# Mortgage Banking Program

## EXAMINATION OBJECTIVES

Determine whether the association has adequate written policies and procedures for each segment of its mortgage banking activities, and that the board of directors periodically reviews and approves the policies and procedures.

Determine that the policies and procedures provide for safe and sound lending and mortgage banking operations, that they are consistent with OTS policies and guidelines, and conform to applicable laws and regulations.

Determine that the association has established prudent written underwriting standards and that it consistently adheres to such standards.

Determine that the board of directors receives and reviews periodic reports on the mortgage banking operations.

Determine that the association maintains appropriate risk management functions over each aspect of its mortgage banking operations, consistent with the size and complexity of its activities.

Determine that management and the board of directors receive periodic management information systems (MIS) reports informing them of all pertinent mortgage banking activities and risks.

Determine that the association adheres to generally accepted accounting principles (GAAP) for all aspects of its mortgage banking activities.

Determine that the association classifies loans and investments in accordance with OTS and interagency guidelines.

Determine whether management appropriately evaluates its operation and risk profile to determine the relevant measurement criteria of the income and expense its operation incurs.

Determine whether management has a cost center reporting system appropriate for the size, nature, and risk profile of the business.

## Scoping Procedures WKP. REF.

1. Obtain and review the completed Mortgage Banking Preliminary Examination Response Kit (PERK).

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2. Review the previous report of examination and all mortgage banking related exceptions noted and determine if management has taken appropriate corrective action.

3. Gain an understanding of how the mortgage banking operation functions by interviewing management and obtaining and reviewing:

- Board and appropriate committee minutes.
- Descriptions of the mortgage banking operation in the association's 10-K and other financial reports.

4. Document how the operation functions, including to what extent decision-making is centralized or delegated, who is responsible for major decisions, and where final authority rests.

5. Determine the type of mortgage banking operation. Is the savings association doing any of the following:

- Acting as a broker or correspondent and selling mortgages servicing released.
- Originating loans through a retail system and retaining the servicing.
- Purchasing loans through a wholesale system and retaining the servicing.
- Buying and/or selling servicing packages.
- Using a combination of these strategies.

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6. Determine whether senior management and the board of directors developed written policies and procedures that define permissible activities, individual responsibilities, and risk limits. Also determine how the policy-making process works and to what degree the mortgage banking staff complies with the policies. Assess whether the policies and procedures ensure compliance with generally accepted business standards, laws, and regulations.

7. Review the strategic plans for both the savings association and the mortgage banking operation to determine if such plans are compatible, reasonable, and achievable.

8. Assess management quality and depth and review the practicability of succession plans.

9. Review audit reports prepared by the major investors. Ascertain whether the savings association has been placed on probation, suspended, or had its approval as a seller or a servicer revoked by Federal Housing Administration (FHA), Veterans Administration (VA), Federal National Mortgage Association (FNMA or Fannie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), Government National Mortgage Association (GNMA or Ginnie Mae), private investors, or any private mortgage insurance companies. Determine if the savings association has corrected the problems that led to the actions by the investors.

10. Review the work performed by the internal audit department. Assess the adequacy of the scope and frequency of reviews. Determine if the internal audit department has a formal tracking system in place that ensures the resolution of audit exceptions.

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11. Review the most recent external audit report to determine the degree to which external auditors review the mortgage banking operation and rely on internal audit work. Review significant findings to determine if management has resolved outstanding issues or if additional corrective action is necessary.

12. Determine if mortgage banking is integrated into the savings association's overall asset/liability management activities.

13. Determine if there is a comprehensive risk management system in place.

14. Review current business volume in relation to personnel, physical facilities, and MIS equipment and software. Assess the adequacy and feasibility of these areas in conjunction with future plans.

## EXAMINATION PROCEDURES

Depending on the level and complexity of the savings association's mortgage banking activities, the review of its mortgage banking operation may constitute a substantial focus of the overall examination. Once you determine the type of mortgage banking operation and the level and complexity of the mortgage banking activities, discuss with the examiner-in-charge (EIC) the appropriate procedures to perform. With the concurrence of the EIC, you may distribute many of the steps in these procedures among examiners in other areas, particularly those responsible for earnings/profitability, loan production/underwriting, and loan securitization. The mortgage banking specialist, capital markets examiner, and/or senior field staff examining the mortgage banking activities of an association should coordinate their activities with the EIC. The final decision on the scope of the examination and the most appropriate way to obtain information rests with the EIC.

You may omit steps that do not apply; however, you should make a notation as to why they do not apply.

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## Production

1. Based on your review or in coordination with other examiners, determine that the association developed written loan production policies that address:

   - The types of loans that will be originated or purchased.
   - Loan sources.
   - Underwriting guidelines including documentation standards, appraisal, and collateral evaluation.
   - Laws, regulations, and consumer compliance.

2. Review the association's systems to ensure that underwriting practices comply with the association's policy and the underwriting criteria established by FNMA, FHLMC, GNMA (FHA/VA), Federal Home Loan Banks (FHLBs), and other investors as applicable.

3. Determine if the association uses an Automated Underwriting System (AUS), Automated Valuation Model (AVM), or other government-sponsored enterprise (GSE) or investor system.

4. Review the organizational chart and reporting structure for the loan production area and determine that the responsibilities and reporting structure for the origination, processing, underwriting, and closing functions are adequately defined. Ascertain if each function operates independently and if the quality control unit operates independently of the production function.

5. Review the qualifications, experience levels, and training programs for originators, processors, underwriters, closers, and the quality control staff.

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6. Determine if the association offers nontraditional mortgage products, Alt-A loans, simultaneous second liens, or other products. Ensure the association developed appropriate written policies for these products that meeting the interagency guidelines.

7. Analyze the savings association's risk layering practices and determine if the association combines interest only loans with reduced documentation or simultaneous second lien loans and what measures the association takes to mitigate these risks such as requiring higher credit scores, lower loan-to-value ratios, or lower debt-to-income ratios.

8. For savings associations engaging in subprime lending, review the Interagency Guidance on Subprime Lending and Securitizations. Determine to what extent the association offered nontraditional mortgage products and risk layered products to these borrowers.

9. Determine the loan channels used for retail versus wholesale production and the types of mortgage products offered through these channels:

- Evaluate product volume, trends, and concentrations.

10. Determine the savings association's use of loan correspondents, mortgage brokers, and other third party arrangements such as affinity groups. Does the association monitor all aspects of the arrangements including:

- Post purchase underwriting reviews.
- Quality control unit evaluation.
- Ongoing monitoring of loan performance.
- Fall-out.

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- Amount of refinance activity after purchase.
- Documentation problems.

11. For third party originators (TPO) such as mortgage brokers and correspondents, determine if the association:

    - Developed adequate systems and controls for establishing and maintaining relationships including procedures for performing due diligence.
    - Ceded underwriting standards to the TPOs and to what extent.
    - Developed systems to monitor the quality of TPO originations, to ensure that these loans reflect the association's lending standards, and to ensure that the loans comply with applicable laws and regulations.
    - Implemented procedures to track the quality of loans by origination source and borrower attribute and to monitor concentrations of loans by type. geography, or other characteristics.
    - Maintained documentation that details the number and dollar volume of loans rejected by investors and the reasons why investors declined to purchase these loans.

12. Assess the quality of loans acquired from different wholesale sources. Review:

    - Historical default and foreclosure levels.
    - History of nondelivery of loans.
    - Documentation and underwriting exceptions by loan production source.

13. For loan closing and post closing review the association's:

    - Process for funding loans and monitoring the loan closer's performance considering adherence to the underwriter's instructions.

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- Post-closing document tracking system to evaluate the volume and trend of documents missing 120 days or more and the actions taken to procure these document.
- Post-closing review process to determine timeliness, effectiveness, and if it evaluates closing documents for accuracy and completeness.

14. Determine if the savings association uses third-party settlement agents and maintains a list of approved settlement agents. Also determine what directions and guidance the association provides to these agents.

15. Assess the association's risk for funding wholesale mortgages including the methods used to obtain liens and collateral before funds disbursement.

16. Determine the method used to compensate loan originators. Ascertain if the association bases compensation solely on loan volume or to what extent it considers the quality of the loans originated. Also, determine that originators do not have the authority to set or significantly influence the association's loan pricing decisions.

17. Determine the association's methods for evaluating collateral values and if the appraisal review process is independent of the loan production process. Also, determine if the association complies with the Interagency Appraisal and Evaluation Guidelines. Determine whether the association:

- Uses automated valuation models (AVMs) and the measures used to review and validate data input into these systems.
- Follows procedures for back-testing valuations against market data and actual representative sales properties. If tax assessment valuations are used, verify that procedures correlate assessment values with the property's market value.
- Uses licensed appraisers in conjunction with the AVMs.

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- Assigns personnel that are independent of the loan production function to select appraisers and individuals providing evaluations.
- Adequately reviews appraisals ordered by third parties.

18. Determine the association's procedures for post-closing reviews including the systems used to track missing documents and follow-up on trailing documents such as recorded mortgages, mortgage assignments, and the final title insurance policy.

19. Determine to what extent the association uses the Mortgage Electronic Recording System (MERS) and any mortgages not registered under this system including mortgage loans acquired or sold to non-MERS participants.

20. Evaluate if the quality control unit:

- Reviews loan underwriting standards and determines that the information contained in the loan files is accurate.
- Uses a reliable sample selection process, maintains appropriate documentation procedures, and reviews compliance with GSE, government, and private investor requirements.
- Reviews nontraditional mortgage products from all origination channels and a representative sample of underwriters to confirm compliance with the association's standards.
- Issues timely reports, follows-up on deficiencies identified, and provides conclusions that summarize scope and work performed.
- Documents and reports findings to the appropriate level of management or board of directors.

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- Covers all employees, vendors, and contractors involved in the origination process.
- Identifies deficiencies by underwriter, broker, or correspondent.

21. Identify any mortgage fraud uncovered since the last examination and assess if the savings association provided required notifications to investors, title insurers, the association's fidelity bond insurers, and the regulatory and law enforcement agencies. Also ensure that the association filed the appropriate forms including suspicious activity reports and criminal referrals. Determine if the association:

    - Trains loan originators to identify loans with higher fraud risk, potential fraud schemes, and inconsistencies in borrower and property data that could be fraudulent.
    - Investigates fraud referral cases and resolves them promptly and effectively.
    - Tracks loans repurchased due to fraud or misrepresentation.
    - Uses automated tools to help detect mortgage fraud such as mortgage fraud databases or fraud scoring models.

## Secondary Marketing

22. Review the savings association's secondary marketing policies and procedures to determine if the board approved them. In your review, conclude whether the policies are appropriate and commensurate with the size and complexity of the activities. Ascertain if the policies and procedures address the following:

    - Loan products offered, product development, and loan pricing.
    - Accounting policies including identification and rationalization of mortgage loans intended for sale and portfolio.
    - Risk management, limits and procedures and notification requirements for limit breaches, and metrics and modeling.

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- Pipeline and warehouse management including preparation and review of reports for warehouse aging, turnover and reconciliation, and pipeline fallout analysis.
- Personnel authorized to engage in trading and hedging activities and appropriate limits on these individuals.
- Procedures for the sale and delivery of loans to investors and for obtaining and tracking missing mortgage documents.

23. Determine the reporting structure for the secondary marketing unit. Review the qualifications, expertise, and turnover of secondary marketing staff. Determine if management and the board:

- Defines personnel responsibilities.
- Establishes limits of authority.
- Compensates personnel for controlling rather taking risk.

24. Determine if the association is an approved seller/servicer with FNMA, FHLMC, and other investors and:

- Identify which entities the association sells loans to.
- Review the loan sales volume to each entity since the previous examination.
- Review the master sales agreements with the GSEs and investors including requirements for underwriting, delivery, and documentation requirements.
- Determine if the association retains servicing or sells servicing released.

25. Review the mortgage loan pricing policy and determine if the association:

- Considered the business plan, earnings objectives, market share targets, loan portfolio growth targets, and servicing volume.

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- Used risk based pricing that incorporated borrowers credit scores, loan to value, debt to income ratios, and product type.
- Implemented a net value approach that factored mortgage servicing values, net interest margin, buy-ups or buy-downs, gain or loss on loan sales, loan production/origination, and hedging costs.

26. Review MIS and procedures used for updating loan pricing intra-day and the association's procedures and methods to disseminate this information to loan originators.

27. Review the pipeline reports. Determine if:

- The association prepares these reports in a timely manner and the reports specifically identify locked and floating rate pipeline commitments.
- The association identifies pipeline commitments intended for sale and portfolio and stratifies by product type and interest rate.
- Management estimates fall-out detailed by loan product type and documents and back-tests these estimates.

28. Review the warehouse loan inventory and aging reports. Determine the following:

- The number and dollar amount of loans in the warehouse for more than 90 days.
- Whether management proactively manages and accounts for aged warehouse loans.
- Whether management accounts for warehouse loans, including 'scratch and dent' loans and loan pools ineligible for sale (or transfer to securitizations) due to delinquency or documentation problems at the lower of cost or market value. Are such loans tracked after the transfer or sale to determine delinquency and any contingent liabilities or loss?

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- The average turnover rate.

29. Determine if the association estimates risk in a timely fashion and adequately segments the pipeline and warehouse by meaningful characteristics such as loan product type, interest rate, and maturity.

30. Review the models used by the secondary marketing unit and determine that the models used are consistent with the size and complexity of the activities and that:

    - Models are reviewed and validated regularly.
    - Data is reconciled to source information such as the general ledger when applicable.
    - Proper controls are exercised over authorized personnel use of the models and changes to the models are documented.
    - Assumptions used are reasonable and regularly updated.
    - Model estimates and assumptions are regularly back-tested and these back-tests are documented.

31. Determine if the savings association participates in any Federal Home Loan Bank mortgage program and if so, review the type of program and the dollar amount of loans involved since the previous examination. If exposure and risk are material, expand your review as follows:

    - Ascertain if the association appropriately reports and accounts for these activities and that the association's risk management systems adequately address the credit exposure resulting from these transactions.
    - Review the association's policies, procedures, and limits regarding these programs.

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32. Review the association's systems and controls for managing recourse and loss indemnification risks including management's disclosures of these items in the PERK. Review and determine the following:

- Loan sale agreements and the seller/servicing guides for any recourse or implicit recourse provisions that extend beyond the standard representations and warranties (including extended Early Payment Default and other nonstandard requirements.
- Loan repurchases and loss indemnifications including early payment defaults segregated by investor. Your review should include related correspondence, accounting, thrift reporting of such repurchases, and all related loan write downs as well as other related costs since the previous examination.
- If the association's sale contracts have any notice clauses that may result in recourse.
- The association complies with risk-based capital rules for any credit-enhancing representations and warranties.

33. Review loan securitizations issued since the last examination and determine if the association complies with the Interagency Guidance for Securitizations and applicable accounting and investor requirements. Determine if the securitizations contain any credit-enhancing representations and warranties.

## Pipeline and Warehouse Hedging

1. Determine if the pipeline and warehouse system includes all hedging activity.

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2. Determine if the board has adopted written policies and procedures governing all of the following:

- Employees authorized to engage in trading and hedging activities.
- Hedging strategies and if they are supported by correlation analysis.
- Acceptable hedging instruments and policies for linking hedges to specific mortgages or pools.
- Position, hedging, and loss limits for individual employees and the entire operation.
- The basis risk incurred as a result of hedging products.
- The formal process for granting exceptions to policies and limits along with escalation procedures.
- Management reports addressing at a minimum: mortgage pipeline, warehouse, and hedging positions, risk exposure (value at risk and earnings at risk), and effectiveness of hedging (both economic and accounting FAS 133 requirements).

3. Determine if risk limits are reasonable and supported by written analyses. Review exposure reports and determine whether the risk exposure is excessive. Determine if the amount of risk approved by the board for the secondary marketing area is safe and sound for the size and capital level of the savings association.

4. Determine if the association follows the exposure (or coverage) rate limits approved by the board. Determine if the exposure rate and any changes are coordinated with the savings association's overall risk management.

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5. Examine the methods for determining hedge ratios or protection/preservation of economic value and evaluate whether they are adequate. Determine how fallout projections are derived/estimated (e.g., whether historic fallout has been tracked).

6. If options are used for pipeline hedges, determine if the costs are excessive. If forward commitments are used, review pair-off fees for the most recent period and determine if those fees are excessive.

7. Review internal tests of correlation for instruments used to hedge the pipeline and warehouse. Based on these tests, determine the extent of any basis risk.

8. Review hedge composition and risk decomposition/attribution analyses to gauge hedge performance.

9. Review gain on sale margins to evaluate overall hedge performance and income volatility of the mortgage pipeline and warehouse portfolios net of hedging activities.

10. Review the savings association's mortgage loan portfolio to determine if loans are properly classified in accordance with management's stated intent.

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## SERVICING

### Servicing Activities and Functions

1. Determine the characteristics of the servicing portfolio, paying specific attention to:

   - The investors (GNMA-guaranteed, FNMA, FHLMC, FHLB, private label).
   - The types of products (30-year fixed, 15-year fixed, adjustable rate mortgages (ARMs), balloons, hybrids, etc.).
   - The level of nontraditional mortgages such as interest-only or payment-option ARMs.
   - The level of mortgage loans with nontraditional features such as reduced documentation and simultaneous second-lien loans.
   - Whether 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 real estate owned (REO).

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2. Evaluate the asset quality of the servicing portfolio:

- Compare the level of delinquencies, foreclosures, bankruptcies, losses, and REO with historical levels, and with comparative industry data, including both regional and national averages (if available).
- Evaluate the extent and impact of geographic concentrations.
- Evaluate the extent and impact of nontraditional mortgage product concentrations.

3. Obtain the association's reconcilement of loans serviced for others reported on internal management reports to the amounts reported on Thrift Financial Report (TFR) Schedules SI and CMR. Typically, there will be some differences, but the association should delineate and explain the amount of, and reasons for, the differences.

4. Obtain the organizational chart and determine the experience and qualifications of key servicing personnel. Evaluate whether staffing of the servicing unit is adequate for the amounts and types of servicing. Obtain a list of servicing sites and functions performed at each location.

5. Obtain reports used by senior management and the head of the servicing function to measure servicing performance against key performance indicators/ benchmarks, and any reports regarding performance against peer comparison data. Review the adequacy of the reports used by management and identify trends and/or issues.

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6. Review the adequacy of the servicing quality control function and reporting mechanisms. Ensure the scope of the servicing quality control function encompasses all servicing functions.

7. As applicable, review the adequacy of any vendor management (outsourcing) function and third party arrangements with regard to the association's due diligence and initial approval of the third party; annual re-certification/approval of the third party; and ongoing oversight, monitoring, reporting of third party performance, etc.

8. Coordinate with the IT examiners to determine the adequacy of the loan servicing system platform.

9. Determine the number and dollar volume of delinquent GNMA loans the association purchased from the servicing portfolio and any other early pool buyouts. Determine whether:

- These GNMA buybacks are appropriately reported on the TFR and follow proper accounting (see Accounting section for guidance).
- There are limits on the total investment in early pool buyouts.
- Early pool buyout decisions are supported by internal analyses evidencing the economic benefit to the association.
- Such buyout activity is supported by the guaranteed yield on the loan, the estimated remaining time to foreclosure, and the likelihood of reinstatement of the loan to a performing status.
- The analysis of individual loans considers the collateral, the status of guarantees, and liquidity ramifications to the association.
- The financial impact of this strategy is appropriate for the association.

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- Monitoring processes ensure timely liquidation and disposition of these loans at no loss to the association.
- There are adequate reports and monitoring processes in place.

10. Review reconciliations of investor accounts that are out-of-balance or have significant stale reconciling amounts:

- Ascertain whether there are stale, unreconciled items that should be charged off.
- Determine whether management reviews the aging of unreconciled items regularly and charges off uncollectible balances.

11. Review investor advances/receivables to:

- Evaluate collectibility.
- Determine if reimbursement claims (i.e., owed to the association from investors) have been filed in accordance with investor requirements for completeness and timeliness, and that the association performs a follow-up on reimbursement claims.
- Verify that management sets up reserves for uncollectible advances/ receivables and writes them off in a timely manner.
- Determine the amount of any expenses disallowed by investors due to the savings association's failure to comply with investor/servicing criteria and ensure that the association expensed such items. Review the need for reserves for future losses.

12. Obtain internal audits for servicing; investor seller/servicer audits; rating agency servicer reviews; agency (Housing and Urban Development (HUD), FNMA, FHLMC) ratings for various servicing functions; significant litigation reports on servicing; customer complaint reports for servicing; the association's trend reports

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on its servicing portfolio versus peer/industry statistics on delinquencies (including bankruptcies); and foreclosures, etc. Review these for trends and issues.

13. As applicable, for the association's use of third party servicers and sub-servicers to service loans for the association only (not with regard to the instititution's role as master servicer):

- Obtain the association's reconcilement of loans serviced by others reported on internal management reports to the amounts reported on TFR Schedules SI and CMR. There may be differences, but the reason(s) and amount(s) of such differences should be explained and delineated.
- Determine if the association performs adequate due diligence for prospective new, unknown, or unregulated servicers and sub-servicers.
- Review the adequacy of the policies and procedures for annual re-certification/approval of servicers and sub-servicers.
- Verify whether servicing agreements with servicers or sub-servicers contain adequate provisions to protect the association.

14. Determine if the association monitors, audits, and assesses the performance of all servicers and subservicers. This step applies to both the association's use of third party servicers and sub-servicers to service loans for the association, as well as the association's oversight of primary servicers in its role as master servicer (if applicable).

15. Verify that a disaster recovery plan is in place that covers all major servicing and any sub-servicing functions performed by the association.

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## Mortgage Servicing Rights (MSR) Purchases and Sales

1. Review bulk sales and purchases of servicing since the last examination to:

- Determine whether the board of directors approved these transactions in advance.
- Assess whether due diligence activities, fair valuations of servicing, and internal analysis to determine the impact on the association were performed before funding bulk purchases or sales. If so, determine the adequacy of this analysis.
- Determine whether servicing sales and purchases were with or without recourse and whether there are implied, partial, or verbal recourse agreements.
- Verify that comprehensive sales and purchase agreements are maintained for each purchase and sale and ensure that the terms and conditions of the contracts are safe and sound.
- Review the appropriateness of the accounting for servicing purchases and sales, including whether any sale of servicing should be recorded either as a sale or as a financing pursuant to SFAS No. 140.
- Ensure that the transfer of servicing has been completed effectively.

2. Determine whether the association hedges MSR. If so, refer this activity to the examiner responsible for the Mortgage Banking Hedging Program. Ensure that the fair value of any financial instruments used to hedge mortgage servicing assets is not included in the fair value of mortgage servicing assets for purposes of determining the fair value limitation of mortgage servicing assets includable in regulatory capital (see Accounting section).

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## Accounting For, and Valuation and Financial Reporting of MSRs

3. Obtain from the association the amount of loans sold/securitized with servicing retained and with servicing released during the review period. Obtain from the association the total amount of gain/(loss) on sale/securitization, and the portion of this that represents the capitalization of MSR during the review period.

4. Obtain the association's reconcilement of MSR assets and liabilities reported on internal management reports to the amounts reported on the most recent TFR Schedule SC.

5. Ensure that management has the proper reports to comply with disclosure requirements for MSR. Obtain and review such reports applicable to the review period.

6. Review the adequacy of the methodology to derive fair value for the initial capitalization of MSR, and the accuracy of the accounting entries used in the initial capitalization of MSR.

7. Review whether the association accounts for MSR under the (a) amortization method or (b) fair value method and obtain the most recent accounting reports for these methods to review their adequacy.

8. Review whether the association records temporary impairment and permanent impairment (as applicable) for MSR. Obtain the most recent reports to review their adequacy and determine the methodology used.

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9. Determine how management derives the MSR fair value and review that process. If the association is using an internal model, determine whether they are using the OAS or static analysis methodology.

10. Review the association's internal model validation process and procedures (including use of broker surveys and peer group surveys, if any) for adequacy and to determine whether the association uses them appropriately.

11. Review any third party valuation of MSR. Review any reconcilement of internal results to third party fair value results as of the same date.

12. In order for you to validate the MSR values from either the internal fair valuation or the third party valuation, you may want to calculate fair value using the OTS Servicing Model available from Regional Capital Markets examiners. This will necessitate the need for valuation assumptions to be in a particular format in order to be input into the model, which you will need to obtain from the association and/or third party as applicable.

13. Review the adequacy of the association's most recent sensitivity analysis (as applicable) for fair value of MSR.

14. Evaluate the adequacy of accounting policies and procedures for MSR.

15. Verify that the association correctly calculates and reports MSR for regulatory capital purposes on TFR Schedule CCR. In this regard, coordinate with the examiner responsible for Capital.

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## MSR Hedging

16. Determine that MSR hedging policies, procedures, and practices are adequate to effectively manage and hedge the MSR portfolio at reasonable risk levels.

17. Determine if the board has adopted written policies and procedures governing:

- Employees authorized to engage in hedging activities.
- Hedging strategies and if they are supported by hedge correlation analysis.
- Acceptable hedging instruments and policies for linking hedges to specific MSR risk tranches or segments.
- Position, hedging, and loss limits for individual employees and the entire operation.
- The formal process for granting exceptions to policies and limits along with escalation procedures.
- Management reports addressing at a minimum: MSR portfolio risk profile and hedging positions, risk exposure (value at risk and earnings at risk), and effectiveness of hedging (both economic and accounting requirements).

18. Determine the adequacy of analytical/tracking systems to measure and monitor the MSR portfolio and their changing effect on the overall interest rate risk of the savings association.

19. Determine if risk limits are reasonable and supported by written analyses. Review exposure reports and determine whether the risk exposure is excessive.

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20. Determine if the amount of risk approved by the board for the MSR portfolio is safe and sound for the size and capital level of the savings association.

21. Determine if the savings association follows exposure (or coverage) limits approved by the board. Determine if the MSR exposure and any changes are coordinated with the association's overall risk management.

22. Review internal tests of correlation or hedge effectiveness for instruments used to hedge the MSR portfolio.

23. Review hedge composition and risk decomposition/attribution analyses for explanation of hedge performance.

24. Access overall income performance and income volatility of the MSR portfolio net of hedging activities.

## INCOME MEASUREMENT

1. Describe and evaluate management's financial reporting system. Is the mortgage banking operation broken out separately from the rest of the savings association's operations? Do management's reports break out each mortgage banking segment separately? Is each segment's financial performance reported in reasonably appropriate metrics, or is it all in dollar terms?

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2. Determine if mortgage banking operation metrics are benchmarked against appropriate industry standards.

3. Describe and evaluate the cost structure of the mortgage banking operation. Evaluate the relationship of fixed to variable costs for the operation as a whole and for each segment. Is each of the operations' expenses scalable to volume? Assess management's ability to reduce costs when volumes shrink.

4. For production operations, does management:

- Separate the costs into the appropriate production methods?
- Consider early payment default and/or early pay-off in the profitability analysis?
- Have flexible funding sources?

5. For secondary marketing:

- How are the loans priced?
- Does management hold loans longer than needed to generate extra interest income? If so, describe and assess the risks of the activity and determine if management has done the same.
- Does management view secondary marketing as a profit center? If so, describe and assess the risks of the activity.

6. For servicing, does management:

- Have reports that separate the MSR into its various parts for income and expense?

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- Have a cost to service analysis that reflects all appropriate costs?
- Consider the economic impact of the MSR (the income and expenses it receives and incurs over time) as well and the mark-to-market impacts?

7. How is the association's quality scoring/review (quality control, quality assurance, consumer compliance, etc.) system reflected in prices paid to the production area?

8. Summarize your evaluation of the earnings profile of the association's mortgage banking operation given the nature and risk profile of its activities.

9. Obtain the most recent Mortgage Bankers Association Cost Study (or similar national standard) and compare the savings association's operations to that standard.

10. Determine how changes in the local or national economy or changes in the mortgage banking operating cycle have affected the association's mortgage banking operation.

## EXAMINATION CONCLUSIONS

1. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

## EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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