 1968 amendment to the National Housing Act (12 U.S.C. 1716). Fannie Mae operates mortgage purchase and securitization programs to support the secondary market in mortgages on residential property.

FHA. See **Federal Housing Administration.**

FHA loan. A loan, made through an approved lender, that is insured by the Federal Housing Administration.

FHA value. The value established by the Federal Housing Administration as the basis for determining the maximum mortgage amount that may be insured for a particular property. The FHA value is the sum of the appraised value plus the FHA estimate of closing costs.

FHLMC. See **Federal Home Loan Mortgage Corporation.**

Fixed-rate mortgage (FRM). An amortizing mortgage for which the interest rate and payments remain the same over the life of the loan.

Float. In mortgage servicing, the period of time between receipt of a borrower's loan payment and remittance of funds to investors.

Floor (interest rate). An investor safeguard on an adjustable-rate mortgage that limits the amount the interest rate may decline per period and/or over the life of the loan. *See also* **Cap**.

FNMA. *See* **Federal National Mortgage Association**.

Forbearance. In mortgage banking, the act of refraining from taking legal action when a mortgage is delinquent. Forbearance usually is granted only if a borrower has made satisfactory arrangements to pay the amount owed at a future date.

GNMA I. A mortgage-backed security program in which individual mortgage lenders issue securities backed by the "full faith and credit of the United States government." The mortgages comprising the security are government-insured or government-guaranteed. The issuer is responsible for passing principal and interest payments directly to the securities holders, whether or not the homeowner makes the monthly payment on the mortgage. All mortgages in a GNMA I pool must have the same note rate.

GNMA II. A mortgage-backed security program in which individual mortgage lenders issue securities backed by the "full faith and credit of the United States government." The mortgages comprising the security are government-insured or government-guaranteed. The issuer is responsible for passing principal and interest payments to a central paying agent whether or not the homeowner makes the monthly payment on the mortgage. The central paying agent then passes principal and interest payments to the securities holders. GNMA II pools are generally larger than those formed under GNMA I and may include mortgages with different note rates.

Government National Mortgage Association (GNMA) also called **Ginnie Mae**. A federal government corporation created as part of the Department of Housing and Urban Development in 1968 by an amendment to the National Housing Act (12 U.S.C. 1716). GNMA guarantees mortgage-backed securities that are insured by the Federal Housing Administration or guaranteed by the Veterans Administration and backed by the full faith and credit of the U.S. government.

Government-sponsored enterprise (GSE). A private organization with a government charter and backing. The Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association are GSEs.

Graduated payment mortgage (GPM). A flexible payment mortgage in which the payments increase for a specified period of time and then level off. GPMs usually result in negative amortization during the early years of the mortgage's life.

Growing equity mortgage (GEM). A graduated payment mortgage in which increases in the borrower's mortgage payments are used to accelerate reduction of principal on the loan. These graduated payment loans do not involve negative amortization.

Guarantee fee. The fee paid to a federal agency (or private entity) in return for its agreement to accept a portion of the loss exposure. Currently, typical guarantee fees required by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association for loan sales without recourse range from 0.16 percent to 0.25 percent of the pool balance annually. The Government National Mortgage Association guarantee fee on pools of federally insured or guaranteed loans is lower, 0.06 percent annually.

Guarantee fee buy-down. An arrangement in which the seller of mortgages pays a lower guarantee fee in return for

less cash when the loans are sold. Guarantee fee buy-downs allow a bank to collect a higher excess servicing fee over the life of the serviced loans. *See also* **Guarantee fee**.

Guarantee fee buy-up. An up-front fee paid to a loan seller in exchange for a higher guarantee fee. Guarantee fee buy-ups increase the cash received for the mortgages when they are sold, and reduce the excess servicing fee to be collected over the life of the underlying serviced loans. *See also* **Guarantee fee**.

Hazard insurance. Insurance coverage that protects the insured in case of property loss or damage.

Investor. A person or institution that buys mortgage loans and/or securities, or has a financial interest in these instruments.

Investor advances. In mortgage banking, funds advanced and costs incurred by the servicer on behalf of a delinquent mortgagor.

Jumbo loan. A mortgage in an amount larger than the statutory limit on loans that may be purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.

Loan guaranty certificate. A Veterans Administration document that certifies the dollar amount of a mortgage loan that is guaranteed.

Loan-to-value ratio (LTV). The ratio of the mortgage amount to the appraised value of the underlying property. Most mortgage lenders and secondary market participants set a maximum LTV for acceptable loans.

Margin. In an adjustable-rate mortgage, the spread between the index rate used and the mortgage interest rate.

Mortgage banker. An individual or firm that originates, purchases, sells, and/or services loans secured by mortgages on real property.

Mortgage broker. An individual or firm that receives a commission for matching mortgage borrowers with lenders. Mortgage brokers typically do not fund the loans they help originate.

Mortgage insurance (MI). Insurance coverage that protects mortgage lenders or investors in the event of default by the borrower. By absorbing some of the credit risk, MI allows lenders to make loans with lower down payments. The federal government offers MI for Federal Housing Administration loans; private companies offer MI for conventional loans. *See also* **Private mortgage insurance**.

Mortgage pool. A group of mortgage loans with similar characteristics that are combined to form the underlying collateral of a mortgage-backed security.

Mortgage Servicing Rights (MSR) The rights to service a mortgage loan or a portfolio of loans for other than a bank's own account. The cost associated with acquiring these rights may be capitalized under certain circumstances. *See also* **Purchased mortgage servicing rights** and **Originated mortgage servicing rights**.

Negative amortization. The situation that arises when the periodic installment payments on a loan are insufficient to repay principal and interest due. Due but unpaid interest is added to the principal of a mortgage loan causing the loan balance to increase rather than decrease.

Negative carry also called **negative spread**. In warehousing, the expense incurred when the interest rate paid for

short-term warehouse financing is greater than the interest rate earned on the mortgages held in the warehouse.

Nonconforming mortgage. A mortgage loan that does not meet the standards of eligibility for purchase or securitization by Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association. The loan amount, the loan-to-value ratio, the term, or some other aspect of the loan does not conform to the agencies' standards.

Nontraditional mortgage product. A type of mortgage that is unlike the typical mortgage instrument. Lenders may create nontraditional mortgages that vary the expected amount of principal, the interest rate, the periodic or monthly payments, borrower income and employment documentation and verification, or repayment terms.

Normal servicing fee. The rate representative of rates an investor pays to the servicer for performing servicing duties for similar loans. The servicing fee rates set by GNMA and GSEs are generally considered normal servicing fees. Currently, the normal servicing fee rate is 0.25 percent for fixed rate mortgages, 0.375 percent for adjustable-rate mortgages, and 0.44 percent for federally insured and guaranteed loans. A bank may not use its cost to service loans as the normal servicing fee.

Optional delivery commitment also called **standby commitment.** An agreement that requires an investor to buy mortgages at an agreed-upon price. The seller is not, however, required to sell or deliver a specified amount of mortgages to the investor.

Originated mortgage servicing rights (OMSR). The right to service a mortgage loan acquired through loan origination activities. The servicer receives an income stream in the form of a contractual servicing fee every period until the maturity of the mortgage, prepayment, or default. *See also* **Retail production** and **Mortgage servicing rights**.

Origination fee. The fee a lender charges to prepare documents, make credit checks, and inspect the property being financed. Origination fees are usually stated as a percentage of the face value of the loan.

Overage pricing. Selectively increasing the price of a mortgage loan above the bank's established rate to certain customers. These activities have the potential to result in disparate treatment of and disparate impact against consumers.

Pair-off arrangement. A method to offset a commitment to sell and deliver mortgages. In this transaction, the seller liquidates its commitment to sell (forward sales contract) by paying the counterparty a fee. The amount of this pair-off fee equals the impact of the market movement on the price of mortgages covered under the commitment.

Pair-off fee. *See* **Pair-off arrangement**.

Participation certificate (PC). A mortgage pass-through security issued by the Federal Home Loan Mortgage Corporation that is backed by a pool of conventional mortgages purchased from a seller and in which the seller retains a 5 percent to 10 percent interest.

Pass-through. A mortgage-backed security in which principal, interest, and prepayments are passed through to the investors as received. The mortgage collateral is held by a trust in which the investors own an undivided interest.

Pass-through rate. The interest rate paid to the investors who purchase mortgage loans or mortgage-backed securities. Typically, the pass-through rate is less than the coupon rate of the underlying mortgage(s).

Pipeline. In mortgage lending, applications in process that have not closed.

Pledged account mortgage (PAM). A graduated payment loan in which part of the borrower's down payment is deposited into a savings account. Funds drawn from the account supplement the borrower's monthly payments during the early years of the mortgage.

Pool. A collection of mortgage loans with similar characteristics.

Positive carry, also called **positive spread.** In warehousing, the excess income that results when the interest rate paid for short-term warehouse financing is less than the interest rate earned on the mortgages held in the warehouse.

Prepayment. The payment of all or part of a loan before it is contractually due.

Prepayment speed. The rate at which mortgage prepayments occur or are projected to occur, expressed as a percentage of the outstanding principal balance. *See also* **Conditional prepayment rate, Public Securities Administration prepayment model, and Single monthly mortality.**

Price level adjusted mortgage (PLAM). A mortgage loan in which the interest rate remains fixed, but the outstanding balance is adjusted for inflation periodically using an appropriate index such as the Consumer Price Index or Cost-of-Living Index. At the end of each period, the outstanding balance is adjusted for inflation and monthly payments are recomputed based on the new balance.

Primary market. For a mortgage lender, the market in which it originates mortgages and lends funds directly to homeowners.

Principal only strips (POs). A security that pays only the principal distributions from a pool of underlying loans. The interest cash flows from the underlying loans are paid to a separate interest only (IO) security. The cash flows from the underlying loans are thus "stripped" into two separate securities. Because the PO holder receives only principal distributions, the value of the PO rises when prepayments on the underlying loans increase, since a fixed amount of cash flow is received sooner than anticipated. As a result, mortgage bankers often use PO's to hedge the value of servicing rights, which have cash flow risks similar to IO securities.

Private mortgage insurance (PMI). Insurance coverage written by a private company that protects the mortgage lender in the event of default by the borrower. *See also* **Mortgage insurance.**

Production flow. The purchase of mortgage loans in combination with the rights to service those loans. The entity acquiring the mortgage loans then resells the loans but retains the accompanying servicing rights. *See also* **Purchased mortgage servicing rights.**

Public Securities Administration (PSA) prepayment model. A standard of measurement of the projected annual rate of prepayment for a mortgage loan or pool of loans. A 100 PSA prepayment rate assumes that loans prepay at a 6 percent annual rate after the 30th month of origination. From origination to the 30th month, the annualized prepayment rate increases in a linear manner by 0.2 percent each month (6 percent divided by 30). For example, the annualized prepayment on a pool of mortgages would be 0.2 percent when the loans are 1 month old, 1 percent when the loans are 5 months old, 4.8 percent at 24 months, and 6 percent at 30 months and beyond. PSA speeds increase or decrease to reflect faster or slower prepayment projections. To illustrate, 200 PSA after the 30th month equals a 12 percent annual prepayment rate; and 50 PSA equals a 3 percent annual prepayment rate. *See also* **Conditional prepayment rate and Single monthly mortality.**

Purchased mortgage servicing rights (PMSR). The rights to service a mortgage loan acquired by purchase. The

servicer receives an income stream in the form of a contractual servicing fee for every period until the mortgage matures, is prepaid, or goes into default. *See also* **Bulk acquisition** and **Production flow**.

Quality control. In mortgage banking, policies and procedures designed to maintain optimal levels of quality, accuracy, and efficiency in producing, selling, and servicing mortgage loans.

Retail production. Mortgage loans generated through origination activities which close in the bank's or a subsidiary's name. *See* **Originated mortgage servicing rights**.

Reverse annuity mortgage (RAM). A mortgage loan in which the lender makes periodic payments to the borrower in return for an increasing equity interest in the underlying property. RAMs are frequently made to retirees who own their residences outright.

Seasoned mortgage portfolio. A mortgage portfolio that has reached its peak delinquency level, generally after 30 to 48 months.

Secondary mortgage market. The market in which lenders and investors buy and sell existing mortgages.

Servicing, also called **loan administration**. A mortgage banking function that includes document custodianship, receipt of payments, cash management, escrow administration, investor accounting, customer service, loan setup and payoff, collections, and other real estate owned administration.

Servicing agreement. A written agreement between an investor and a mortgage servicer stipulating the rights and obligations of each party.

Servicing fee. The contractual fee due to the mortgage servicer for performing various loan servicing duties for investors.

Servicing released. A stipulation in a mortgage sales agreement which specifies that the seller is not responsible for servicing the loans.

Servicing retained. A stipulation in a mortgage sales agreement which specifies that, in return for a fee, the seller is responsible for servicing the mortgages.

Servicing runoff. Reduction in the principal of a servicing portfolio resulting from monthly payments, mortgage prepayments, and foreclosures. Runoff reduces future servicing fee income and other related cash flows as well as the current market value of the servicing portfolio.

Settlement. The consummation of a transaction. In mortgage lending, the closing of a mortgage loan or the delivery of a loan or security to a buyer. *See also* **Closing**.

Shared appreciation mortgage (SAM). A mortgage loan in which the lender offers the borrower a below-market interest rate in exchange for a portion of the profit earned when the property is sold.

Short sale. An arrangement entered into between a loan servicer and a delinquent borrower. The servicer allows the borrower to sell the property to a third party at less than the outstanding balance. This saves the servicer the time and expense involved in a foreclosure action. The servicer must normally obtain the approval of the investor before entering into a short sale agreement. *See also* **Forbearance**.

Single monthly mortality (SMM). SMM is the conditional prepayment rate (CPR) expressed on a monthly basis. *See also* **Conditional prepayment rate** and **Public Securities Administration prepayment model**.

Standby commitment. *See* **Optional delivery commitment**.

Table funding. A method of acquiring mortgage loans from a non-affiliated source, usually a correspondent. The acquiring party funds the mortgage at closing. If certain conditions are met, the right to service table funded loans may be capitalized as purchased mortgage servicing rights.

VA. *See* **Veterans Administration**.

VA loan. A loan made through an approved lender and partially guaranteed by the Veterans Administration.

VA no-bid. An option which allows the Veterans Administration (VA) to pay only the amount of its guarantee on a defaulted mortgage loan, leaving the investor with the title to the foreclosed property. The VA must exercise this option when it is in the government's best interest. No-bid properties become other real estate owned.

Veterans Administration (VA). The traditional name for the Department of Veterans Affairs, now a cabinet-level agency of the U.S. government. The Servicemen's Readjustment Act of 1944 authorized the VA to offer the Home Loan Guaranty program to veterans. The program encourages mortgage lenders to offer long-term, low down payment financing to eligible veterans by partially guaranteeing the lender against loss.

Warehouse (loan). In mortgage lending, loans that are funded and awaiting sale or delivery to an investor.

Warehouse financing. The short-term borrowing of funds by a mortgage banker based on the collateral of warehouse loans. This form of interim financing is used until the warehouse loans are sold to a permanent investor.

WARM. *See* **Weighted average remaining maturity**.

Weighted average coupon (WAC). The weighted average of the gross interest rates of the mortgages in a mortgage pool. The balance of each mortgage is used as the weighting factor.

Weighted average maturity (WAM). The weighted average of the remaining terms to maturity of the mortgages in a mortgage pool as of the security issue date.

Weighted average remaining maturity (WARM). The weighted average of the remaining terms to maturity of the mortgages in a mortgage pool subsequent to the security issue date. The difference between the weighted average maturity and the weighted average remaining maturity is known as the weighted average loan age (WALA).

General Procedures

Many of the steps in these procedures require gathering information from or reviewing information with examiners in other areas. Since interrelationships exist between the departments of a mortgage banking company (e.g., Loan Production and Secondary Marketing), discussing your findings with other examiners can reduce burden on the bank and avoid duplication of effort. Sharing examination findings also can be an effective crosscheck of data and can help examiners assess the integrity of management information systems.

Information from other areas should be appropriately cross-referenced in working papers. The final decision on examination scope and best to obtain needed information rests with the examiner-in-charge.

Objective: Determine the scope of the mortgage banking examination.

1. Review the following documents to identify any previous problems that require follow-up:
 - ☐ The examination scope memorandum issued by the bank examiner-in-charge (EIC).
 - ☐ Previous mortgage banking examination reports and related working papers.
 - ☐ Pertinent OCC and other regulatory reports, electronic or otherwise.
 - ☐ Internal memorandums and senior management reports on the mortgage banking unit since the last examination.
 - ☐ Reports issued by internal and external auditors, government-sponsored agencies, and significant private investors.
 - ☐ Written policies and procedures for the mortgage banking unit.
2. Obtain and review reports management uses to supervise mortgage banking activities. Determine any material changes in the following:
 - Types of products.
 - Underwriting criteria.
 - Servicing volumes.
 - Market focus.
3. Determine if the board of directors has a separate mortgage banking committee. If so, review committee minutes for significant activities.
4. Determine, during early discussion with management:
 - How management supervises the mortgage banking operation.
 - Any significant changes in policies, practices, personnel, systems, etc.
 - Any internal or external factors that could affect the unit.
 - Whether bank officers are operating in conformance with the established guidelines and following appropriate management practices.
5. Based on the performance of the previous steps and discussions with the bank EIC and appropriate supervisors, determine the scope and objectives of the examination.
6. As examination procedures are performed, test for compliance with established policies and procedures and

the existence of appropriate internal control measures. Identify any area with inadequate supervision and/or undue risk.

7. Select steps necessary to meet examination objectives from among examination procedures provided under the following sections:

- Management and Supervision
- Internal/External Audit.
- Loan Production.
- Pipeline, Warehouse, and Hedging.
- Secondary Marketing.
- Servicing.
- Mortgage Servicing Assets.

Note: All steps under the following examination procedures are seldom used.

Quantity of Risk

Conclusion: The quantity of risk is (low, moderate, or high).

Management and Supervision

Objective: Determine the risk exposure derived from management and supervisory practices in the mortgage banking department.

1. In reviewing the effectiveness of management and supervisory practices, assess the impact of mortgage banking activities on the bank's:
 - Profitability.
 - Capital.
 - Funds management activities.
 - Liquidity.
2. Determine the reasonableness of risk limits. Evaluate whether management and the board have defined risk limits for mortgage banking activities.
3. In assessing the risk exposure, review the strategic plan for mortgage banking activities. Consider:
 - If the plan is reasonable and achievable in light of the bank's capital position, physical facilities, data processing systems, capabilities, size and expertise of staff, market conditions, competition, and current economic forecasts.
 - If the goals and objectives of the mortgage banking business are compatible with the overall business plan of the bank and/or its holding company.
4. Determine if mortgage banking has been integrated into the bank's overall asset/liability management strategies and risk limits.
5. Determine if management tracks and evaluates the mortgage banking unit's risk exposure and financial performance as a line of business.
6. Given the level of risk in the mortgage banking unit, determine the adequacy of capital.
7. Determine if the bank has met the capital requirements of different agencies (GSEs) with which it has relationships.

Internal and External Audit

Objective: Assess the risk exposure, if any, resulting from the (in)effectiveness of the audit function for mortgage banking activities.

1. Determine if the board and management have established internal and external audit coverage for the mortgage banking unit.
2. Determine the adequacy of the internal and external audit program for mortgage banking activities. Refer to

specific procedures under quality of risk management, the control section.

3. Quantify the risk exposure based on the review of the internal/external audit function.

Loan Production

Objective: To determine the quality and marketability of the mortgage loan inventory and servicing resulting from the bank's mortgage production and acquisition activities.

1. Assess the mortgage banking unit's credit culture and lending philosophy, including to what degree it is willing to relax credit standards or offer below-market pricing in order to increase mortgage production volume.
2. Determine if the unit assumes excessive risk in order to enhance income.

Source and Types of Products

1. Review the types of mortgage products offered. Evaluate product volume, trends, and concentrations. Determine if management has developed a profitability profile for each line of business.
2. Determine if the bank's origination activities are primarily retail or wholesale oriented. Determine key differences in the programs including price, product type, and interest rate lock period.
3. Determine the volume of nonconforming and nontraditional mortgage products, such as jumbo, no/low documentation, and negative amortization loans. Determine:
 - If the type and volume of nonconforming and nontraditional products conform to policy.
 - If management identifies and controls the risks associated with nontraditional products.
 - If concentrations of nontraditional mortgage products exist and, if so, whether they are effectively monitored.

Origination

1. Determine how frequent originators alter loan pricing parameters set by the secondary marketing unit.
2. Determine if bank personnel routinely provide initial consumer compliance disclosures (i.e., good faith estimate and informational booklet, and Truth-in-Lending) to the applicant within prescribed time frames.

Processing

1. Determine the number of instances where required loan documents were not obtained and accurately completed within the bank's prescribed time frames. Determine if the volume of exceptions appears excessive in relation to the total pipeline and volume of closed loans.
2. Determine the volume of underwriting suspense items caused by processing errors. Assess whether the volume of the aforementioned exceptions is high in relation to the bank's internal guidelines and industry standards.

Underwriting

1. Review the underwriting guidelines published by FNMA, FHLMC, FHA, and VA for GNMA, private investors, or other principal buyers of the company's mortgage products. Determine:
 - If the bank has a contractual relationship with each purchaser.
 - If the bank's underwriting practices comply with the underwriting criteria specified by the purchaser(s).
2. Determine if mortgage insurance is obtained in accordance with investor requirements (i.e., original loan-to-value over 80 percent) and for loans sold with recourse or those that are retained by the bank (if required by policy).
3. Determine the number and dollar volume of loans originated which do not conform to written policy. Determine the reasonableness of the volume of loans approved with policy exceptions.
4. Determine if customers denied credit are informed in an appropriate manner.

Wholesale Activities

1. Review the list of wholesale sources of loans approved by the bank. Determine the types and dollar volume of loans purchased from each wholesale source.
2. Assess the quality of loans acquired from different wholesale sources. Consider:
 - Historical default and foreclosure levels.
 - Nondelivery history.
 - HUD/FNMA/FHLMC investor status (when applicable).
 - Documentation deficiencies.
3. Assess the bank's risk(s) for funding wholesale mortgages. Determine:
 - If collateral is received prior to payment.
 - If controls are in place to prevent unnecessary loss exposure.

Overages

1. Determine whether overages are an essential component of the bank's earnings and origination activities. Review the percentage of mortgages originated since the last examination that resulted in an overage and the average overage collected.
2. Determine if overages are a major component of loan officer compensation.

Portfolio Management

1. Determine the number and dollar volume of existing past due loans, first and early payment defaults, and loans repurchased since the last examination by each retail and wholesale source. Analyze how the bank compares to industry averages, as well as against government agency-provided data.
2. Assess the risk of any significant concentrations in loan production.
3. Determine the number and dollar volume of loans rejected by investors and the reasons why investors

declined to purchase these loans. Determine if the volume of rejected loans appears excessive in relation to total production volume.

Production Quality Control

1. Determine if the quality control program meets investor(s) guidelines specifying scope, timeliness, content, and independence.

Fraud Detection

1. Determine the number of fraud referral cases identified since the last examination.
2. Determine the numbers of criminal referrals submitted since the prior examination.

Delinquencies and Reserves

1. Assess the level and trends of delinquencies and losses on mortgages held by the bank and sold with contractual recourse.
2. Review the allowance for loans and lease losses (ALLL). Determine its adequacy relative to inherent credit risk in loans held by the mortgage banking unit.
3. Assess the adequacy of the recourse reserve.

Pipeline, Warehouse, and Hedging

Objective: To determine the level of interest rate, price, and other risks in pipeline, warehousing, and hedging activities.

1. Assess the degree of interest rate, price, and transaction risks that management is willing to accept. Determine if the bank routinely assumes excessive risks in relation to the volume and complexity of daily operations and management philosophy.
2. Determine the scope of the mortgage unit's pipeline and warehouse activities. Identify the size of outstanding:
 - Pipeline commitments.
 - Warehouse inventory.
 - Forward sales commitments.

Pipeline Management

1. Review the management reports that contain pipeline fallout ratios for each product type. Assess the impact of unanticipated fallout on hedging results.

Warehouse Management

1. Assess the quality and marketability of loans in the warehouse inventory. Determine:
 - The number, dollar volume, and percentage of delinquent loans in the warehouse inventory.
 - The number and dollar volume of loans which have a coupon significantly below current market rates.

- The volume of loans which have been in the warehouse in excess of 90 days.
 - The reasons why a portion of the warehouse inventory is not marketable, if applicable.
 - Whether the warehouse inventory has other characteristics that might make it difficult to market.
2. Determine whether transfers of loans from the warehouse to the permanent portfolio are accounted for at LOCOM.
 3. Determine if the bank takes speculative positions with warehouse inventory (i.e., warehouse loans are held beyond the bank's normal time frames in anticipation of improved market conditions). If so, verify that the positions are within prudent, approved dollar limits.
 4. Determine the volume of warehouse loans ineligible for sale due to delinquency or documentation problems. Assess whether this volume is reasonable in relation to the size of the warehouse inventory, and the bank's established guidelines and financial condition.

Hedging Practices

1. Determine whether the bank appropriately hedge pipeline/warehouse loans. Consider:
 - Whether management uses forward sales commitments and/or options to hedge pipeline/warehouse loans.
 - Management's strategies for hedging loans with special risks, i.e., ARMs or loans with interest rate caps and floors.
2. Review pair-off activity and determine the causes and frequency.
3. Determine if the bank assumes excessive basis risk for any hedging product.
4. Determine if the bank supports hedging strategies by using correlation analysis.
5. Review recent profit/loss reports for hedging activities. Determine the overall success of hedging activities and their impact on mortgage banking operations.

Secondary Marketing

Objective: To quantify and evaluate the risk associated with the mortgage banking unit's secondary marketing activities, including product development; and pricing, selling, documenting, and delivering mortgage products to investors.

Mortgage Pricing

1. Review mortgage pricing and determine its consistency with the bank's strategic plan.
 - Determine if management prices mortgages off security price screens and determine if mortgages are priced below, above, or at market prices.
 - Determine if the frequency of price changes for retail, wholesale, and broker channels. Evaluate the timing of changes relative to significant market interest rate movements.
 - Evaluate management's pricing analysis. Assess the impact of pricing decision on current and future profitability.

Selling Mortgages

1. Determine the secondary marketing programs used to sell mortgages to investors. Review and assess the volume of sales under each program.
2. Review master sales commitments with investors.
 - Determine commitment amounts, maturities, and terms.
 - Assess the bank's ability to meet mandatory commitments and determine potential financial exposure.
 - Review investor requirements for underwriting, delivery, documentation, and servicing.
3. Determine if the bank participates in the mortgage-backed security swap program. Verify that bank continues to defer origination fees and costs in accordance with SFAS 91.
4. Determine if the bank buys up or buys down guarantee fees. Assess the appropriateness of this activity and compare actions with the unit's strategic plan.

Recourse Transactions

1. Review management reports to determine the existing number and dollar volume of loans the bank transferred to other entities and retained recourse. This includes loans where regulatory rules do not permit the transaction to be reported as "sales treatment."

Nonconforming Security Structures

1. Assess the associated risk of security structures used for nonconforming mortgages. Determine:
 - If the bank uses senior/subordinate security structures or third-party guarantees. If so, assess the bank's obligations and exposures and the accuracy of its financial reporting.
 - If adequate recourse reserves are established for expected losses, and loss experience is tracked for each transaction.
 - The source(s) and cost of third-party guarantees. If the holding company provides the guarantee to the bank without cost, determine if the bank reports the benefit as a capital contribution from the parent on the Report of Income (schedule RI-A).
 - If the bank pays a guarantee fee to the holding company, determine if the fee is comparable to general market-level fees.
 - If the bank reviews the financial condition of third-party guarantors on a regular basis.

Documentation and Loan Delivery

1. Review the risk exposure resulting from the effectiveness of the bank's post-closing document tracking system. Consider:
 - The number of documents that have been missing more than 120 days. Review the cause(s) of the problem.
 - The significance of documents missing more than 120 days, by comparing their volume with the size of the servicing portfolio and the prior year's production volume.
 - The financial impact missing documents have had on the bank and assess the potential exposure by

reviewing investor requirements.

2. Determine the volume of uncertified GNMA pools. Determine the breakdown of uncertified pools by month of issuance.
3. Determine if GNMA requires the bank to post a letter of credit because of an excessive number of uncertified pools.
4. Review pool certification requirements for other investors.
 - Determine the bank's obligation for final pool certification for other investors.
 - Determine any requirements to post letters of credit, provide indemnification, hold back sales proceeds, or make other pledges of collateral.

Servicing

Objectives: Assess the quantity of risk associated with mortgage servicing and determine if mortgage servicing activities are performed in compliance with applicable laws, rulings, regulations and investor requirements.

Portfolio Supervision and Assessment

1. Determine the characteristics of the servicing portfolio, paying specific attention to:
 - The investors (GNMA-guaranteed, FNMA, FHLMC, private label).
 - The types of products (30-year fixed, 15-year fixed, ARMs, balloons).
 - If transactions with investors are with or without recourse.
 - The geographic dispersion of borrowers.
 - The range of interest rates on the loans.
 - The projected life of the loans.
 - The average loan size.
 - The average age of the loans.
 - The delinquency level.
 - The foreclosure level.
 - The bankruptcy level.
 - The loss experience.
 - The amount of OREO.
2. Evaluate the asset quality of the servicing portfolio.
 - Compare the level of delinquencies, foreclosures, bankruptcies, losses, and OREO to historical levels and to comparative industry data.
 - Evaluate the extent and impact of geographic concentrations.
3. Review the most recent analysis of servicing revenues and costs for each product type. Determine if cost estimates are done on an average or incremental basis.
 - Determine if the revenue analysis considers income from contractual servicing fees, ancillary fees and charges, earnings from payment float, and the benefits derived from compensating balances from custodial funds.

- Determine if the cost analysis includes all direct and indirect servicing expenses.
 - Determine the servicing unit's current and projected profitability. Determine if management has analyzed profitability on a product-by-product basis and how that analysis is factored into strategic business decisions (i.e., buying or selling servicing).
4. Determine if a disaster recovery plan is in place that covers all major servicing functions performed in-house. Determine:
 - If backup systems exist in case primary systems fail.
 - The existence of any unnecessary risk exposure.
 5. Review the list of outside subservicers and vendors employed by the bank to perform servicing functions.
 - Assess the financial condition of each subservicer and vendor.
 - Determine if the bank has a contingency plan to ensure it fulfills servicing responsibilities if subservicers or vendors fail to perform.
 - Assess the quality of work performed by vendors and subservicers and any associated risk(s).

Investor Accounting and Reporting

1. Review the list of investors for whom the bank services loans.
 - Determine if a written servicing contract is in place with each investor.
 - Review a sample of the servicing contracts to determine investor servicing requirements, funds remittance schedules, contractual servicing fees, guarantee fees, and servicer representations and warranties.
2. Track the flow of funds from the investor accounting cutoff date, the remittance of funds to investors and security holders, and the recognition of servicing revenue. Determine:
 - If loan delinquencies have prompted the use of corporate funds to meet remittance requirements to investors and security holders.
 - If the bank appropriately recognizes servicing revenue.
3. Review reconciliations on investor accounts that are out-of-balance.
 - Determine whether there are stale, unreconciled items that should be charged off.
 - Determine whether management reviews the aging of unreconciled items regularly and charge off uncollectible balances.
4. Determine the number and dollar volume of delinquent loans the bank purchased from the servicing portfolio.
 - Evaluate the financial impact of this strategy and its appropriateness for the bank.
 - Determine if delinquent loans have been inappropriately purchased from pools before investor-established time frames.
5. Determine if periodic interest rate charges on adjustable-rate mortgages are properly performed. Determine if the bank maintains adequate documentation of adjustments and notifies the borrower in a timely manner.

Escrow Account Administration

1. Determine if escrow account administration complies with 12 U.S.C. 2609 (RESPA), "Limitation on advance deposits in escrow accounts."

Considerations

- Evaluate the process for establishing the required escrow account balance at loan inception.
 - Determine if the bank sends each borrower an annual recap of escrow account activity.
 - Determine if the bank analyzes each escrow account annually. Evaluate the appropriateness of the bank's calculation methodology and assumptions.
2. Determine if the bank sends the borrower a statement showing the amount of any overage or shortage in the account and an explanation of how the bank will correct it. Ensure that overages and shortages in escrow accounts are administered in accordance with 12 U.S.C. 2609 (RESPA) requirements.
 3. Determine the volume of serviced loans that do not have an escrow requirement. Evaluate how the bank documents that tax and insurance payments are current for these loans.
 4. Review management reports to determine the number and dollar volume of loans that the bank does not have a hazard insurance policy in place. Determine how management protects the bank against losses on those loans.
 5. Determine the number and dollar volume of loans with a delinquent tax bill. Determine how management protects the bank and investor's lien position on those properties.

Collections

1. Determine the number of foreclosure actions that have not been completed within the time periods allowed by investors and government agencies. Determine the reasons for delay and whether the bank has notified the investors.
2. Review the list of delinquent loans for which foreclosure action is delayed due to forbearances. Select and review a sample of forbearance files. As appropriate:
 - Determine if the bank has sound reasons for delaying foreclosure action.
 - Determine if the forbearance actions comply with investor guidelines. Determine if the bank obtains investor approval, if necessary.
 - Determine if the bank documents the reasons for forbearance action.
3. Review outstanding investor advances and advances to cover borrower escrow account obligations for taxes and insurance. Determine if there are advances with uncollectible balances that should be charged off.
4. Consider the average foreclosure costs for each product type. Assess the adequacy of foreclosure reserves relative to the volume of loans currently in foreclosure and those severely delinquent, as well as average historical foreclosure costs.
 - Affirm that the bank makes chargeoffs, recoveries, and provision expenses directly to the foreclosure reserve.
 - Determine if the bank processes its reimbursement claims to investors in a timely manner, if applicable.

Other Real Estate Owned

1. Determine, when title has or will be obtained to an OREO property, if the bank follow applicable law, regulations, and financial reporting rules.
2. Select and review a sample of investor-owned OREO properties.
3. Determine if OREO property administration and marketing practices comply with investor guidelines.
4. Identify any associated risk(s) with OREO.

Loan Setup and Payoff

1. Determine how management ensures loans are set up accurately and in a timely manner (normally within 15 days of loan closing, or moderately longer for purchased servicing).
2. Determine the volume of loans that were not set up on the bank's servicing system before the first payment came due.
 - Determine the reason(s) why loans were not set up in a timely manner.
 - Determine whether adequate controls are in place to notify the mortgagor where to send note payments.
 - Determine the impact on the servicing unit's operating performance.
3. Determine whether the bank has incurred fines for failing to file mortgage satisfactions in accordance with laws of the borrower's state. Determine if the amount of fines paid is reasonable.

Customer Service

1. Determine the number of customer complaints pertaining to mortgage banking that the bank has received since the previous examination.
2. Determine if customer complaints are appropriately resolved in a timely manner.

Mortgage Servicing Assets

Objectives: To determine the appropriateness of accounting treatment and the quantity of risk associated with mortgage servicing assets.

Mortgage Servicing Rights

1. Evaluate the due diligence reviews for bulk acquisitions of PMSR since the previous examination. Determine:
 - If the valuation assumptions include data on the characteristics of the underlying mortgages, projected servicing revenues and costs, prepayment estimates, and the discount rate.
 - If the assumptions were reasonable at the time the bank booked the servicing rights.
 - If the bank's documentation for valuation assumptions includes an explanation of how the bank arrived at the particular valuation assumptions employed.

2. Review MSR recorded as a result of retail production (originated) or production flow (purchased) activities.
 - Determine if the bank obtains commitments to resell the mortgages prior to, or within 30 days of, their purchase at the time it capitalizes the servicing rights.
 - Confirm that the purchase or origination cost of the loan is allocated between the MSR and the loans based on the relative fair value of the servicing and the loans without servicing rights. Ensure that only direct costs are capitalized for retail production.
 - Determine if the bank's valuation techniques are consistent with fair value and do they incorporate market participant assumptions.
 - Determine if the market prices or assumptions used to determine the fair value of servicing rights and the loans are reasonable.
 - If prices of similar assets discounted cash flows or other valuation techniques are used, determine if the assumptions include data on the characteristics of the underlying mortgages, projected servicing revenues and costs, prepayment estimates, and the discount rate.
 - Determine if the assumptions were reasonable and based on the characteristics of the individual pools at the time the bank booked the servicing rights.
 - Determine if the assumptions for ancillary income, float, earnings on escrows, servicing costs, foreclosure expenses, and other revenue and expense items are realistic.
 - Determine if the bank's documentation supports how management arrived at the particular fair value.
3. Determine if the bank amortizes the capitalized values of MSR over the estimated life of the asset or 15 years, whichever is shorter.
 - Determine if the bank customizes amortization periods for particular products (for example, 15-year fixed, 30-year fixed, and ARMs).
 - Determine if the bank adjusts the rate of amortization if the actual prepayment speed is faster or slower than originally projected.
4. Assess MSR book values for possible impairment. When checking impairment, ensure that the current (not the original) level of servicing fees is used. Prepayments on the underlying loans cause the pool WAC to change, which changes the level of servicing fees over time.
 - Ensure that the market price or valuation assumptions used for impairment analyses are current and reflect expected levels of mortgage prepayments and market discount rates.
 - Ensure that management has implemented a system to track actual prepayment experience on individual pools of mortgages.
 - Determine if adjustments to the valuation allowance account have occurred as a result of impairment analyses.
 - Verify that total MSR reconciles to the general ledger and to the bank's Report of Condition (schedule RC-M, line 6a).
5. Review the list of all servicing rights sold since the last examination. Review the sales contracts to determine if the bank has any continuing obligations to the purchaser, beyond normal representations and warranties. For example, the bank is required to repurchase all 120-day delinquent mortgages. If such obligations exist, determine if the transaction is accounted for as a financing.

Excess Servicing Fee Receivables

1. Review the bank's methodology for establishing ESFR. Confirm that the bank documents all assumptions for each ESFR transaction.

- Review the assumptions for the normal servicing fee.
 - Determine if the normal servicing fee equals or exceeds the actual servicing cost.
 - Determine if the normal servicing fee equals or exceeds the contractual servicing rate established in the master servicing agreement with each investor.
 - When the actual servicing cost exceeds the contractual servicing fee, confirm that the bank records a loss at the time of the sale.
 - Review the guarantee fees used for establishing ESFR.
 - Determine if guarantee fees are correct and consistent with investor contracts.
 - Determine if the bank evaluates the financial capacity of all private guarantors.
 - Confirm that the bank deducts the normal servicing fee and the guarantee fee before determining any applicable excess servicing fee.
 - Review the prepayment speed assumptions.
 - Determine the method for establishing the prepayment speed used in ESFR calculations.
 - Determine if prepayment assumptions are realistic and conform to acceptable industry standards.
 - Determine if the bank considers the characteristics of individual mortgage products, including their weighted average coupon.
 - Determine if the bank uses an independent third party to substantiate prepayment assumptions.
 - Review the discount rate assumptions.
 - Review the discount rate used to calculate the present value of excess servicing fees.
 - Determine if discount rates are realistic and conform to acceptable industry practice at the time the bank books an ESFR asset.
 - Determine if the bank uses an independent third party to substantiate the discount rates.
2. Review the amortization method used for ESFR.
- Determine if the amortization rate corresponds to the prepayment rate initially projected by the bank when the asset was booked, and if it is appropriately adjusted for subsequent changes in prepayment rates.
 - Confirm that the amortization period for the ESFR does not exceed the estimated life of the underlying mortgages.
 - Determine if the bank uses different amortization periods based upon the characteristics of individual products (for example, 15-year fixed, 30-year fixed, and ARMs).
3. Determine if the bank reviews the ESFR at least quarterly for possible impairment in value. Determine:
- If the actual prepayment experience on the underlying mortgages exceeds the speed originally projected when the ESFR asset was booked. If so, verify that the bank computes the book value of ESFR using the currently projected prepayment speed and writes down the book value of ESFR to its present value.
 - That the discount rate used in the impairment analysis is the original discount rate used to record the ESFR asset.
 - Changes in the excess servicing fee caused by changes in the weighted average coupon on the mortgage pools.
 - If the bank writes down impaired ESFR.
 - If the results of the impairment analysis require the bank to accelerate the amortization rate.
 - That total ESFR reconciles to the general ledger and to the bank's Report of Condition (Schedule RC-F, line 3).

4. Determine if loan sales are with or without recourse. If with recourse, confirm that a recourse reserve was established. Confirm:
 - Whether the bank includes the recourse reserve expense in the equation.
 - That the reserve expense used in the equation is in addition to the guaranty fee used in the ESFR valuation calculation.

Hedging Mortgage Servicing Assets

1. Determine the bank's strategy for managing interest rate risk from mortgage servicing assets. Evaluate the effectiveness of the strategy relative to the bank's exposure.
2. Determine if management measures the change in the value of mortgage servicing assets for changes in interest rates.
3. Determine the types of instruments used in hedging mortgage servicing assets.
4. Determine if the bank uses correlation analysis to monitor and support hedging activities.
5. Review overall profit and loss reports for mortgage servicing assets and hedging activities.
 - Determine the overall financial success of hedging activities.
 - Compare actual results to management projections.
 - Assess the overall net returns and reduced volatility.

Quality of Risk Management

Conclusion: The quality of risk management is (strong, satisfactory, weak).

Policy

Management and Supervision

Conclusion: The board (has/has not) established adequate policies governing mortgage banking.

Objective: Determine the adequacy of policies, practices, and procedures for mortgage banking activities.

1. Determine if the board of directors and senior management have established operating policy and procedural guidelines for the mortgage bank operation. Ascertain whether guidelines have been established to:
 - Define permissible mortgage banking activities.
 - Identify individuals responsibilities.
 - Define risk limits.
 - Require segregation of duties.
2. Review the mortgage banking unit's written policies and procedures. Determine if they are communicated to relevant staff and if they are followed.
3. Review corporate/bank plans, policies, procedures, and systems for funds management, risk management, and liquidity management. Determine the extent to which they incorporate mortgage banking activities.

Internal and External Audit

Conclusion: The board/audit committee (has/has not) established effective audit guidelines for mortgage banking activities.

Objective: Determine if a comprehensive audit program has been implemented to assess the effectiveness of policies governing mortgage banking activities.

1. Review the bank's internal audit program for mortgage banking activities. Determine if it includes adequate objectives, written procedures, an audit schedule, and reporting systems.
2. Determine the extent to which the internal audit program covers the following mortgage banking areas, if applicable:
 - Production.
 - Pipeline and warehouse operations.
 - Hedging Activities.
 - Servicing.
 - PMSR.
 - OMSR.
 - ESFR.
 - Secondary marketing activities.
 - Internal Control.

- Financial and Regulatory reporting.
- Accounting treatment.
- Inter Company transactions.
- MIS.
- Electronic data processing.
- Compliance with Federal and State laws.

Loan Production

Conclusion: The board (has/has not) established adequate policies for mortgage loan production activities.

Objective: To determine the adequacy of policies on mortgage loan production activities.

1. Determine if the board or its mortgage banking committee, consistent with its duties and responsibilities, adopted written policies.
2. Review the loan production unit's written policies and procedures. Determine if policies adequately address:
 - The types of loans the bank will originate or purchase.
 - Loan sources.
 - Underwriting guidelines.
 - Overages.
 - Compliance activities.
 - Documentation standards.

Pipeline, Warehouse, and Hedging

Conclusion: The board (has/has not) established adequate policies governing pipeline, warehouse, and hedging activities for the mortgage banking unit.

Objective: Determine the adequacy of policies on pipeline, warehouse, and hedging activities.

1. Determine if the board of directors or its mortgage banking committee, consistent with its duties and responsibilities, has adopted written mortgage banking policies governing pipeline, warehouse, and hedging activities that define:
 - Limits for the degree of interest rate, price and transaction risk that management is willing to accept.
 - Position and earnings-at-risk limits.
 - Permissible hedging activities.
 - Individuals authorized to engage in hedging activities.
 - Acceptable hedge instruments.

Secondary Marketing

Conclusion: The board (has/has not) established adequate policies for the mortgage banking unit's secondary marketing activities.

Objective: To determine the adequacy of policies and procedures governing secondary marketing activities.

1. Determine if the board of directors or its mortgage banking committee, consistent with its duties and responsibilities, has adopted written mortgage banking policies governing secondary marketing activities that define:
 - The secondary marketing programs used to sell mortgages.
 - Permissible credit enhancements.
 - The responsibilities of the secondary marketing department for sale and delivery of loans.
 - Procedures for tracking and obtaining missing loan documents.
 - Procedures for mortgage pricing.

Servicing

Conclusion: The board (has/has not) established adequate policies for mortgage servicing activities.

Objective: Determine the adequacy of policies on mortgage servicing activities.

1. Determine if the board of directors or its mortgage banking committee, consistent with its duties and responsibilities, has adopted written mortgage banking policies that adequately cover all facets of the servicing operation.

Mortgage Servicing Assets

Conclusion: The board (has/has not) established adequate policies for mortgage servicing assets.

Objective: To determine whether mortgage servicing assets policies are adequate.

Mortgage Servicing Rights

1. Review the written policies and procedures for mortgage servicing rights. Determine if they incorporate:
 - A method for assigning a relative fair value to each MSR asset.
 - Procedures for amortizing the book value of each MSR asset over its estimated life.
 - A program for impairment
 - A system for documentation and record keeping.
 - A system for accounting and regulatory reporting treatment.
 - A statement of risk-based capital limits.
 - Procedures for the ongoing supervision of MSR.
2. Review the written policies and procedures for ESFR. Determine if they incorporate:
 - A method for assigning initial value to each ESFR asset.
 - Procedures for amortizing the book value of each ESFR asset over its estimated life.
 - A system for documentation and record keeping.
 - Procedures for the ongoing supervision of ESFR.

Processes

Management and Supervision

Conclusion: Management and the board (have/have not) established effective managerial and supervisory processes relating to mortgage banking.

Objective: Determine the adequacy of processes established to manage mortgage banking activities.

1. Review the process management uses when planning new products. Determine if customer needs and wants are taken into account, if financial projections and risk analyses are made, if legal opinions are obtained, if automated systems requirements are considered.
2. Review the budget process and financial performance of the mortgage banking unit. Determine:
 - If management and the board have communicated performance goals to the mortgage banking unit.
 - If management tracks and evaluates the mortgage banking unit's financial performance as a separate line of business.
 - If staff periodically compares current financial results to the unit's financial plan and past performance.
 - If staff analyzes and documents significant deviations from the financial plan.
3. Determine if the risk management process is effective and based upon sound information. Evaluate its comprehensiveness, and whether it adequately addresses significant risks in each functional area of the mortgage company.
4. Determine if management has adequate knowledge of product profitability. Assess whether management has quantified the servicing time necessary to recapture production costs (i.e., loan origination expense, marketing losses, and mortgage servicing rights) and whether it is incorporated into the risk management process.
5. Determine if management has established a system to ensure the mortgage company maintains adequate capital.

Internal and External Audit

Conclusion: Management and the board have (effective/ineffective) audit processes in place to monitor the mortgage banking unit.

Objectives: Determine the adequacy of audit review processes to monitor mortgage banking activities.

Internal Audit

1. Review internal audit working papers. Evaluate the effectiveness of the audit by considering the scope, frequency and working paper documentation, as well as the conclusions reached.
2. Determine if the internal audit staff reviews the audit, inspection, or examination reports prepared by the external auditors, GNMA, FHLMC, FNMA, private investors, and regulators.
3. Determine to what extent the internal audit follows up on criticisms and recommendations contained in those

reports.

External Audit

1. Review the most recent engagement letter, external audit report, and management letter.
2. Determine to what extent the external auditors rely on the internal audit staff and the internal audit report.
3. Determine if the external auditors review all the principal mortgage banking operational areas.

Loan Production

Conclusion: Management and the board (have/have not) established effective processes to manage mortgage loan production activities.

Objectives: Evaluate the effectiveness of systems and processes in place to monitor mortgage loan production activities.

1. Determine whether the head of production effectively oversees work flow to ensure loans are originated, processed, underwritten, and closed before the expiration of interest rate locks and in accordance with bank and investor requirements.
2. Determine if management of each of these areas is held accountable to ensure basic mortgage activities are done correctly on the front end.

Financial Analysis

1. Review management's analysis of origination costs. Determine if all direct and indirect costs are appropriately measured and accounted for.
 - Determine if the analysis covers all major product types and sources of production.
 - Determine if management calculates the amount of time that the bank must service a loan before it recaptures all origination expenses.
 - Evaluate management's comparison of key production functions (i.e., origination costs, underwriting efficiency, and processing time) to budget and industry averages.
 - Review management's analysis of origination costs within the organization.
 - Determine if costs are assessed by product unit.

Origination

1. Determine whether originators have the authority to alter loan pricing parameters set by the secondary marketing unit.
2. Determine how the bank ensures initial consumer compliance disclosures (i.e., good faith estimate and informational booklet, and Truth-in-Lending) are sent to the applicant within prescribed time frames.
3. Determine the methods used to evaluate loan originators.
 - Determine whether performance and compensation programs consider qualitative factors such as loan quality, completeness of application information, and timeliness and accuracy of initial consumer

- disclosures, as well as origination volume.
- Determine whether management adequately holds originators accountable for quality.

Processing

1. Determine the method used to ensure all required loan documents are obtained and accurately completed.
2. Review management's system for monitoring processor workflow and efficiency. Determine if industry standards are used as a benchmark.
3. Determine the volume of underwriting suspense items caused by processing errors. Determine whether management has evaluated the underlying cause of these errors and has taken appropriate corrective action.
4. Determine if the bank has procedures so that processors notify pipeline management of withdrawn mortgage applications.

Underwriting

1. Review management's process for measuring underwriter efficiency and quality. Determine if industry standards are used as a benchmark.
2. Determine if management reviews investor feedback to evaluate underwriter performance.
3. Review the procedure for handling loans that do not conform to written policy. Determine if the bank requires, and obtains, senior management's written approval for policy exceptions.

Closing

1. Determine how management ensures that loan closers follow the underwriter's instructions.
2. Determine if the bank has a post-closing review process to evaluate closing packages for accuracy and to ensure all front-end closing documents are obtained. Assess the timeliness and effectiveness of the post-closing review process.
3. Determine how management monitors loan closers' performance. Review procedures to implement corrective action.
4. Review the bank's process for funding loans. Determine if adequate controls are in place.

Wholesale Activities

1. Determine if the bank reviews the following information prior to purchasing loans from a wholesale source, and at least annually thereafter:
 - Historical default and foreclosure levels.
 - Nondelivery history.
 - HUD/FNMA/FHLMC investor status (when applicable).
 - Documentation deficiencies.

- Financial statements.
2. Determine if the bank underwrites mortgages purchased from wholesale sources. If the bank delegates underwriting responsibilities to the correspondent or a third party, determine the process for evaluating and monitoring the quality of mortgages purchased.
 - Determine if post-purchase reviews adequately assess loan quality and completeness of file documentation.
 - Determine if the bank maintains records of post-purchase reviews, including the volume of rejected loans from each source.
 - Determine if the bank rejects non-complying loans (loans not meeting contractual requirements) and returns them to the seller. If the bank retains non-complying loans, determine their ultimate disposition.
 - Determine if and how the bank monitors the quality of mortgages purchased from wholesale sources on an ongoing basis.
 3. Determine if management effectively monitors the quality of bulk acquisitions of servicing. Review quality statistics for individual acquisitions.

Delinquencies and Reserves

1. Review the analysis of the allowance for loan and lease losses (ALLL). Determine the reasonableness of the methodology relative to inherent credit risk in loans held by the mortgage banking unit.
2. Determine whether losses on portfolio and warehouse loans are recognized in a timely manner and taken against the ALLL.
3. Review the recourse reserve. Determine if adequate reserves are established at the time of sale for loans sold with recourse. If recourse is limited, determine whether systems are in place to prevent payments to purchasers above the bank's contractual obligation.
4. Review the adequacy of the existing recourse reserve. Determine whether losses on loans sold with recourse are recognized in a timely manner and recorded against the recourse reserve.

Other Related Issues

1. Determine if the bank sufficiently documents the proposed disposition of each mortgage at the time it is acquired or originated, i.e., hold in warehouse for sale or for the permanent portfolio.
2. Determine if the bank defers loan fees in excess of cost in accordance with SFAS 91 for retained mortgages. Determine if the income is recognized over the estimated life of the asset and not recognized in the current period. This accounting treatment includes loans swapped for securities when the securities are retained by the bank.
3. Determine if the bank defers loan fees in excess of cost in accordance with SFAS 91 for retained mortgages. Determine if the income is recognized over the estimated life of the asset and not recognized in the current period. This accounting treatment includes loans swapped for securities when the securities are retained by the bank.

Pipeline, Warehouse, and Hedging

Conclusion: Management and the board have (effective/ineffective) processes in place to manage pipeline, warehouse, and hedging activities for the mortgage banking unit.

Objective: Determine the adequacy of processes in place to manage pipeline, warehouse, and hedging activities.

1. Determine how the bank establishes and quantifies risk limits (for example, earnings-at-risk, economic value of equity at risk, or percentage of capital at risk). Determine if limits are supported by documented analysis.
2. Determine the process for granting exceptions to policies and limits. Consider:
 - If prior approval is required before policies or limits are violated.
 - If policy limit exceptions are reported to the Asset/Liability Committee and explained in the committee minutes.
 - If control systems are in place to ensure mark-to-market activities are performed by an individual not directly responsible for pipeline and warehouse hedging activities.
 - How management measures risk(s).
3. Determine if limits, exceptions, approval requirements, MIS reports, and pipeline/warehouse hedging strategies are in place to monitor and control risk.

Pipeline Management

1. Determine how management tracks fallout activity and incorporates this information into hedging strategies.
2. Review the timeliness and accuracy of pipeline commitment reporting.
 - Determine the process for identifying and reporting pipeline commitments on MIS reports.
 - Determine if commitments are specifically identified by product type and interest rate.
 - Determine if locked-rate commitments and floating-rate commitments are separately identified.
 - Review reconcilements of signed pipeline commitments with pipeline position reports.
 - Ensure the pipeline is properly reported at the lower of cost or market (LOCOM) as required by SFAS 65.
3. Determine if pipeline commitments are accurately disclosed on financial reports and Report of Condition (schedule RC-L).

Warehouse Management

1. Determine if assets held-for-sale are segregated from portfolio mortgages. Determine if assets held-for-sale are reflected on the books at LOCOM as required by SFAS 65. Ensure that transfers from the warehouse to the permanent portfolio are accounted for at LOCOM.

Note: In compliance with 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.

2. Review warehouse reconciliation reports.
 - Determine if reconcilements are performed at least monthly.

- Assess the adequacy of controls over the warehouse account.
 - Determine if errors are promptly corrected (i.e., mortgages funded more than once, or funded but not closed).
3. Review warehouse turnover and aging reports.
 - Determine if mortgage loans are removed from the warehouse within a reasonable time period, usually 90 days or less.
 - Determine the reason(s) loans remain in the warehouse after 90 days.
 4. Review the method for handling warehouse loans ineligible for sale due to delinquency or documentation problems.
 5. Determine if the warehouse is accurately reflected on financial reports and the bank's Report of Condition (schedule RC-C).

Hedging Practices

1. Determine the procedures for hedging pipeline/warehouse loans and the types of hedge instruments used.
 - Determine if the bank maintains a list of individuals authorized to engage in these activities.
 - Determine if the board of directors approved all hedging activities and the individuals who perform them.
2. Review controls governing forward sales trading.
 - Determine if individual trade tickets are properly prepared and submitted to an independent operating unit for processing.
 - Determine if third-party trade confirmations are received and reviewed by an independent operating unit.
 - Determine if the bank established prudent follow up procedures for unconfirmed trades and confirmation discrepancies.
 - Determine if traders are prohibited from entering forward sales data into bank systems.
 - Determine if management back-tests the effectiveness of hedging activities.
3. Determine if outstanding trades (commitments to sell mortgages) are accurately disclosed on financial reports and the bank's Report of Condition (schedule RC-L).
4. Determine if options are regularly used as part of management hedging strategy.
5. Determine the adequacy of management's strategies for hedging loans with special risks, i.e., ARMs or loans with interest rate ups and floors.

Secondary Marketing

Conclusion: Management and the board (have/have not) established effective processes to manage secondary marketing for the mortgage banking unit.

Objective: To assess the adequacy of processes in place to manage secondary marketing activities.

Mortgage Pricing

1. Assess the reasonableness of the mortgage pricing process, and determine its consistency with the bank's strategic plan.
 - Determine how management establishes prices.
 - Determine if management prices mortgages off security price screens.
 - Evaluate management's pricing analysis.
 - Determine if management analyzes its pricing decisions in relation to the bank's competitors, the overall costs of loan production and secondary marketing, and the value of servicing rights generated.
 - Determine if the secondary marketing unit is responsible for establishing mortgage prices. Ensure originators are prohibited from overly influencing or dominating pricing decisions.
 - Determine if profit and loss records for individual transactions are periodically reconciled to general ledger records.

Selling Mortgages

1. Determine if the bank participates in the mortgage-backed security swap program. Verify that the bank continues to defer origination fees and costs in accordance with SFAS 91.
2. Determine if the bank has systems in place for loan delivery. Assess the effectiveness of those systems.

Recourse Transactions

1. Determine if the bank transfers loans with recourse.
 - Determine if the bank has adequate management information systems to track all recourse obligations.
 - When regulatory rules do not permit the transaction to be reported as "sales treatment," determine if management accurately reports the transaction as a financing on the Report of Condition and Income.

Documentation and Loan Delivery

1. Review the bank's post-closing document tracking system.
 - Determine if the process is organized and identifies individual missing documents, the name of the customer, the number of days since loan closing, and the disposition of the documents.
 - Determine if post-closing documents are obtained in a timely manner and in accordance with investor requirements.
2. Review the process for pool certification. Determine if effective procedures are in place to ensure compliance with GNMA pool certification requirements and guidelines established by other investors.

Servicing

Conclusion: Management and the board have effective (ineffective) processes in place to manage mortgage servicing activities.

Objective: To assess the quality of mortgage servicing processes.

Portfolio Supervision and Assessment

1. Review the most recent management reports in which the operating results for the servicing unit are described. Determine if the amount of detail provided is sufficient to supervise each servicing function.
2. Review the bank's process of reviewing outside subservicers and vendors employed to perform servicing functions.
 - Determine if the bank annually appraises the financial condition of each subservicer and vendor.
 - Determine if the bank's planning process includes contingency planning to ensure it fulfills servicing responsibilities if subservicers or vendors fail to perform.
 - Determine if management reviews the quality of work performed by vendors and subservicers at least annually.

Cash Management

1. Review the procedures for receiving payments from borrowers, depositing the funds into segregated custodial accounts, and remitting funds to investors.
 - Assess the bank's system for ensuring that borrower's payments are applied accurately and that investors receive payments on schedule.
 - Determine if adequate controls exist over custodial accounts, including daily balancing, monthly reconcilements, assigned authority for disbursements, and segregation of administrative duties.
 - Determine if custodial accounts are reconciled in a timely manner.
 - Ensure that the duties associated with the administration of custodial accounts are properly segregated.
 - Verify that custodial balances are deposited into the types of accounts and financial institutions specified in investor guidelines.

Investor Accounting and Reporting

1. Determine if monthly investor reports are accurate and timely.
2. Review a sample of investor account reconciliations. Assess management's process for reconciling investor accounts.
 - Determine that a schedule is maintained that lists all investors for whom servicing is being performed.
 - Verify that each investor account is reconciled at least monthly.
 - Determine if a supervisor reviews and approves the reconciliations.
 - Determine if the bank resolves outstanding items in a timely manner.
 - Determine whether the bank reviews the aging of unreconciled items regularly and charges off uncollectible balances.
3. Determine if periodic interest rate changes on adjustable-rate mortgages are properly performed. Determine if the bank maintains adequate documentation of adjustments and notifies the borrowers in a timely manner.
4. Determine if investor accounting and reporting internal control processes are adequate.
 - Assess whether adequate procedures and controls are in place to ensure that investors receive payments on schedule.
 - Determine if management has established controls to prevent delinquent loans from being prematurely

- removed from mortgage pools.
- Determine if a monthly report is sent to each applicable investor detailing principal and interest collections from homeowners, delinquency rates, foreclosure actions, property inspections, loan losses, and OREO status.

Document Custodianship

1. Evaluate the procedures for safeguarding loan documents.
 - Determine if loan documents are stored in a secured and protected area.
 - Determine if the bank's safekeeping facilities are appropriate.
 - Determine if the bank maintains a log of documents held in safekeeping.
 - Determine if the log identifies documents which have been removed, and by whom.
 - Determine if copies of critical documents are stored separately from original documents.

Escrow Account Administration

1. Review the effectiveness of the system for ensuring the timely payments of taxes, insurance, and other obligations of borrowers.
2. Assess the bank's process for ensuring escrow account administration complies with 12 U.S.C. 2609 (RESPA), "Limitation on advance deposits in escrow accounts."
3. Review the method for correcting shortages and surpluses in escrow accounts. Determine if the bank sends the borrower a statement showing the amount of any overage or shortage in the account and an explanation of how the bank will correct it.
4. Review the method for substantiating that insurance is in place for each property. Determine if the bank uses a blanket insurance policy or forced-placed hazard insurance (a bank-purchased policy covering a specific property) for borrowers with expired insurance.
5. Review the procedures for ensuring that tax and insurance payments are made on delinquent loans. Evaluate their effectiveness.
6. Evaluate the controls in place for preventing the use of escrow custodial balances to meet other bank obligations.

Collections

1. Review procedures for collecting delinquent loans.
 - Determine if collection efforts follow investor guidelines.
 - Determine if the bank documents all attempts to collect past due payments, including the date(s) of borrower contact, the nature of the communication, and the borrower's response/commitment.
 - Determine if the bank conducts appropriate property inspections for delinquent loans.
 - Determine the methods used by management to ensure collection procedures comply with applicable state and federal laws and regulations. Evaluate their effectiveness.
2. Review loan delinquency reports. Select and review a sample of files for borrowers delinquent 121 days or

more. Assess the bank's foreclosure process.

- Determine if the bank initiates foreclosure proceedings in a timely manner and properly notifies borrowers and investors of the initiation of foreclosure actions.
 - Determine if foreclosure practices comply with investor guidelines.
 - Determine the methods used by management to ensure that foreclosure procedures comply with applicable state and federal laws and regulations. Evaluate their effectiveness.
 - Determine the number of foreclosure actions that have not been completed within the time periods allowed by investors and government agencies. Determine the reasons for delay and whether the bank has notified the investor.
 - Determine if the bank has established a foreclosure reserve.
 - Determine if uncollectible investor advances are charged off in a timely manner.
3. Assess the bank's process for handling delinquent loans in forbearance status.
- Determine if the bank has sound reasons for delaying foreclosure action.
 - Determine if the forbearance actions comply with investor guidelines. Determine if the bank obtains investor approval, if necessary.
 - Determine if the bank documents the reasons for forbearance actions.
4. Review outstanding investor advances and advances to cover borrower escrow account obligations for taxes and insurance. Determine if the bank has an effective process in place to collect or charge off uncollectible balances in a timely manner.

Other Real Estate Owned (OREO) Administration

1. Select and review a sample of bank-owned OREO properties.
- Determine if accounting practices are consistent with the instructions for the Report of Condition.
 - Review the bank's practices to ensure compliance with 12 U.S.C. 29, where applicable, and the Other Real Estate Owned section of the *Comptroller's Handbook*.

Loan Setup and Payoff

1. Determine the amount of time between loan closing and when the file is received and the loan setup. Assess the effectiveness of systems used to track the timeliness of file submission and setup.
2. Determine how management ensures loans are set up accurately and in a timely manner (normally within 15 days of loan closing, or moderately longer for purchased servicing).
3. Determine whether the bank processes pay-offs appropriately, including filing the mortgage satisfactions and returning the original note to the borrower. Determine whether the bank has incurred fines for failing to file mortgage satisfactions in accordance with laws of the borrower's state.
4. Determine how management limits interest expense incurred on loans which pay off during the month. Evaluate the effectiveness of management's actions.

Customer Service

1. Determine if customer service tracks the number and type of customer complaints. Determine if the unit appropriately informs senior management of the mortgage company of significant and recurring complaints.
2. Determine if customer complaints are appropriately resolved.

Mortgage Servicing Assets

Conclusion: Management and the board have (effective/ineffective) processes in place to manage mortgage servicing assets.

Objective: Determine the adequacy of processes in place to manage mortgage servicing assets.

1. Evaluate the due diligence process for bulk acquisitions of PMSR.
 - Determine if the bank performs a comprehensive due diligence review before it purchases a servicing portfolio.
 - Determine if the valuation assumptions include data on the characteristics of the underlying mortgages, projected servicing revenues and costs, prepayment estimates, and the discount rate.
 - Determine if the bank file documents the valuation assumptions applied to servicing assets. Determine if the documentation includes an explanation of how the bank arrived at the particular valuation assumptions employed.
2. Determine if due diligence reviews are required to be reviewed by the board before the transaction is approved.
3. Determine if the board is required to approve significant sales and purchases of servicing rights.
4. Determine if the bank reassesses MSR book values for possible impairment at least quarterly. 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 pool WAC to change, which changes the level of servicing fees over time. Determine:
 - 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.
 - Whether adjustments are made to the valuation allowance account as a result of impairment analyses.
 - Whether in-house staff, consultants, or outside auditors conduct impairment analyses.
5. Determine whether the bank has a system in place to track actual prepayments experience on individual pools of mortgages.

Hedging Mortgage Servicing Assets

1. Evaluate the quality of management information systems used to measure the change in the value of mortgage servicing assets for changes in interest rates. (Consider interest rate movements of at least 2 percent both up and down.)

Personnel

Management and Supervision

Conclusion: The board, management, and effected personnel (do/do not) display the skills and knowledge required to manage and perform duties related to mortgage banking.

Objective: Given the size and complexity of the bank, determine if bank management and personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to mortgage banking.

1. Assess the expertise and experience of the mortgage banking unit's management team and staff. Review management succession plans and evaluate if designated successors have the necessary background and experience.
2. Review the organizational chart for mortgage banking activities.
 - Determine if decision making is centralized or delegated.
 - Determine which individuals are responsible for major decisions and where final decisions are made.

Compensation Program

Objective: Determine the adequacy of the mortgage banking department's compensation program.

1. Review compensation plans, including incentive components, for mortgage banking staff. Determine if the plans:
 - Are based on qualitative factors rather than just production volume.
 - Are designed to recruit, develop, and retain appropriate talent.
 - Encourage employees to take risk that is incompatible with the bank's risk appetite or prevailing rules or regulations.
 - Are consistent with the long-term strategic goals of the bank.
 - Include compliance with bank policies, laws, and regulations.
 - Consider performance relative to the bank's stated goals.
 - Consider competitors' compensation packages for similar responsibilities and performance.
 - Consider individual overall performance.
2. If the employees are compensated under an incentive compensation program, evaluate if:
 - The program has been reviewed and approved by the board of directors.
 - Incentive compensation is calculated in a manner other than a percentage of the profit based on the volume of securities trades.

Internal and External Audit

Conclusion: The board/audit committee, management and effected personnel (do/do not) display the skills and knowledge required to provide oversight and perform audit duties related to mortgage banking activities.

Objective: Given the size and complexity of the bank, determine if bank management and the audit staff possess and display acceptable knowledge and technical skills in managing an audit function and conducting audit reviews for the mortgage banking unit.

1. Review the education, experience, and ongoing training of the internal audit staff and make a conclusion about its expertise in auditing mortgage banking activities.
2. Determine the independence of the internal audit staff by considering whether it has necessary authority and access to records and to whom it reports audit findings.

Loan Production

Conclusion: The board, management, and effected personnel (do/do not) possess the skills and knowledge required to manage and perform duties related to mortgage loan production activities.

Objective: Given the size and complexity of the bank, determine if bank management/personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to mortgage loan production activities.

1. Review the organizational chart and reporting structure for loan production functions to familiarize yourself with the structure of the loan production area.
 - Determine if overall responsibilities for all production functions are centralized under a "Head of Production."
 - Determine whether responsibilities for the origination, processing, underwriting, and closing functions are clearly defined.
 - Determine if each function is sufficiently independent.
 - Ensure that the quality control unit reports outside of the production function.
2. Review the qualifications and experience levels of underwriters.
3. Evaluate the quality control staff's competence and experience.
4. Evaluate the training program for mortgage production personnel and determine if it is adequate.

Pipeline, Warehouse, and Hedging

Conclusion: The board, management, and effected personnel (do/do not) display the skills and knowledge required to manage and perform related to pipeline, warehouse, and hedging activities for the mortgage banking operation.

Objective: Given the size and complexity of the bank, determine if bank management/personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to pipeline, warehouse and hedging activities.

1. Assess bank managers/personnel knowledge and technical skills related to pipeline, warehouse, and hedging activities based on conclusions developed while performing these procedures.

Secondary Marketing

Conclusion: The board, management, and effected personnel (do/do not) display the skills and knowledge required to manage and perform duties related to secondary marketing activities.

Objective: Given the size and complexity of the bank, determine if bank management/personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to secondary marketing activities.

1. Assess bank managers/personnel knowledge and technical skills related to secondary marketing activities based on conclusions developed while performing these procedures.

Servicing

Conclusion: The board, management, and effected personnel (do/do not) display the skills and knowledge required to manage and perform duties related to mortgage servicing.

Objective: Given the size and complexity of the bank, determine if bank management/personnel possess and display acceptable knowledge and technical skills required in managing and performing duties related to mortgage servicing.

1. Review the organization chart for the servicing unit. Evaluate the qualifications and experience of senior management and key staff.
2. Assess bank managers/personnel knowledge and technical skills related to servicing activities based on conclusions developed while performing these procedures.

Mortgage Servicing Assets

Conclusion: The board, management, and effected personnel (do/do not) possess the skills and knowledge required to manage and perform duties related to mortgage servicing assets.

Objective: Determine if bank management/personnel possess and display performing duties related to mortgage servicing assets.

1. Assess bank managers/personnel knowledge and technical skills related to mortgage servicing assets activities based on conclusions developed while performing these procedures.

Controls

Management and Supervision

Conclusion: Management has (effective/ineffective) managerial and supervisory control systems for mortgage banking.

Objective: Determine the adequacy of control systems instituted by management to supervise mortgage banking activities.

1. Evaluate the systems for managing risk within the mortgage banking unit. Determine to what extent the bank uses simulation modeling to assess the impact of interest rate changes on the mortgage company.
2. Review management information systems (MIS) and determine management's capacity to evaluate and monitor mortgage banking activities. Evaluate MIS reports for detail, accuracy, and timeliness.
 - The adequacy of MIS and operating systems to monitor current operations and handle future product growth.

- If the board receives MIS reports on profitability, monthly production volume, inventory aging, hedged and unhedged positions, mark-to-market analyses, delinquencies, foreclosures, status of reserves, OMSR, PMSR, ESFR, operational efficiency, and policy exceptions.
 - If current MIS allocates all costs (including overhead and administrative support and all revenues including those associated with production, secondary marketing, and servicing).
3. Assess the extent to which the board and management use the data obtained from MIS in their decision-making process.
 4. Assess current business volume related to physical facilities, including the bank's data processing and human resources capabilities. Consider:
 - The adequacy of facilities.
 - Plans for the future and assess their feasibility.
 5. Determine if the mortgage banking functions have adequate independence and segregated reporting lines.
 6. Determine if comprehensive procedures are in place to ensure compliance with laws and regulations.

Internal and External Audit

Conclusion: Management has (effective/ineffective) audit control systems for mortgage banking activities.

Objective: Determine that management has instituted adequate audit controls for the mortgage banking unit.

Internal Audit

1. Determine if the internal auditors periodically verify the accuracy of MIS reports. If they do not, determine if the bank contracts with an external, independent source to verify the accuracy of MIS reports.
2. Review the criticisms and recommendations in the internal audit report. Determine if, and the extent to which, management changes operating and administrative procedures as a result of report findings.

External Audit

1. Review the findings contained in the external audit report. Determine if the auditors rendered an opinion on the effectiveness of internal controls and assessed the overall condition of the mortgage banking operation.
2. Determine if management promptly and effectively responds to the external auditor's recommendations, and if management makes appropriate changes to operating and administrative procedures as a result of report finding.

Loan Production

Conclusion: Management has (effective/ineffective) control systems for mortgage loan production activities.

Objective: Determine the adequacy of management's control systems employed to manage mortgage loan production activities.

Production Quality Control

1. Review the bank's quality control program and determine whether this function is independent from the production process. Determine if the bank performs the program internally or uses an outside vendor. Evaluate the quality control staff's competence and experience.
2. Determine if the quality control program meets investor(s) guidelines specifying scope, timeliness, content, and independence.
3. Determine if the quality control program adequately and equitably covers both retail and wholesale loan production, including all locations, underwriters, and correspondents.
4. Review a sample of reports issued by the quality control unit. Determine if quality control reports:
 - Are reported to personnel outside of the production unit.
 - Accurately identify concerns with underwriting standards or procedures, fraudulent loan activity, and reappraisal results.
 - Provide qualitative analysis and make conclusions regarding trends, common deficiencies, and deficiency concentrations by branch, underwriter, broker, or correspondent.
 - Adequately document findings and conclusions.
5. Determine if the quality control findings are effectively communicated. Determine if management requires written responses for significant deficiencies.
6. Determine if management takes timely corrective action to resolve adverse quality control findings.

Fraud Detection

1. Determine if the individual or group of individuals responsible for fraud detection adequately investigate and resolve fraud referral cases promptly and effectively.
2. Determine if effective controls, such as timely MIS, are in place to detect possible fraud.
3. Determine if required criminal referrals are promptly submitted to the appropriate authorities.
4. Determine if a tracking system is in place that details criminal referrals and identifies loans repurchased due to fraud or misrepresentation.
5. Determine if the individual or group of individuals responsible for fraud detection adequately train originators, processors, underwriters, and collection personnel to help them identify fraud schemes and inconsistencies in borrower and property data that indicate potential fraud.

Other Control Systems

1. Review the recent reports of the internal and external audits, compliance, GNMA, FNMA, and FHLMC. Determine if management follows up on production deficiencies identified in these reports.

Pipeline, Warehouse, and Hedging

Conclusion: Management has (effective/ineffective) control system for pipeline, warehouse, and hedging activities.

Objective: Determine the adequacy of management's control systems employed to manage pipeline, warehouse, and hedging activities.

1. Determine if daily position reports are prepared which identify pipeline commitments, warehouse inventory, and forward sales commitments. Review its accuracy and determine whether it is provided to senior management.

Pipeline and Warehouse Management

1. Review MIS reports for pipeline and warehouse operations, including the reports on inventory, commitments, age, and turnover.
 - Determine if the reports are complete, accurate, and timely.
 - Determine if the reports adequately detail risk exposures, limit excesses, and exception approvals.
 - Determine the dollar amount and percentage of total volume generated for each product type.
 - Determine if the reports segregate and classify closed loans as either permanent portfolio or held-for-sale.
 - Review the warehouse inventory reports. Determine if any inventory is past due, has a coupon significantly below current market rates, has been in the warehouse more than 90 days, or has other characteristics that might make it difficult to market. If a portion of the inventory is not marketable, determine the cause.

Hedging Practices

1. Review MIS reports relating to hedging activities.
 - Determine if the reports are complete, accurate, and timely.
 - Determine if the reports sufficiently detail risk exposures.
 - Review reconcilements of outstanding trades to the daily position report.
 - Determine if profit/loss reports are generated for all mortgage banking hedging activities.
2. Determine if the bank uses simulation modeling to establish risk limits and hedging strategies.
 - Determine if simulation assumptions are reasonable and if volatility assumptions are consistent with those implied by the market.
 - Determine how frequently assumptions and other model inputs are updated.
 - Determine if model assumptions incorporate budgeting and management decisions. If so, determine the extent to which they are incorporated.

Secondary Marketing

Conclusion: The quality and level of control systems are (adequate/inadequate) given the size and complexity of the mortgage banking unit's secondary marketing operation.

Objective: Determine the adequacy of control systems employed to manage secondary marketing activities for the mortgage

banking unit.

1. Determine whether profit and loss reports for individual transactions are periodically reconciled to general ledger records.
2. Determine if management has instituted effective controls to ensure that recourse transactions are accurately reported on the bank's Report of Conditions and Income.
3. Ensure that a quality assurance review is conducted periodically to determine if mortgage pools are certified in a timely manner.
4. Determine whether an independent process has been implemented to verify the accuracy of the post-closing documentation tracking systems.

Servicing

Conclusion: Management has (effective/ineffective) control systems for mortgage servicing activities.

Objective: Determine the adequacy of management's control systems employed to manage mortgage servicing activities.

Portfolio Supervision and Assessment

1. Review the most recent management reports in which the operating results for the servicing unit are described. Determine if the amount of detail provided is sufficient to supervise each servicing function.
2. Contact the examiner assigned Internal and External Audit and review:
 - Whether audit coverage of the servicing function is adequate relative to the size and complexity of the operation.
 - Whether servicing unit management conducts appropriate follow up on the findings contained in the audit reports.
3. Ensure that a master servicing agreement is on file for each investor.

Cash Management

1. Ensure that duties associated with the administration of custodial accounts are properly segregated.

Investor Accounting and Reporting

1. Determine if monthly investor reports are accurate and promptly submitted.

Servicing Quality Control

1. Determine if the bank has a quality control program for the servicing unit. If so, assess its scope and effectiveness.

Mortgage Servicing Assets

Conclusion: The quality and level of control systems are (adequate/inadequate) given the size and complexity of the bank's mortgage servicing assets activities.

Objective: Determine the adequacy of management's control systems employed to manage mortgage servicing assets activities.

1. Determine if the bank has adequate record keeping systems in place to support and account for MSR.
2. Ensure that records are maintained that document original valuation assumptions for each bulk acquisition of MSR.
3. Determine if records are maintained by product type and month of origination for MSR acquired through retail production (origination) and production flow (purchase) activities.

Hedging Mortgage Servicing Assets

1. Evaluate the quality of management information systems used to measure the change in the value of mortgage servicing assets for changes in interest rates. (Consider interest rate movements of at least 2 percent both up and down.)
2. Determine if senior management and the board receive information regarding this interest rate risk.

Conclusion

Objective: To communicate findings and initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of law, rulings or regulations have been noted.

1. Review conclusions from each of the following applicable mortgage banking areas reviewed:
 - Management and Supervision.
 - Internal/External Audit.
 - Loan Production.
 - Pipeline, Warehouse, and Hedging.
 - Secondary Marketing.
 - Servicing.
 - Mortgage Servicing Assets.
2. Provide EIC with brief conclusion memorandum.
 - Address the adequacy of policies and procedures.
 - Assess the quality of management and board supervision.
 - Assess the aggregate risks posed by the mortgage banking operation.
 - Address compliance with laws and regulations
 - Note profitability levels and comment on future plans.
 - Comment on the adequacy of control systems including internal/external audit, and internal quality control reviews.
 - Comment on any violations and significant deficiencies noted.
3. Determine the impact on the aggregate and direction of risk assessments for any applicable risks identified by performing the above procedures. Examiners should refer to guidance provided under the OCC's large and community bank risk assessment programs.
 - Risk Categories: Compliance, Credit, Foreign Currency, Translation, Interest Rate, Liquidity, Price, Reputation, Strategic, Transaction
 - Risk Conclusions: High, Moderate, or Low
 - Risk Direction: Increasing, Stable, or Decreasing
4. Determine in consultation with EIC, if the risks identified are significant enough to merit bringing them to the board's attention in the report of examination. If so, prepare items for inclusion under the heading Matters Requiring Board Attention. Consider the following:
 - MRBA should cover practices that:
 - Deviate from sound fundamental principles and are likely to result in financial deterioration if not addressed.
 - Result in substantive noncompliance with laws.
 - MRBA should discuss:
 - Causative factors contributing to the problems.
 - Consequences of inaction.
 - Management's commitment for corrective action.
 - The time frame and person(s) responsible for corrective action.

5. Discuss significant findings with management including conclusions regarding applicable risks.
6. As appropriate, prepare a brief mortgage banking comment for inclusion in the report of examination.
 - Policy Adequacy.
 - Management and operations processes.
 - Controls including internal audit and quality control functions.
 - Quality of management and board supervision.
 - Address major risks.
 - Quality of risk management practices.
7. Prepare a memorandum or update the work program with any information that will facilitate future examinations.
8. Update the appropriate OCC electronic files and any applicable report of examination schedules or tables.
9. Organize and reference working papers in accordance with OCC guidance.

Government-run and Government-sponsored Programs

- The **Federal Housing Authority** (FHA) encourages private mortgage lending by providing insurance against default. It sets standards for construction and underwriting, and provided the initial standardization of terms and conditions in residential mortgage lending.
- The **Veteran's Administration** (VA) facilitates home ownership for individuals who have served in the U.S. military services by offering partial guarantees on mortgage loans with certain VA-set terms.
- The **Federal National Mortgage Association** (FNMA or Fannie Mae) supports conventional, FHA, and VA mortgages by operating programs for purchase and securitization. The Reconstruction Finance Corporation (RFC), created in 1935 and followed in 1938 by a wholly owned subsidiary, the National Mortgage Association of Washington, soon renamed the FNMA, was the first federal attempt to establish and assist a national mortgage market. From its beginning until 1970, FNMA only purchased FHA/VA mortgages. In 1970, Congress, in the same bill which created the Federal Home Loan Mortgage Corporation, authorized FNMA to purchase certain other mortgages. These "conventional" mortgages now represent the bulk of the loans FNMA purchases.
- The **Government National Mortgage Association** (GNMA or Ginnie Mae) issues guarantees on securities backed by FHA-insured and VA-guaranteed mortgages. The GNMA guarantee and securitization makes these loans more attractive to investors. In 1968, Congress enacted legislation to partition FNMA into two separate corporations: a residual FNMA and the new GNMA. After that partition, GNMA offered the special assistance and loan liquidation functions formerly provided by FNMA, as well as a mortgage-backed securities program. GNMA is located in the Department of Housing and Urban Development (HUD).
- The **Federal Home Loan Mortgage Corporation** (FHLMC or Freddie Mac) supports conventional mortgage lending by purchasing and securitizing loans. It was created to provide secondary market facilities for members of the Federal Home Loan Bank System, but its charter was later modified to include all mortgage lenders. FHLMC was the first issuer of mortgage-backed securities based on conventional mortgages in 1971 when it sold participation certificates backed by mortgages purchased from savings and loan associations.

Statement of Financial Accounting Standards (SFAS)

- No. 5, Accounting for Contingencies
- No. 65, Accounting for Certain Mortgage Banking Activities
- No. 77, Reporting by Transferors for Transfers of Receivables with Recourse
- No. 80, Accounting for Futures Contract
- No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- No. 122, Accounting for Mortgage Servicing Rights

Code of Federal Regulations

- 24 CFR 2.203, HUD Requirements for Mortgage Servicers
- 24 CFR 3500, Real Estate Settlement Procedures Act (RESPA)

OCC Bank Accounting Advisory Series

- Topic 1A Question 3, Purchase Accounting
- Topic 3C Questions 8, 15, 16, and 17, Sale of Loans
- Topic 11A Question 9, Miscellaneous Accounting
- Topic 4A Question 9, Loan Origination and Servicing
- Topic 4B Questions 11 and 12, Loan Origination and Servicing

OCC Chief Accountant's Opinion Letters (CA)

- 8/25/89 Memo, Asset Securitization
- 9/19/89 Letter, Excess Servicing Fees
- 9/28/90 Letter, Acquired Mortgage Servicing Rights
- 10/25/90 Memo, Credit Card Asset Securitization
- 4/24/91 Letter, Asset Securitization
- 6/24/91 Letter, FHA Title I Loan Servicing Rights
- 12/20/91 Memo, Purchased Mortgage Servicing Rights
- 3/4/92 Memo, Purchased Mortgage Servicing Rights (92-18)
- 3/27/92 Letter, Purchase of Mortgage Sub-Servicing Rights (92-23)
- 7/17/92 Letter, Accounting for Mortgage Servicing Activities (92-62)
- 8/11/92 Letter, Accounting for Mortgage Servicing Activities (92-69)
- 12/16/92 Letter, Purchased Mortgage Servicing Rights; Qualified Intangible Assets (92-108)
- 1/15/93 Memo, Gain on Sale of FHA Loans (93-3)
- 1/27/93 Letter, Asset Securitization (93-6)
- 2/18/93 Letter, Mortgage Servicing Rights (93-12)
- 5/28/93 Letter, Delinquent Single Family Residential Loans Acquired (93-30)
- 6/16/93 Memo, Accounting for Asset Securitization (93-38)
- 8/16/93 Letter, Accounting for Mortgage Servicing Portfolio (93-55)

OCC No Objection Letter

- 92-5 (6/18/93), Applicability of OCC Appraisal Regulation to Residential Mortgage Warehouse

Instructions to Reports of Condition and Income