

**ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY**

Policy Number	<u>95-1</u>
Effective Date	<u>7-19-95</u>
Supersedes	_____
Approval	_____

SUBJECT: Mortgage Banking Activities

MORTGAGE BANKING OVERVIEW

Mortgage banking activities include loan origination, loan production, mortgage servicing, secondary marketing, and other areas such as mortgage banking management, accounting, and reporting. The areas evaluated during an examination should be determined on a case-by-case basis depending upon the size of a particular company and the business activities in which it engages.

Loan origination is the retail operation in which loans are made directly to the public. The loans are processed, underwritten, and closed. These mortgages become part of the "mortgages held for resale" account where they will remain for the two to three month period necessary to complete the recording of the loan documents and to find a permanent investor to purchase the loans. The mortgage banker obtains purchase commitments from permanent investors and submits completed loan documentation packages to the investors for their approvals in satisfaction of the commitments. The mortgage banker maintains a relationship with a variety of permanent investors to whom the originated mortgages are sold.

Loan production is the function in which the mortgage company acts as a wholesaler and purchases loans in bulk or individually from other mortgage bankers, brokers, and bankers. These loans are purchased with the intent to pool the loans and resell in the secondary market. The mortgage company may then pool loans and sell to private or public investors with servicing rights retained or released. Generally servicing is retained in order to generate an ongoing income stream. During the production process, loans may be warehoused. Loans are retained in an inventory either pending commitment to a pool or to speculate on interest rates.

Mortgage servicing is performing the required duties of a mortgage seller such as collecting and remitting payments, managing the tax and insurance escrow accounts, inspecting the properties when required, pursuing delinquent borrowers, foreclosing on the mortgages when necessary, and providing accounting support. Servicing may be done by the lender or by a company acting for the lender. Due to economies of scale, the servicing portfolio must be sizable for the company to be profitable.

MORTGAGE COMPANY MANAGEMENT

Evaluation of management will entail a review of the organizational structure, board supervision, management oversight, management and board reporting, and the adequacy of management control systems. The organizational structure should be reviewed to determine, on a legal entity basis, the relationship between the mortgage banking company, the bank holding company, and any other bank or nonbank subsidiaries. Supervisory oversight is generally provided through the mortgage banking company's board, which may consist of mortgage banking company executives, bank holding company executives, and outside representatives. The examiner should determine whether

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a separate board exists, its membership and qualifications. Minutes should be reviewed to determine whether directors are fulfilling their fiduciary responsibilities. Directors' duties include: 1) selecting and retaining a competent executive management team; 2) establishing, with management, the company's short and long-term objectives, and adopting operating policies to achieve those objectives in a safe and sound manner; 3) monitoring operations to ensure they are controlled adequately and are in compliance with laws and policies; 4) overseeing the mortgage banking company's business performance; and 5) ensuring that the company meets the community's residential mortgage credit needs. Board reports should include default rates, new loans, liquidity levels, capital needs, policy exceptions, past dues, geographic concentrations, departmental profit and loss statements, and foreclosure rates.

Management should be evaluated in terms of technical competence, leadership skills, administrative capabilities, and knowledge of relevant State and Federal laws and regulations. Without adequate management oversight, excessive errors can occur, fraud or violations of law may go undetected, and financial information may be reported incorrectly. Management should also be evaluated on its ability to plan effectively. Effective planning entails the annual approval of an operating budget and the development of a long-term business plan which helps management anticipate changes in the internal and external environment and respond to changing circumstances. Without appropriate planning, the company can only react to external events and market forces. Compensation of management should also be examined. Compensation based on volume of production may increase risk, conflicts of interest, and an absence of independence.

Management controls consist of internal audit, external audit, quality control, insurance coverage, fraud detection procedures and related employee training programs. The internal audit function is responsible for detecting irregularities, determining compliance with applicable laws and regulations, and appraising the soundness and adequacy of accounting, operating and administrative control systems. The auditor must be independent and should report directly to the board or a designated committee. Small financial institutions may rely solely on their external auditor to perform these functions. Examiners should review the most recent external audit report and note any significant concerns or weaknesses in the company's internal control structure. Management's response to the audit should also be reviewed.

Quality Control services can be provided internally by an independent party or externally. In a small organization there may be little separation between the person underwriting the loan and the individual reviewing it. Quality Control reviews are necessary to test the quality of loans produced and serviced for investors. Investors such as GNMA, FHLMC, and FNMA issue very specific guidelines that must be met with respect to the scope and frequency of such reviews. At a minimum, these investors require that the servicer/seller sample at least ten percent of all closed loans each month for accuracy, completeness, and adherence to agency underwriting standards. The Quality Control person basically re-underwrites the loan, verifies deposits and employment, recomputes the APR, interest rate, loan to value, debt to equity and so forth. The Quality Control

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function should serve as an early warning system which alerts management to situations which may jeopardize the financial strength, image, or origination and sale capacity of the company. Quality Control should not substitute work performed by the internal audit and loan review functions. Insurance programs should be reviewed to determine whether coverage adequately protects the company and its affiliate against exposure to undue financial risk. The board should review and approve insurance policies at least annually. A letter should also be obtained from the mortgage company's attorney to determine if any pending litigation could cause losses to the bank and or the mortgage company.

MORTGAGE RELATED AGENCIES

Loans are categorized as either government or conventional loans. Government loans generally carry a below-market interest rate and are either insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). To be insured or guaranteed, a loan must meet agency standards regarding the size, interest rate, and terms. The lender must obtain a certificate of insurance or guarantee in order to qualify a loan for inclusion in a security.

Loans which are not FHA-insured or VA-guaranteed are referred to as conventional loans. Conventional loans are generally originated for larger loan amounts and can be offered with a fixed or variable interest rate. These loans typically require higher down payments and bear market interest rates. Lenders often require borrowers to obtain mortgage insurance coverage in high-ratio loans (generally, any loan with a loan-to-value ratio above 80 percent). In the primary market, private mortgage insurance (PMI) insurers provide coverage for the top 20 to 25 percent of a mortgage loan.

There are three major organizations involved with the facilitation of mortgage loans in both the primary and secondary mortgage markets: Federal National Mortgage Association (FNMA), Government National Mortgage Association (Ginnie Mae or GNMA), and Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). The extent of credit risk depends upon the secondary market program under which the loan is originated. GNMA pass-through securities, which are issued by the lender, are backed by pools of FHA-insured or VA-guaranteed mortgages and are fully-guaranteed by the U.S. Government. Pass-through securities provide for monthly installments of interest at the stated certificate rate plus scheduled principal amortization on specific dates, despite the delinquency status of the underlying loans, as well as any prepayments and additional principal reduction. The issuer collects the mortgage payments and after retaining servicing fees, remits monthly payments to the certificate holders. This agency is under general policy direction of HUD.

FNMA operates a secondary market facility for FHA, VA, and conventional loan products which provides a degree of liquidity to holders of mortgage investments. FNMA will purchase FHA

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approved mortgages from qualified sellers through an auction format, using competitive and noncompetitive bidding procedures, and through convertible standby purchase commitments. These FNMA purchases enable originators to adjust their mortgage inventory levels periodically and maintain their origination capabilities. FNMA will also sell mortgages to qualified buyers which allows the purchasers to meet investor commitments by making up mortgage inventory shortages. The FNMA purchases and sales of the loans are dependent upon market conditions. FNMA guarantees the monthly pass-through of interest, the scheduled amortization of principal, and the ultimate repayment of principal. Participation certificates are not backed by the full faith and credit of the U.S. Government. FNMA is regulated by HUD.

Similar to FNMA, FHLMC is also a private corporation which purchases conventional loans from lenders and sells mortgage-participation certificates which are similar to GNMA pass-through securities. Participation certificates represent an ownership interest in pools of conventional loans. FHLMC guarantees the monthly pass-through of interest, the scheduled amortization of principal, and the repayment of principal. The certificates are not backed by the full faith and credit of the U.S. Government.

Conventional loans are classified as either conforming or nonconforming. Conforming loans must comply with FNMA and/or FHLMC size limitations, underwriting and documentation guidelines. Conforming mortgages may be sold to FNMA or FHLMC on either a recourse or nonrecourse basis. Nonconforming loans that do not meet FNMA or FHLMC guidelines may be sold in the secondary market under a private label structure. Nonconforming loans are often "nontraditional" products such as loans with teaser rates, limited documentation, graduated payment schedules, and "jumbo" loans which exceed maximum agency size requirements.

LOAN ORIGINATION

Loan origination entails five principal steps: 1) application; 2) processing; 3) underwriting; 4) closing and funding; and 5) post closing. Each of these functions should be independent of one another and separately supervised to ensure the quality of the loans produced. Loan originators must be knowledgeable of bank policy, procedures, laws, rules, and regulations. This is a highly regulated industry and noncompliance in any of these areas may disqualify a loan from sale in the secondary market.

Loan origination begins with the completion of a loan application. The applicant authorizes the lender to verify their employment, credit history, bank deposits, and other information which evidences repayment capacity. The loan processing area is responsible for gathering all documents which verify the financial condition of the borrower and the collateral. Processing activities should be controlled through standardized procedures, checklists, and systems. The underwriting unit approves or disapproves applications based on underwriting criteria established by FHA, VA,

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FNMA, FHLMC, private mortgage insurers, and institutional investors. Once a loan is approved by the underwriter, a commitment letter is sent to the applicant which states the interest rate and terms of the loan. At the loan closing, the legal title to the property passes from seller to buyer and the mortgage banker establishes a first lien on the property to secure the loan. After closing, a post-closing review is performed to ensure that documents were properly executed and underwriting instructions were followed. The post-closing review also identifies any trailing or missing documents which must be tracked and obtained to meet investors' pool certification requirements.

Certain risks are evident in the origination process. Operational inefficiencies can result in high staff turnover, an inability to meet investor documentation requirements, an increasing number of pools which lack final certification, or an unusually high production cost structure. Credit risk and operational inefficiencies may also create liquidity problems and additional interest rate risk if the company is unable to sell its loans in the secondary market. Other risks include product risk, borrower fallout risk, and reverse price risk. Product risk occurs when the product offered or made is not desired on the current secondary markets. If it can be sold, it is often at a steep discount. Borrower fallout risk is the risk that the loan will not close due to an action or inaction of the borrower. Reverse price risk occurs when a commitment is made to sell the loan to an investor at a certain rate prior to committing to the borrower. In the interim, a decrease in rates requires that the loan be delivered at an unexpected discount.

Prior to or at closing, the mortgage banker has an option whether to retain the loan in their own inventory (warehouse); pool loans and sell them to one of the federal agencies, a private investor, or choose to securitize the loans themselves; sell the loan individually; or sell it as part of a loan participation. The size and scale of the mortgage banking entity, liquidity, funding limits, and the product itself influence which decision is made.

WAREHOUSING

The term pipeline is typically used to describe mortgages that are in the process of being originated, while warehouse refers to the inventory of mortgages that have been closed and are awaiting sale in the secondary market. Making a distinction between the pipeline and the warehouse is important because the risks of mortgages that are already closed differ from those that have not, and might not, close.

Once a mortgage is closed and the final documents are received, a mortgage leaves the pipeline and enters the warehouse, where it is either held for sale and marketed to investors, or shipped to a prearranged buyer. The amount of non-committed inventory is often restricted by mortgage company policy. Loans maintained in the warehouse with an intent to resell should be marked to market at least quarterly. After write-downs, write-ups to market values in subsequent periods are recorded, but total recorded market value may not exceed cost. The marking to market is often

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insignificant for loan pools committed to be delivered within a short period of time. The most adversely affected loans will be those held for a longer period of time with unusual features. While mortgages are being held in the warehouse, but before a contract has been signed agreeing to their sale price and terms, the mortgage company bears an enormous risk of the mortgages going down in value as a result of changes in overall interest rates or merely changes in the secondary mortgage market. It is critically important that a mortgage banking operation's interest rate risk is controlled, especially if the company's average pipeline and warehouse volume is significant relative to its capital.

Since a mortgage company typically obtains working capital from the sale of mortgage loans, warehoused loans can impair the sources of funds for new loans. Mortgages held for resale are frequently funded by a "warehouse mortgage" line of credit. This is a collateralized line of credit from a bank which is supported by a pledge of the mortgages in the resale inventory. The warehouse line operates as a revolving line of credit, with additional advances to the company for new mortgages to be placed in "warehouse" and repayments from the proceeds of sales to investors. Warehouse lines are a prime source of liquidity for the mortgage banker operating in the residential mortgage market. Refer to Arkansas State Bank Department Rules and Regulations, Section 5, Page 4 for additional information.

The primary risks in the area of warehousing are interest rate risk, market risk, and product risk. Interest rate risk occurs from holding a product, and it represents the difference between the rate paid for the loan versus the rate it can be sold at on the market. Market risk is the risk that either the market pricing will change or the market perception changes. Product risk is the risk that the product is undesirable to investors.

LOAN PRODUCTION

Wholesale production channels, where contact with the borrower is made by another party, take several forms. Whole loans can be purchased either individually or using bulk commitments. Bulk commitments either require the correspondent to deliver a set amount of loans (mandatory), or deliver all registered loans that close (best effort or optional). Loans are purchased in this manner to increase volume and to expedite the securitization process. Since this entails buying loans from outside sources, certain key factors should be considered and established by mortgage company policy: 1) guidelines for due diligence reviews; 2) definitions of loan products to purchase; 3) amount of loans desired; and 4) authority for purchase approval/commitment letter. The integrity and the independence of the introducing broker should be determined to ensure the purchases are made at arms length. If the mortgage company determines that it wants to proceed with a due diligence review of the loans, individuals are assigned internally or hired externally to perform the review on behalf of the mortgage company. Either way due diligence policies and procedures should be established by the mortgage company. These procedures should define scope, sample

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size, and specific review guidelines. If an external review team is used, a contract should be written which defines both parties responsibilities and compensation. For purchasers of correspondent production, credit risk increases to the extent that the lender relies on other parties to correctly process and underwrite the loan. Contracts with correspondents should include representations and warranties from the correspondent that loans delivered meet the underwriting requirements of the agency or investor program for which the loan was originated. Risks in this area include: 1) sampling risk; 2) pricing risk; 3) delivery risk; and 4) interest rate risk. Sampling risk is the risk of obtaining a biased sample which does not reflect the overall condition of the portfolio to be purchased. Pricing risk is the risk of offering too much for the loans purchased. Delivery risk is the risk that the loans purchased won't be delivered upon the commitment date or will not conform with the commitment requirements. Interest rate risk is the risk that the rate paid was too much based on the time frame for delivery and what the market will tolerate.

SECONDARY MORTGAGE MARKETING

The marketing department is typically responsible for the development of mortgage products, determination of products to be offered, as well as the establishment of daily mortgage prices. The marketing department which is also referred to as Secondary Marketing, is also responsible for the sale of mortgage loans to investors. The marketing department acts as an intermediary between the borrower and the investor. In a small mortgage company, the president, an executive officer, or a combination of individuals may be responsible for the marketing function.

Marketing activities are generally supervised by a marketing committee, which may consist of the Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, and the executive officers responsible for marketing, production, and servicing/loan administration. The committee is responsible for the formulation of marketing policies, departmental operating procedures, pricing strategies, and parameters governing the use of various mortgage-related products and strategies used to hedge the interest rate risk associated with certain mortgage loans. Bank policy should establish reasonable guidelines for the amount of loans that can be retained in the mortgage pipeline, liquidity levels, levels of uncommitted inventory, number of pools in process (including dollar amounts), approval authority, types of pools and securities in process, pair off procedures and guidelines or restrictions on hedging the current position. Identified risks in this area are: 1) interest rate risk; 2) product risk; 3) investor/counterparty performance risk; 4) fallout risk; and 5) delivery risk. Interest rate risk is the risk arising from timing differences which occur from the point of application to the point of sale to an investor. Product risk is the risk that there is no market for that particular type of loan. Investor/counterparty risk can be reduced by establishing dealer limits to limit the maximum amount of trades outstanding with each firm and monitoring the financial capacity of the brokers and dealers. The company should also ensure that when a loan is sold to an investor the payments for each loan are received in a timely manner. If loans are sold with recourse, management reports should identify and track potential recourse obligations. Fallout

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risk is the risk the borrower may not qualify for the loan, may walk away from the loan or a contingent event occurs preventing the mortgage loan from closing. Delivery risk is the risk that the commitment to deliver by the mortgage company is unable to be met.

Mortgage pricing decisions are critical because price is the major determinant in the volume of mortgages originated. A neutral price structure sets mortgage prices that are equivalent to the expected price for which the mortgages will be sold to investors, plus a normal servicing spread of 25 to 50 basis points. Daily adjustments are usually made to prices to reflect market changes for future settlement of mortgage-backed securities (MBS). Due to regional or local competition, mortgage banking companies often find it necessary to deviate from a purely neutral pricing strategy to maintain volume in certain markets. However, large deviations from market price in either a lower, or even upward, direction can have adverse consequences. Price cutting could place operational strains on the production and servicing areas. Premium pricing can position the company as a lender of last resort with adverse credit quality implications. The marketing department attempts to minimize price risk by matching origination pricing with the price they expect to receive from investors.

Risk exists that the proportion of loans in the rate-committed pipeline that are expected to close will change with a given change in interest rates. Conservative management, who do not want to take a great deal of interest rate risk, may obtain a forward commitment once they have a certain percentage of the pool/security complete. Speculative management may utilize numerous hedging tools and assume a greater degree of interest rate risk. Mortgage companies use hedging strategies to protect the inventory of closed loans and the rate-committed pipeline against adverse interest rate movements. In order to control exposure to rate movements, management must estimate the percentage of the rate-committed pipeline that is expected to close in the current economic environment. Other products used to hedge inventory loans and the rate-committed pipeline include loans with an adjustable rate feature or other specialized characteristics.

LOAN SERVICING/ADMINISTRATION

In the loan administration or servicing function, the mortgage company is acting as an agent for the investors whose loans are being serviced. While the quality of the serviced assets is not a primary concern of the examiner, the quality of the operations and its impact on the company's earnings are matters of concern. A poor quality portfolio may be very costly to service; therefore, management should recognize the importance of a proper due diligence review prior to purchasing servicing rights. The examiner should be alert to servicing costs that exceed income. The examiner should also review the amortization of mortgage servicing rights to determine whether the amortization period exceeds the average life of the serviced mortgage loan portfolio. Servicing rights, when properly managed, provide a stable source of earnings. Long-term profitability is achieved through efficient processing, cost containment and the attainment of economies of scale.

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Mortgage banking companies that originate and sell residential real estate loans in the secondary market often retain the right to service those loans for the investor for a fee. Each investors' servicing funds should be maintained in separate accounts. The servicer's specific responsibilities with regard to each investor are specified in a formal written servicing agreement. The servicer collects the monthly payments from mortgagors, collects and maintains escrow accounts, pays the mortgagors' real estate taxes and insurance premiums, and remits principal and interest payments to the ultimate investors. The servicer also maintains records for the mortgagor, collects late payments on delinquent accounts, inspects property, initiates and conducts foreclosures, and submits regular reports to investors. Additionally, most servicing departments are responsible for customer complaints, retaining complaint logs, channelling complaints and ensuring proper follow-up. Investor reporting and customer complaint records must be complete and accurate.

Servicing agreements establish minimum conditions for the servicer such as its fiduciary responsibilities, audit requirements and fees. Real and contingent liabilities arise out of the contract. Most investors, including the federally-sponsored agencies, hold servicers responsible for full compliance with investor requirements. Investors may require a loan to be purchased or request reimbursement for losses that occur as a result of servicing errors, omissions or improper documentation. The agreements should be reviewed to determine that no additional liabilities, real or contingent, are imposed upon the company beyond its responsibilities as a servicing agent.

Mortgage servicing revenues are derived from five sources. The primary source is the servicing fee. Because this fee is usually expressed as a fixed percentage of the outstanding mortgage loan principal balance, servicing fee revenues decline over time as the loan balance amortizes. The second source of servicing income arises from the interest that can be earned by the servicer from the escrow balance that the borrower often maintains with the servicer. The third source of revenue is the float earned on the monthly loan payment. The opportunity for float arises because of the delay permitted between the time the servicer receives the payment and the time the payment must be remitted to the investor. Ancillary income, such as a late fee charged to the borrower if the monthly payment is not made on time, is another source of revenue. Finally, the servicer might generate fee income by selling mailing lists to third parties.

Many companies have established aggressive growth targets for their servicing portfolios. The usual source of growth in the servicing portfolio is the company's own origination activity. However, it is not uncommon for a company to supplement this growth with bulk or individual purchases of loans or purchased servicing rights from other companies. Portfolio size is reduced through normal runoff, prepayments, and sales of either loans or servicing rights only.

Subservicers can be used to perform the tax services, insurance, etc. The mortgage company continues to be responsible for these activities and errors that may occur. The company's method of evaluating and monitoring the financial condition of its subservicers should also be reviewed.

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Subservicing agreements should be evaluated in terms of the subservicer's responsibilities, reporting requirements, performance, and fees.

CAPITALIZED SERVICING ASSETS

The right to service mortgages are generally acquired in four ways: (1) the origination of mortgages by the mortgage company that are kept in the portfolio which is called portfolio servicing; (2) the origination of mortgages that are sold with servicing retained which is called retained servicing or originated mortgage servicing rights (OMSR); (3) the purchase of servicing rights from third parties called purchased mortgage servicing rights (PMSR); or (4) as a by-product in a purchase of mortgages and their servicing (servicing released purchase) where a definitive plan for the sale of the mortgages with the servicing rights retained exists at the time the mortgages are acquired, also called purchased mortgage servicing rights (PMSR).

Capitalized servicing assets consist of purchased mortgage servicing rights (PMSR) and excess servicing fee receivables (ESFR). PMSRs are acquired assets which represent the right to service loans owned by investors in exchange for a share of the future cash flows generated by the underlying loans. The purchase price represents the buyer's estimate of the present value of the future servicing fees net of servicing costs. The right to service mortgage loans for investors is an intangible asset which may be acquired separately, in a purchase of mortgage loans, or in a business combination. Statement of Financial Accounting Standards SFAS No. 65, "Accounting for Certain Mortgage Banking Activities, is the relevant accounting guidance for mortgage banking activities. Under SFAS 65, a mortgage banking company shall capitalize the cost of acquiring the right to service a loan as a separate asset if: 1) the loan qualifies as a purchase transaction, and 2) a definitive plan for the sale of that loan exists when the loan is acquired. A definitive plan for sale exists if: a) the mortgage banking company has either obtained, prior to purchase, commitments from permanent investors to purchase the mortgage loans or related mortgage-backed securities, or obtains such a commitment within a reasonable period (i.e. 30 days), and b) the plan includes estimates of the purchase price and selling price.

The initial amount capitalized cannot exceed the lesser of 1) the purchase price of the loan, including any transfer fees paid, in excess of the market value of the loans without servicing rights at the purchase date or 2) the present value of net future servicing income discounted at an appropriate long-term interest rate. Management should be able to substantiate the rate used. The capitalized amount shall be amortized in proportion to, and over the period of, estimated net servicing income.

PMSRs are highly subject to interest rate and prepayment rate risk since the amount of future cash flows is dependent upon the outstanding balances of the underlying mortgage loans. Unanticipated changes in interest rate, prepayment speed, or other valuation assumptions may impair the carrying

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value of PMSRs and require accelerated amortization or a write-down. The recoverability of the unamortized balance should be evaluated periodically, and amortization and/or the value of the asset should be adjusted accordingly. To the extent impairment is not recognized, PMSR values may be inflated. As a result, assets, earnings, and capital may be overstated. Regulatory guidance requires that PMSR values be evaluated at least quarterly. Evaluation models may be developed in-house or purchased from an outside vendor.

Excess servicing fee receivables are recorded when the mortgage company's fee for servicing mortgages sold exceeds the normal servicing fee for a comparable pool of mortgages. The asset to be recorded represents the present value of the expected future excess fee income. The company should first estimate the amount of excess cash flows that it expects to receive from servicing the loans. The estimated cash flow stream must consider expected prepayments of the underlying mortgages. Next the estimated cash flow stream should be discounted to determine its present value. The discount rate should be an appropriate long-term interest rate that reflects the risks of the assets. Once the amount of the excess servicing fee receivable is determined, it is recorded as an asset. ESFR should be reevaluated at least quarterly to determine the impact of unanticipated prepayments of the underlying cash flows. According to EITF 86-38, the ESFR must be written down to the present value of the estimated remaining future excess service fee revenues. The discount rate used to compute the present value of the estimate future servicing fee income should be the same rate as that used to initially record the asset. Unlike PMSRs, which require that an actual service be performed, ESFRs merely represent the purchase of the right to receive the underlying cash flows. ESFRs are considered tangible assets.

OMSRs represent the future net servicing income which is associated with loans that are originated through a mortgage banking company's own production network. Currently OMSR are not recognized on the balance sheet as an asset distinct from the mortgage. SFAS No. 65 also prohibits the recognition of a mortgage servicing asset representing the normal servicing fee when a mortgage company originates a mortgage loan and then sells it to a third party with the servicing rights retained by the seller; only the excess servicing fee, if any, may be recorded as an asset.

In a press release dated June 21, 1995, an FFIEC Task Force announced recommendations regarding the appropriate regulatory reporting treatment for mortgage servicing rights (MSRs) by banks. The need for this guidance is a result of FASB's issuance of Statement No. 122 "Accounting for Mortgage Servicing Rights," in May 1995. The FFIEC recommended Federal regulators adopt interim capital rules to clarify the regulatory capital treatment for MSRs. Prior to the adoption of Statement No. 122, only PMSRs but not OMSRs could be capitalized as balance sheet assets. Once an institution adopts Statement No. 122, it generally must capitalize OMSRs on a prospective basis. In addition, Statement No. 122 requires all capitalized MSRs (both originated and purchased) to be evaluated for impairment based on their fair values.

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For purposes of the bank Reports of Condition and Income, all insured banks must adopt Statement No. 122 for fiscal years beginning after December 15, 1995. For institutions with a calendar year fiscal year that do not elect early option, the March 31, 1996, Call Report will be the first report to be completed in accordance with Statement No. 122. As an interim measure, banks should continue to report PMSRs in Call Report Schedule RC-M, item 6.a, "Mortgage Servicing Rights, " and on the balance sheet in Schedule RC, item 10, "Intangible Assets." OMSRs that are capitalized as balance sheet assets in accordance with Statement No. 122 should be reported in these same Call Report items. The FFIEC's Task Force also recommends that the agencies issue interim capital rules that would apply the same regulatory capital provisions to OMSRs that presently apply to PMSRs. Under the recommended interim approach, capitalized MSR (both purchased and originated) would be subject to a quarterly valuation requirement and a restriction limiting the amount of MSR that may be recognized for Tier 1 capital purposes to the lesser of 90 percent of fair value or 100 percent of book value (net of any valuation allowance). In addition, the aggregate amount of PMSRs, OMSRs, and purchased credit card relationship intangibles that may be recognized for regulatory capital purposes would be limited to no more than 50 percent of Tier 1 (core) capital. The quarterly valuations of the fair value of OMSRs would be based on the same regulatory guidance the agencies have issued with respect to determining the fair value of PMSRs.

FINANCIAL ANALYSIS

The analysis of the financial condition of a mortgage company should incorporate a review of primary balance sheet and income statement levels and trends, contingent off-balance sheet liabilities such as the servicing portfolio, asset quality, earnings performance, funding sources and liquidity needs, and capital adequacy. Financial statements should be reviewed to detect assets, liabilities, income or expense items which are either large relative to the company's operations or may post undue financial risk for other reasons. Any unusual trends, which appear inconsistent with the mortgage banking company's normal operation, the current economic and interest rate environment, and the company's growth plans, should be investigated.

The asset side of the balance sheet will consist of items such as cash; marketable securities; mortgage loans available-for-sale; purchased mortgage servicing rights; excess servicing fee receivables; mortgage loans held-to-maturity; reserves for loan and other credit-related losses; other real estate; premises and equipment; and other miscellaneous assets. The examiner should determine whether the accounting treatment for securities and loans is consistent with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Under SFAS No. 115, any debt or equity security that has a readily determinable fair value should be classified as either trading, available-for-sale, or held-to-maturity. Loans held for investment may include loans that: 1) do not meet secondary market guidelines and are therefore unsalable; 2) loans that were repurchased from an investor due to poor documentation and/or improper servicing; and 3) loans put back to the mortgage company under recourse agreements.

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

Asset quality is evidenced by underwriting standards, borrower performance, and the degree of protection which is afforded by collateral. Credit risk is reduced for an originator when insurance and guarantees are provided by federally-sponsored agencies. However, the originator remains responsible for the quality of loans sold to investors for at least the first 90 days, and any loans sold under recourse arrangements. As a servicer, the company can also be held liable if it does not initiate collection and foreclosure actions in strict accordance with investor servicing agreements. In addition, certain interest losses and expenses relating to collections, foreclosure, and ORE are not fully reimbursable and should be anticipated.

The primary indicators of portfolio problems are: declines in the turnover rate of the "resale" account (the industry turnover has generally averaged about four times a year but does vary with market conditions); consistent losses in the sales of the mortgages; increases in the "investment" category; and write-downs of the value of the "investment" account. It is a general industry practice to price the "resale" inventory at the lower of cost or market each reporting quarter for balance sheet purposes. One of the principal measures of portfolio quality is the delinquency rate. Delinquencies in the report should be presented by portfolio category and spread by the periods past due, such as 15-30 days, 31-90 days, 91-180 days, and 181 days and over. The delinquency status of loans available-for-sale, loans-held-to maturity, and loans serviced for investors should be monitored. Management information systems should also include an internal loan grading system which is consistent with guidelines used by the bank, the parent company, and regulatory agencies. Information to be tracked includes the borrower's ability to meet its payment obligations, collection and foreclosure actions initiated by the servicer, and repurchase requests initiated by a permanent investor or other third party. Appraisal practices should be verified to ensure consistency with state and federal laws and regulations. Mortgage banking companies that are subsidiaries of either state-member banks, state non-member banks, or bank holding companies are subject to the same appraisal standards and requirements as their parent companies. Management should establish and maintain adequate reserves to cover all identified loss exposure. Policies and procedures should clearly state the purpose of each reserve. The level of each reserve account should be evaluated at least quarterly, documented, and replenished as necessary.

Earnings performance should be assessed in terms of the level, composition and trend of net income. The earnings analysis should take into consideration internal factors such as the company business orientation and management's growth plans. The examiner should consider the company's ability to generate positive earnings consistently over time, and the proportionate share of consolidated earnings (or losses) which are a result of this business activity.

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Management's ability to satisfy the company's liquidity needs and plan for contingencies without placing undue strain on affiliate bank resources or reliance on the parent bank holding company are crucial. Liquidity needs depend upon the size of the mortgage company's warehouse and the nature and extent of other longer-term assets. Liquidity can quickly erode if investor perceptions of a company's credit standing change. The ability to fund mortgage operations under economic duress and access to alternate liquidity sources become key considerations. Funding instruments may include repurchase agreements, commercial paper, revolving warehouse lines of credit and/or long-term debt. Financial flexibility, which is the ability to obtain the cash required to make payments as needed, should also be evaluated. Cash should be able to be obtained from 1) business operations; 2) liquid assets already held by the company; and 3) deriving funds from external sources via lines of credit, bank borrowing or the money and capital markets through the issuance of debt or equity securities.

Capital must be adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by third party creditors and investors. At a minimum, a mortgage banking company must meet the nominal capital levels required by investors such as FNMA (\$250,000). Companies that have excessive off-balance sheet risk or high growth expectations may require additional capital. Capital levels should be monitored and reported to the company's board of directors regularly to mitigate the risk of inadequate or eroding capital. The examiner should evaluate capital adequacy, the amount of dividends which are upstreamed to the bank or parent company, and the extent to which the parent company can be relied upon to augment the ongoing capital needs of its bank and nonbank subsidiaries. In some instances, the bank or parent company may operate on the premise that the mortgage banking company requires little capital of its own as long as the bank or parent company remains adequately capitalized. The bank or parent company must be prepared to support its subsidiaries should the financial need arise. There are no state/federal guidelines requiring specific capital levels for a mortgage banking company.

OVERVIEW

Critical material can be reviewed at the bank or parent company level to help determine whether or not to go on-site. Some of the determinants of this decision should include: relative size; current earnings performance; overall contribution to the corporation's condition; asset quality as indicated by nonaccrual and delinquency reports; and the condition of the company at a prior examination. From the information provided, it might be determined that the company is operating properly and is in sound condition. Conversely, a deteriorating condition might be detected which would require a more in depth review. Mortgage subsidiaries in unsatisfactory condition should be inspected each time the bank or parent company is inspected. All significant mortgage banking subsidiaries should be fully inspected at least once every three years.

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POLICY REQUIREMENTS

Strategic Planning

Management should develop a strategic plan for the mortgage company or incorporate a long-term business plan for mortgage banking activities into the bank's and/or bank holding company's strategic plan. Characteristics of long-term business plan include:

- * Identifying strengths and weaknesses
- * Growth targets
- * Other strategic initiatives over a one-to-three year time horizon

Goals and objectives should be specific, measurable, understandable, and communicated throughout the organization. To help achieve the goals established, progress must be monitored. The board should review and approve the plan annually.

Mortgage Banking Policy

A well written mortgage banking policy will, at a minimum, address the following:

- A. the mortgage banking activities the bank or mortgage company will be involved, including loan production, pipeline and warehouse administration, secondary market transactions, servicing operations, and management of mortgage servicing rights (MSR) and excess servicing fees receivable (ESFR);
- B. documentation standards for all aspects of mortgage banking activities, including substantiating the initial book values of MSR and ESFR assigned to each pool of loans, as well as the results of periodic reviews of each asset's book and fair-market value;
- C. systems that track and collect required loan documents;
- D. impairment analyses, including using the discount rate applied when each MSR and ESFR asset was originally booked and employing realistic prepayment estimates;
- E. quality control reviews;
- F. interest rate risk and liquidity levels;
- G. guidelines for due diligence reviews, definitions of loan products to purchase, amount of loans desired, and authority for purchase/commitment letter;
- H. guidelines for amount of loans that can be retained in the pipeline, levels of uncommitted inventory, number and dollar amount of pools in process, and approval authority;
- I. board review of mortgage banking activity reports including default rates, new loans, liquidity levels, capital needs, past dues, geographic concentrations, departmental profit and loss statements, and foreclosure rates.

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SUGGESTED MORTGAGE COMPANY REVIEW AREAS

Management and Board Supervision

1. Review minutes from board and committee meetings to determine whether directors are fulfilling their fiduciary and supervisory responsibilities. Determine if management is providing sufficient information to the board.
2. Determine if any officer is paid based on volume/commissions.
3. Determine if the mortgage company's goals and objectives are incorporated into a long-term business plan. Determine whether objectives, goals, and growth targets are reasonable.
4. Evaluate the mortgage banking operations policy manual. Ensure that the policy addresses such items as: mortgage company's objectives, scope of operations, description of the lines of approval for transactions, and reporting requirements.
5. Determine the frequency and scope of internal and external audits. Determine if the audit program adequately addresses: loan origination, mortgage servicing, secondary mortgage marketing, internal controls, and management information systems.
6. Review audit reports and management responses to reports prepared by internal and external auditors, FNMA, GNMA, and HUD.
7. Determine if auditor's exceptions are brought to the attention of the bank's or bank holding company's board and the mortgage company's board.
8. Review the Quality Control plan to determine reasonableness and ensure compliance with investor requirements.
9. Determine whether Quality Control results are relayed to executive management, and whether follow-up procedures are adequate to ensure corrective action.
10. Review board minutes to ascertain the date the board last reviewed and approved the insurance program.
11. Review all current and pending litigation of a material nature and determine whether adequate reserves are maintained to cover anticipated financial exposure.
12. Evaluate staffing requirements and knowledge and skills of executive officers.

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13. Evaluate adequacy of management information systems (internal and external).

Loan Origination

1. Determine the types of mortgage products offered and the company's target markets. Evaluate portfolio trends for over reliance on one product type and undue concentrations in one geographic area.
2. Determine whether the level of nonconforming or unsalable loans originated present undue risk and whether the quality and delinquency trends for such loans are adequately monitored.
3. Ensure that all mortgage production offices conform to uniform policies for underwriting, pricing, and product type.
4. Determine if limits are set for uncommitted inventory for the mortgage operation. Ascertain if a funding limit is set for the loan origination. How is it monitored for liquidity?
5. Evaluate procedures, checklists and systems for closing loans. Are all required documents obtained from the borrower before funds are disbursed? If not, evaluate appropriateness of suspense items.
6. Review Quality Control reports to determine if underwriting concerns are identified.
7. Determine if the bank monitors fall-out risk for borrower withdrawals and underwriting concerns.
8. Determine who makes the decision for loans to be warehoused. Is there a dollar limit for loans committed to be resold in pools or for loans held in uncommitted inventory? Is there a limit on the length of time it can be carried in inventory?

Loan Production

1. Determine if the mortgage operations purchase loans on a wholesale basis. Are purchases primarily new origination, seasoned loans or both?
2. Determine how the mortgage company is informed that loans are for sale.

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3. Determine if there are policies and procedures for Due Diligence Reviews. Do contracts specify scope, sampling, loan products, compensation, etc.?
4. Does the loan policy limit purchases by loan type? geographic area? product features (ie ARMs)?

Secondary Marketing

1. Review minutes from recent committee meetings to determine the nature and scope of responsibilities, the frequency of meetings, and the degree to which oversight over marketing activities is provided.
2. Determine whether loans or securities are sold with recourse. If so, are recourse obligations monitored? Are recourse losses analyzed by investor and product type? Are reserves held for recourse loans? Are reserves adequate?
3. Are all mortgage products originated by the mortgage company intended to be salable in the secondary market? How is actual salability monitored?
4. Are mortgage loans that are not salable generated specifically for the permanent investment portfolio of either the mortgage banking company or its bank affiliates. Related intercompany purchase and sale agreements should be reviewed for compliance with Sections 23A and 23 B of the Federal Reserve Act.
5. What methods do management use to predict the volume of applications that are expected to "fall out" of the mortgage pipeline. Is methodology well documented?
6. Determine if any hedging products are used to hedge interest rate risk associated with inventory loans and rate-locked loan applications in the pipeline? Review the marketing policy to determine hedging products and strategies.
7. Review information provided to executive management and the board to determine whether hedging practices are adequately supervised.
8. Review list of approved brokers and dealers. Have appropriate dealer limits been established and limits adhered to? Are exceptions monitored?
9. Does management monitor the financial capacity of brokers and dealers?

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Loan Servicing and Administration

1. Determine if a periodic review of services provided by each subservicer is conducted. The financial condition of each subservicer should be evaluated at least annually.
2. Has a contingent operating plan been established should subservicers and vendors be unable to perform their contractual obligations?
3. Are periodic quality control reviews performed on the subservicer? If not, does the subservicer have their own quality control review?
4. Does a disaster recovery plan exist to cover all servicing functions performed in house? Verify that backup systems exist should primary systems fail.
5. Review the list of investors for which servicing is performed. Discuss the nature of any recourse or repurchase provisions and nonreimbursable collection and/or foreclosure expenses.
6. Determine if an annual analysis of escrow accounts is performed. How are underages and overages handled?
7. Review procedures for collecting late payments. At what point do collection efforts start once an account becomes delinquent? (i.e. 20 day requirements for some investors)
8. Review loan delinquency reports by product type and originator.
9. Determine the number and volume of delinquent loans that were purchased from the servicing portfolio (buyouts and buybacks). Assess the impact of repurchases on profitability.
10. Review the system for logging, tracking, and responding to customer complaints. Has the volume of complaints grown? Are complaints addressed promptly, with any problems resolved in a timely manner? Review mortgage complaint log and files and determine if complaints are concentrated in one area.

Financial Analysis

1. Review the mortgage company's financial statements over the previous three year period. Discuss significant balance sheet and income statement categories with management.

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2. Are financial trends consistent with the economic environment, interest rate movements, and management's intended growth strategy?
3. Obtain a copy of the loans past due 30, 60, and 90 days by loan type.
4. Obtain a list of loans in the process of foreclosure and bankruptcy. Review with management.
5. Reconcile all other real estate owned by the mortgage banking company to the general ledger. Compare current appraisals to carrying value for potential write-downs.
6. Review the reserve account for accuracy and adequacy.
7. Determine the mortgage banking company's liquidity needs based upon a review of the size of its warehouse and the nature and extent of other longer-term assets.
8. Are sources of liquidity adequate under current conditions and economic duress?
9. Does the company have the ability to obtain the cash required to make payments as needed? Easy access to lines of credit?
10. Review asset/liability management practices to determine whether funding maturities closely approximate the maturities of underlying assets or whether a funding mismatch exists.
11. Are capital levels adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by investors whose loans are serviced and other external parties?
12. Does management adequately monitor and report capital levels to the board of directors?
13. Is the parent company prepared to support its subsidiaries should the financial need arise? Are cash dividends paid by the mortgage subsidiary to the parent company reasonable?
14. Evaluate the overall financial condition of the mortgage company, considering its asset quality, earnings, liquidity, and capital adequacy.

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APPENDIX A: ACCOUNTING LITERATURE

Banks must conform to Regulatory Accounting Principles. Bank holding companies and their direct subsidiaries must conform to Generally Accepted Accounting Principles (GAAP). The following is a list of GAAP governing the mortgage banking industry which are in the form of accounting standards and interpretations.

FASB Statement No. 122, "Accounting for Mortgage Servicing Rights."

SFAS No. 65, "Accounting for Certain Mortgage Banking Activities."

SFAS No. 80, "Accounting for Futures Transactions."

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

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

Emerging Issues Task Force (EITF) Issue No. 85-13, "Sale of Mortgage Service Rights on Mortgages Owned by Others."

EITF Issue No. 86-38, "Implications of Mortgage Prepayments on Amortization of Servicing Rights."

EITF Issue No. 86-39, "Gains from the sale of Mortgage Loans with Servicing Rights Retained."

EITF Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan is Sold."

EITF Issue No. 89-5, "Sale of Mortgage Loan Servicing Rights."

EITF Issue No. 92-10, "Loan Acquisitions Involving Table Funding Arrangements."

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

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APPENDIX B: REGULATORY GUIDANCE

State and Federal issuances which may be useful in reviewing mortgage banking activities:

23-32-701	A.C.A. - Powers of Banks
FDIC	Transactions Between Member State Banks and Their Affiliates
FFIEC	Mortgage Servicing Rights
2010.0.1	Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks
2020.0 - .7	Intercompany Transactions
2050.0	Extensions of Credit to BHC Officials
2060.0 - .6	Management Information Systems
2065.2	Determining an Adequate Level for the Allowance for Loan and Lease Losses
2080.0 - .3	BHC Funding Practices
2130.0	Futures, Forward, and Option Contracts
2150.0	Repurchase Transactions
2190.0	Asset Securitization
2190.0.5	"Interagency Supervisory Policy Statement on Securities Activities"
3070.0	Section 4 (c) (8) - Mortgage Banking
3080.0	Section 4 (c) (8) - Servicing Loans
4000	Financial Analysis
4070	BHC Rating System