ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

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SUBJECT: **Mortgage Banking Activities**

BACKGROUND

Mortgage banking generally involves the origination, acquisition, and sale of residential real estate loans to permanent investors (the secondary mortgage market). A bank engaged in mortgage banking may retain or sell loans it originates or purchases from affiliates, brokers, or correspondents. The bank may also retain or sell the servicing on the loans. Through mortgage banking, banks can participate in any combination of these activities.

The earnings stream, cash flow, and capital needs of a mortgage banking company are all highly influenced by management's decision whether to retain or sell the mortgage loans as well as the related mortgage servicing rights. The majority of loans that are sold in the secondary market are originated under government-sponsored programs. Such loans are either sold for retention or are converted into securities that are collateralized by the underlying mortgages (mortgage-backed securities). The pools of collateralized mortgage loans backing mortgage-backed securities provide a form of risk diversification for the investor.

The sections that follow contain comprehensive discussions and examiner considerations related to mortgage banking. The review of mortgage banking activities during an examination should incorporate an assessment of management and Board supervision, operations and risk management practices related to the mortgage banking company's primary activities, and the mortgage banking company's overall financial performance. The areas of review should be determined on a case-by-case basis depending on the size of a particular mortgage banking company, the business activities in which it engages, and the overall level of risk posed to the bank. Examiners should use discretion in order to ensure that the areas reviewed and procedures performed are relevant to the bank's activities, business model, risk profile, and complexity. *Refer to the "Examination Procedures" section of this Policy for more detail.*

MORTGAGE COMPANY MANAGEMENT

Evaluation of management will entail a review of the organizational structure, Board supervision, management oversight, management and Board reporting, and internal control programs. 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.

Board reports must provide accurate and timely information to directors with respect to operating results, asset quality trends, liquidity and capital needs, and relevant industry and peer group performance statistics for each operational area. Directors should also receive information regarding exceptions to established policies and operating procedures, volume-related processing data, and the effectiveness of the internal control programs. Minutes should be reviewed to determine whether directors are fulfilling their fiduciary responsibilities. 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, the level of risk associated with mortgage banking activities increases dramatically. 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 strategic 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, fraud detection procedures and related employee training programs, insurance coverage, and legal review. The internal audit function is responsible for detecting irregularities, determining compliance with applicable laws and regulations, and assessing 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 the Government National Mortgage Association (Ginnie Mae or GNMA), the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), and the Federal National Mortgage Association (Fannie Mae or 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 mortgage banking company sample at least ten percent of all closed loans each month and conduct a quality control review to determine the extent of accuracy, completeness, and adherence to agency underwriting standards. The Quality Control function should serve as an early warning system that alerts management to situations which may jeopardize the financial strength, image, or origination and sale capacity of the company. Quality Control should complement, 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 expose the company or its affiliates to undue financial risk.

LOAN PRODUCTION

Loan production covers the process of originating or acquiring loans. Mortgage loan applications are generated through either retail (internal) or wholesale (external) production channels. Retail loans are originated through the company's own branch network.

Most mortgage originators operate on a nonrecourse basis. 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.

Types of Loans

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 can obtain a certificate of insurance or guarantee to give support to a loan for securitization. A certificate of insurance or guaranty may or may not be necessary for a loan to be securitized.

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 made to stronger borrowers. These loans typically require higher down payments and hold commensurate market interest rates. Lenders often require borrowers to obtain mortgage insurance coverage in high-LTV 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 5 to 20 percent of a mortgage loan.

The extent of credit risk depends upon the secondary market program under which the loan is originated. The market for residential real estate loans is dominated by three government-sponsored entities including GNMA, FNMA, and FHLMC.

Production Process

Production begins with the initial loan application and normally consists of four phases: origination, processing, underwriting, and closing. Management is responsible for supervising each phase of the production process and ensuring adherence to internal and external requirements, including complying with applicable law. Each phase is discussed below:

- *Origination*
  Loan origination is the retail operation in which loans are made directly to the public. These mortgages become part of the "mortgages held for sale" account where they will remain for a period necessary to complete the recording of the loan documents and to find a permanent investor to purchase the loans. Mortgage originators are the sales staff whose primary role is the solicitation of applications from prospective borrowers. Originators must be appropriately knowledgeable regarding investor loan requirements, company loan products, origination technology, and consumer law. They must also be appropriately registered or licensed, and organizations should ensure that loan originator employees not required to be licensed are qualified, trustworthy, and properly trained.

  Management may compensate mortgage loan originators only as permitted by law. Originators should not be compensated solely on volume without regard for the quality of loans originated. Specific pricing guidance and origination practices should be established to prevent abusive pricing and origination practices.

  Originators must be aware of and comply with the regulations implementing consumer protection laws and requiring various disclosures, as noncompliance may disqualify a loan from sale in the secondary market. Management should ensure that timely and accurate disclosures are provided to mortgage applicants and that all other applicable requirements are met. Originators should provide information to applicants which enables them to understand material terms, costs, and risks of loan products at a time that helps the applicant select a product. Banks offering mortgage banking services should not become involved, directly or indirectly, in abusive, predatory, unfair, or deceptive lending practices and must comply with regulatory and investor requirements relative to predatory lending.

- *Processing*
  Processing personnel verify the applicant's employment history and credit information and order an appraisal on the property. The processor must ensure that the loan file contains all of the supporting documents for credit analysis and that all necessary steps are performed in accordance with investor requirements and applicable law.

- *Underwriting*
  The underwriting unit's primary function is to approve or deny loan applications based on underwriting criteria established by the FHA, VA, FNMA, and FHLMC and by private mortgage insurers and institutional investors. Underwriters determine whether a prospective borrower qualifies for the requested mortgage loan program, and whether income and collateral coverage meet bank and investor requirements. To ensure that loans are eligible for sale in the secondary market, most lenders apply underwriting and documentation

standards that conform to those specified by the GSEs or private investors. To ensure objectivity, the underwriting unit should not report to management of the production function.

- *Closing*
  At closing, the lender or its agent obtains all the legal and related documents executed by the parties to the sale, provides all required disclosures, disburses the proceeds of the loan, and collects certain funds from the borrower. Closings may be performed by an internal loan closing unit or by title companies or attorneys acting as agents for the bank. Management should ensure that adequate internal controls exist over loan closings, including third-party settlement services. The controls should promote the integrity of settlement documents, fraud prevention, and compliance with all applicable laws and regulations. The post-closing unit should review each loan in order to determine whether the bank or its agent closed each loan according to the underwriter's instructions and that all documents were properly executed.

  Prior to or at closing, the bank or mortgage banking company may retain individual loans in its inventory (warehouse); pool loans and either sell them to a government-sponsored agency/private investor or securitize the loans themselves; or sell the loans individually or as part of a loan participation.

<u>Loan Production Risks</u>

The production process can present risks of both a short- and potentially long-term impact. 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. Operations risk often increases during peak volume periods. If additional resources (which can include independent service providers) are not allocated to the processing, underwriting, closing, and post-closing areas, delinquency levels may increase and workloads may exceed existing capacity. Furthermore, an inability to adequately comply with consumer compliance regulations could further increase regulatory risk exposure for the institution.

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. To the extent a company retains servicing on either its retail or correspondent production, long-term credit risk issues may develop. These include exposure to the pools being serviced through recourse arrangements, potential non-reimbursable foreclosure costs, or costs associated with VA ''no-bid'' options. Examiners should review the amount of time loans remain unsold for potential negative trends and other risk exposure or elevated risk indices.

PIPELINE AND WAREHOUSE LOANS

A mortgage enters the pipeline when a loan application is taken from a prospective borrower. Pipeline commitments with locked rates pose unique risks and uncertainty because they are not closed loans. Mortgage lenders generally allow an applicant to "lock" the loan terms at application or during the underwriting process. While locked commitments give customers the right to receive the stated loan terms if they otherwise qualify for the loan, they are not obligated to close on the loan. Commitments remain in the pipeline throughout the processing and underwriting stages. Changes in interest rates can significantly influence the customer's desire to execute the option to close the loan. By locking an application, the lender is exposed to price risk until the loan is sold.

Warehouse loans are closed mortgages awaiting sale to a secondary market investor (held-for-sale). Closed loans purchased from correspondents with the intent to sell are also booked in the warehouse. Loans that the bank plans to retain should be transferred to the held-for-investment portfolio after closing. The bank often holds loans in the warehouse pending receipt of critical documents and aggregation of a sufficient volume to economically sell and deliver. The ability to sell and deliver a warehouse loan to an investor depends on whether the loan meets investor underwriting, documentation, and operational guidelines.

Since a mortgage banking 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 revolving warehouse line of credit, secured by a pledge of the mortgages in the resale inventory, with additional advances to the company for new mortgages to be placed in the warehouse. Repayment comes from the proceeds of sales to investors. Warehouse lines are a prime source of liquidity for the mortgage banking company.

Pipeline Management

Pipeline management involves managing the price risk of loan commitments during processing, underwriting, and closing. When a consumer submits a loan application, a bank normally grants the consumer the option of locking in the interest rate at which the loan will close in the future.. If the consumer decides not to lock in at the current established rate, the loan is said to be "floating." Floating rate commitments do not present price risk because the lender has not committed to providing a particular interest rate to the loan applicant. Locked-in pipeline commitments (also known as the rate-committed pipeline) subject the bank to price risk because the bank must make the loan at the locked rate and terms, regardless of market rate changes. To the extent the bank has hedged the loan through a forward sale to an investor, not closing the loan during the rate-lock period could expose the bank to price risk if it is unable to deliver the loan to an investor as contracted. It also exposes the bank to reputation risk with the investor and the customer.

Interest rate fluctuations affect mortgage pipeline activities. Changes in rates influence the volume of loan applications that must be processed and the percentage of applications that eventually close, as well as the value of pipeline commitments, commitments to sell mortgages in the secondary market, and other hedges used to manage risk. Examiners should review pipeline and pricing management to ensure excessive risk does not build up within the bank's mortgage pipeline. This risk can come in the form interest rate risk, hedging risk, liquidity risk, as well as the potential impact on earnings and capital.

Warehouse Management

A bank normally holds a loan in the warehouse for no more than 90 days to complete documentation, processing, and sale. However, some types of loans are held longer. While in the warehouse, the bank earns net interest income on the spread between the coupon rates on the loans and the cost of funding the warehouse. If the loan is maintained in the warehouse longer than originally expected at the time the rate lock was granted, some of the net interest income will be offset by the cost of maintaining a hedge on the loan.

Loans remaining in the warehouse for longer time frames may reflect documentation or other salability problems, such as underwriting deficiencies, delinquency, or significantly below-market interest rates. The valuation of such loans should take into account these salability problems. Management should track the number, dollar volume, aging, and reasons for warehouse holdings and ensure that they are accounted for in accordance with generally accepted accounting principles (GAAP). Examiners should review these reports to ensure that loans are sold in a timely manner and, if not, what is driving these delays. If the bank no longer intends to sell a loan in the warehouse, the loan should be transferred to the bank's permanent loan portfolio in accordance with GAAP, with consideration given to any marketability issues.

Hedging the Pipeline and Warehouse

Managing the risk in the pipeline and warehouse is a key component of a successful mortgage banking operation. Changes in interest rates can affect the value of pipeline commitments and warehouse loans and cause market losses if not adequately hedged. The overall objective of hedging the pipeline and warehouse is to manage the operation's price risk and minimize market losses, not to speculate on the direction of interest rate movements. Effectively hedging the pipeline depends on accurately predicting and measuring the fallout and pull-through percentages.

Examiners should review hedging policies, procedures and activity to determine if management is appropriately using hedging to offset in unfunded commitments, as well as funded but unsold loans. Interest rate risk modeling should also be reviewed to ensure that these hedges are appropriately implemented. In addition, examiners should ensure that all hedging is appropriately reported within the call report, counterparty risk is fully assessed, and management is satisfactorily adhering to Board-established risk limits.

For additional information related to hedging activities, refer to the following:

- *Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans*
- *FASB ASC Topic 815, "Derivatives and Hedging"*

SECONDARY MORTGAGE MARKETING

The marketing department, also referred to as secondary marketing, is typically responsible for the development of mortgage products, determination of products to be offered, establishment of daily mortgage prices, and sale of mortgage loans to investors. Secondary marketing also acts as an intermediary between the borrower and the investor and manages the previously discussed price risk from loan commitments in the pipeline and loans held-for-sale in the warehouse.

The marketing department's primary tool in performing its activities involves securitization outlets. A review of the securitization process can provide a clearer understanding as to the value the marketplace assigns to a mortgage banker's production. Mortgage securities, however, are usually issued by an entity other than the mortgage banking company under inspection (such as government- sponsored agencies, securities affiliates, or brokerage firms).

Operating procedures governing the selection of mortgage loans for pooling, packaging, and sale should be evaluated to ensure that the shipping and pooling processes are efficient and that loan files ultimately contain complete documentation. Management reports should identify and track the number of pools that lack final agency certification and the status of missing and trailing (delayed) documentation.

If third-party guarantees are used during the securitization process, procedures should also establish methods for evaluating and monitoring the financial condition of all third-party entities that provide credit enhancement. If loans or securities are sold with recourse, management reports should identify and track potential recourse obligations. Management should also analyze historical recourse losses by investor and product type and determine the appropriate level of reserves to cover estimated recourse exposure.

The marketing division is also generally responsible for managing investor/counterparty performance risk. The division should approve all brokers and dealers to which securities are sold before trading commences. Dealer limits should be established to limit the maximum amount of trades outstanding with each firm, and frequent position reports should be prepared to monitor compliance with established limits. The accounting department may be responsible for the ongoing monitoring of the financial capacity of the brokers and dealers.

SERVICING

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. In return, 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 final 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. In order to be successful, a servicer must comply with investor requirements and applicable laws, efficient processes and strong internal controls, invest in and closely manage technology infrastructure, and manage costs. Examiners should consider the quality of servicing operations and overall impact on the company's earnings.

The right to service mortgage loans, when properly managed, provides a stable source of earnings and the potential for one-time gains. For this reason, servicing portfolio growth has become a primary objective for many mortgage banking companies. A servicer's long-term profitability is achieved through cost containment, technological improvements, and economies of scale, which reduce the per-unit cost of servicing.

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. Portfolio size is reduced through normal runoff, prepayments, and sales of either loans or servicing rights only.

<u>Servicing Agreements/Recourse</u>

Servicers generally operate under a written servicing agreement with each investor. Servicing agreements establish minimum conditions for the servicer such as its fiduciary responsibilities, audit requirements and fees. A servicer may also enter into an agreement with another company to subservice certain loans or portfolios of loans. The company's method of evaluating and monitoring the financial condition of its subservicers should also be reviewed. Servicing and subservicing agreements should be evaluated in terms of the subservicer's responsibilities, reporting requirements, performance, and fees. They should also be reviewed to determine that no additional liabilities, real or contingent, are imposed upon the company beyond its responsibilities as a servicing agent. Ultimately, if a bank fails to appropriately service an investor's portfolio, the servicing rights could be revoked.

A servicing agreement may contain specific recourse obligations that go beyond the servicer's customary fiduciary obligations. The degree of recourse varies by investor. A mortgage banking company can choose to service loans for investors either with or without recourse back to the mortgage banking company. Servicing agreements should be reviewed to determine the extent of any recourse obligations, and the risk of recourse should be discussed with management to assess whether this risk is being identified and effectively managed. The amount of guaranty fee the mortgage banking company pays the government-sponsored agencies (or private issuer) is negotiated. Guaranty fees vary based on the amount of recourse assumed by the servicer and the timing of the cash flows.

Internal Controls

The control environment that sets the tone of a servicing department's operation should be assessed. A servicing department's management faces a variety of risks that it should identify and control. In addition to identifying and controlling risks, management also needs to institute adequate and effective internal controls to match a servicing portfolio's growth and the department's technological changes. When assessing the control environment, the examiner needs to consider the extent to which management uses internal and external audits, quality control reports, and investor audits to ensure that its policies and procedures are followed.

The servicer's performance should be evaluated, with any loss of servicing due to operating inefficiencies or excessive risk-taking. Examiners should ensure that the servicer maintains proper controls with respect to the following: safekeeping loan documents; processing loan payments and remitting principal and interest to investors; managing escrow accounts; investor reporting; collections activities, foreclosures, and other real estate owned (OREO); performing payoff obligations; and handling customer complaints.

MORTGAGE SERVICING ASSETS

Mortgage servicing assets (MSAs), sometimes referred to as mortgage servicing rights (MSRs), are financial assets that are originated, purchased, and sold by various financial institutions. MSAs are complex, intangible assets that arise from owning the rights to service mortgage loans that have been securitized or sold to third-party investors. Servicing of mortgage loans includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interest in the mortgage loans. Servicers typically receive certain benefits from the servicing contract and incur the costs of servicing the assets.

The success of a mortgage banker's operations often depends on how effective the banker is at creating or acquiring the MSA and how the bank disposes of it (through sale or the operation of a servicing department). 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 assets. Effective risk management of servicing assets includes systems related to the initial valuation, subsequent measurement, impairment recognition, and hedging of the MSA portfolio.

Servicing is inherent in all mortgage loans; however, it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If the MSA is sold, the value is reflected in the gain on sale. If retained, the benefit to the bank is the value of the MSA relative to the cost of servicing it. The value of the MSA depends on the size and timing of the various costs and income streams associated with the entire servicing operation. MSAs are generally acquired in the following ways:

- Portfolio Servicing – Origination of mortgages that are kept in the portfolio
- Retained Servicing – Origination of mortgages that are sold with servicing retained
- Servicing Released Purchase – Purchase of servicing rights from third parties
- As a by-product in a purchase of mortgages and their servicing where a definitive plan for the sale of the mortgages with the servicing rights retained exists at the time the mortgages are acquired

A mortgage banking company may acquire servicing in bulk acquisitions or from third-party production flow. In a bulk servicing acquisition, the bank purchases the MSAs of a portfolio of mortgage loans, leaving ownership of the underlying mortgages or securities with the investor. When a bank acquires servicing rights through third-party production flow, it is purchasing the servicing on an ongoing basis from another originating institution.

Valuation

The accounting and reporting standards for servicing assets and liabilities are set forth in FASB ASC Topic 860-50, "Transfers and Servicing: Accounting for Transfers of Financial Assets" and ASC 948, "Financial Services – Mortgage Banking". Under ASC 860-50, a mortgage banking company is required to recognize as separate assets or liabilities the right to service mortgage loans for others, however those servicing rights are acquired.

A servicer recognizes MSAs only when the benefits of servicing (estimated future revenues from contractually specified servicing fees, late charges, and other ancillary sources) are expected to more than adequately compensate the servicer for performing the servicing. Servicing liabilities result from contracts to service financial assets under which the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing.

A bank must recognize and **initially measure at fair value** a servicing asset or a servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following situations:

- The bank's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting; or
- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the bank or its consolidated affiliates included in the Call Report.

If quoted market prices are not readily available, the estimate of fair value shall be based on the best information that is available, including prices for similar assets and the results of valuation techniques used by management. Valuation techniques may include (1) the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved; (2) option-pricing models; (3) matrix pricing; (4) option-adjusted spread models; and (5) fundamental analysis. Valuations should incorporate various input data, including assumptions regarding prepayment, default, and interest rates. Input assumptions must be documented to support the valuation conclusion for MSAs and to provide a means for independently validating those conclusions.

A bank that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting under ASC 860 and is accounted for as a secured borrowing with the underlying assets remaining on the bank's balance sheet must not recognize a servicing asset or a servicing liability.

A bank should **subsequently measure** each class (classes based on availability of market inputs to determine fair value and/or bank's method for managing risks) of servicing assets and servicing liabilities **using either the amortization method or the fair value measurement method**.

Under the amortization method, all servicing assets or servicing liabilities in a particular class should be amortized in proportion to, and over the period of, estimated net servicing income for assets or net servicing loss for liabilities. Under the fair value measurement method, all servicing assets or servicing liabilities in a particular class should be measured at fair value at each quarter-end, with changes in fair value reported in earnings for that quarter. A bank may elect to change the subsequent measurement method for a particular class of servicing from amortization to fair value at the beginning of any fiscal year. However, once a bank elects the fair value measurement method for a class of servicing, that election must not be reversed.

Impairment

MSAs 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 value of MSAs and require accelerated amortization or a write-down. Therefore, 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 that impairment is not recognized, MSA values may be inflated. As a result, assets, earnings, and capital may be overstated.

The servicing assets or servicing liabilities should be assessed for impairment or increased obligation based on fair value at each quarter-end. Management should adequately document this review and adjust the book value as necessary. Servicing assets within a class should be stratified into groups based on one or more of the predominant risk characteristics (loan type, size, rate, origination date, geographic location, etc.) of the underlying financial assets. If the carrying amount of a stratum of servicing assets exceeds its fair value, the bank should separately recognize impairment for that stratum by reducing the carrying amount to fair value through a valuation allowance for that stratum. The valuation allowance should be adjusted to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. For servicing liabilities within a class, if subsequent events have increased the fair value of the liability above the carrying amount, the bank should recognize the increased obligation as a loss in current earnings.

Regulatory Reporting – Call Report Guidelines

Examiners should determine whether or not MSAs are reported in accordance with Call Report guidelines. The carrying amount and fair value of MSAs should be reported in the appropriate line items in Schedule RC-M – Memorandum. Servicing liabilities should be appropriately accounted for in Schedule RC-G – Other Liabilities. Servicing assets and servicing liabilities may not be netted on the balance sheet (Schedule RC). Instead, they must be reported gross as assets and liabilities, respectively. Readily marketable MSAs may be included in a bank's Tier 1 capital (Schedule RC-R – Regulatory Capital) subject to certain limitations. MSAs that are not appropriately valued cannot be included in capital.

Changes in the fair value of any class of servicing assets and servicing liabilities accounted for under the fair value measurement method should be included in earnings and reported in Schedule RI, item 5.f, "Net servicing fees." In addition, certain information about assets serviced by the reporting bank should be reported in Schedule RC-S.

For more detail regarding regulatory reporting of MSA activities, refer to the Call Report Instructions for the aforementioned schedules as well as Call Report Glossary entries for "Servicing Assets and Liabilities" and "Transfers of Financial Assets" (pertinent Call Report schedules are included in Appendix C).

Hedging MSAs

MSAs are subject to wide changes in fair value as interest rates and prepayment assumptions change. As interest rates decline, borrowers tend to refinance and prepay their mortgage loans. This can drastically reduce the estimate of net servicing income from MSAs and reduce their value. As interest rates rise, MSA values tend to increase, but generally not as much as they decline when rates fall. This negative convexity of MSAs makes them more complex to hedge. A number of mortgage servicers recognize the "natural" hedge provided in a declining rate environment by new servicing created from increased originations. However, the natural hedge may not cover the entire change in MSR value. An effective hedge for this profile is the purchase of financial instruments that exhibit positive convexity, that is, instruments that increase in value as rates decline faster than they decrease in value as rates rise. Management should understand the nature and magnitude of the risks in the MSA portfolio and, if engaged in hedging, the costs and benefits of their particular hedge strategy, and the effectiveness of that strategy.

Excess Servicing Fee Receivables (Interest-Only Strip)

A servicer shall account separately for rights to future income from the serviced assets that exceed contractually specified servicing fees. Those rights are not servicing assets; instead, they are financial assets, effectively interest-only strips that represent earnings and capital to the bank when they are recognized. Overly optimistic or unreasonable assumptions used to capitalize interest-only strips could result in overstated earnings and capital.

Selling MSAs

Management should periodically assess its strategic decisions to retain or sell servicing. Factors underlying this decision may include the bank's MSA valuation relative to current market prices, management's interest rate risk appetite, strategic servicing portfolio considerations, and capital management issues. Servicing is normally sold in a bulk sale, on a flow basis, or through sales of individual loans with servicing released. Bulk sales are made in the secondary market and involve aged servicing. "Flow" refers to a bank selling loans under a master commitment as loans are produced or pools are formed.

In an "assignment of trade" flow sale arrangement, the seller of the loans and associated servicing assigns a forward sale commitment of MBSs to the buyer of the servicing. The seller delivers the loans to the buyer, who is then responsible for creating the MBSs and delivering them to the broker/dealer while retaining the servicing.

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, off-balance sheet items such as the servicing portfolio, asset quality, market share and earnings performance, funding sources, 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 otherwise pose undue financial risk. 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.

<u>Balance Sheet</u>

The asset side of the balance sheet may consist of cash, reverse repurchase agreements, marketable securities, receivables and advances, mortgage loans held-for-sale, mortgage loans held-for-investment, MSAs (including mortgage servicing rights), reserves for loan and other credit-related losses (contra accounts), OREO, and other assets.

The examiner should determine whether the accounting treatment for mortgage-related securities and loans is consistent with ASC Topic 320, "Investments – Debt and Equity Securities". Under ASC 320, 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. Mortgage loans held-for- investment may include the following: loans that do not meet secondary market guidelines and are therefore unsalable; loans that were repurchased from an investor due to poor documentation and/or improper servicing; loans put back to the mortgage company under recourse agreements; and loans intentionally originated for portfolio.

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.

<u>Income Statement</u>

Mortgage banking revenues generally consist of the following: loan servicing/administration revenue; loan-origination-fee revenue; interest income; gains (losses) on the sale of mortgage loans, mortgage securities, or mortgage servicing rights; and management and other fee income.
Expenses may include interest expense; salaries, commissions, and other personnel costs; interest losses on MBS pools; amortization of mortgage servicing assets and any other purchased

intangible assets; electronic data processing and other selling, general, and administrative costs; occupancy and equipment; depreciation; provision for foreclosure and other loan losses; and a provision for income taxes.

Asset Quality

Asset quality is evidenced by underwriting standards, borrower performance, and the degree of protection which is afforded by collateral. Credit risk is mitigated for an originator when insurance and guarantees are provided by government-sponsored agencies and other third parties; however, the originator remains responsible for the quality of loans sold to investors for at least the first 90 days as well as 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 OREO are not fully reimbursable and should be anticipated.

Primary indicators of portfolio problems include the following: declines in the turnover rate of the held-for-sale account; consistent losses in the sales of the mortgages; increases in the held-for-investment category; and write-downs of the value of the held-for-investment account. One of the principal measures of portfolio quality is the delinquency rate. Delinquencies in the report should be spread by balance sheet asset category (for example, mortgage loans held-for-sale, mortgage loans held-for-investment), product type, and delinquency status. 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 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. Management should evaluate the level of each reserve account at least quarterly, document this analysis, and replenish each reserve as necessary.

Earnings

Earnings performance should be assessed in terms of the level, composition and trend of net income. The earnings analysis should consider internal factors such as the company business orientation and management's growth plans, as well as relevant external factors such as interest rates and economic trends. The examiner should consider the company's ability to generate sustainable positive earnings consistently over time, as well as the proportionate share of consolidated earnings (or losses).

Liquidity and Funding

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 is 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 (i.e. the ability to obtain the cash required to make payments as needed) should also be evaluated. Cash can be obtained from (1) business operations; (2) liquid assets already held by the company either in the form of cash or marketable securities or by selling liquid assets such as receivables or inventories for cash; and (3) external lines of credit, bank borrowings, or the issuance of debt or equity securities in the money markets.

In general, funding liability maturities should closely approximate the maturities of underlying assets to mitigate the risk of a funding mismatch. Otherwise, the company is exposed to short-term interest-rate fluctuations unless appropriately hedged. Funding mismatches can lead to significant earnings volatility in the event that interest rates change rapidly.

Capital

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 and GSEs such as FNMA and FHLMC. 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 distributed 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.

EXAMINATION PROCEDURES

The scope of the review should be determined on a case-by-case basis depending upon the size of a particular mortgage banking company, the business activities in which it engages, and the overall level of risk posed to the bank. Examiners should follow procedures contained within the Interagency Examination Documentation Modules (ED Modules) for Mortgage Banking. Mortgage banking activities vary greatly among banks, and it may not be necessary to perform all of these procedures. Examiners should complete only the procedures relevant to the bank's activities, business model, risk profile, and complexity. If necessary, examiners can complete additional procedures based on other identified risks.

The Mortgage Banking - Abbreviated Core Analysis ("Abbreviated Core") module may be used in banks with non-complex mortgage banking operations that sell loans with servicing released.

The Mortgage Banking - Core Analysis ("Core") module is intended for use in banks with more complex mortgage banking operations, including programs that service sold loans and retain mortgage servicing assets. Examiners should consider using this module in more complex situations when the bank:

- Has a formal mortgage banking department or a mortgage banking subsidiary
- Has purchased and integrated a mortgage banking operation or company
- Engages in wholesale activities, including loans originated through third-parties
- Has warehouse line(s) of credit to fund the mortgage banking pipeline
- Is experiencing delinquencies, foreclosures, or extended agings within the warehouse
- Speculates on interest rate movements through unhedged positions
- Originates and sells nontraditional or subprime mortgage products; or
- Services sold loans or retains mortgage servicing assets

Examiners may also combine portions of the Abbreviated Core module with portions of the Core module when useful. Examiner judgment will ultimately determine which module(s) should be utilized. Regardless of which module is used, consideration should be given to each of the following decision factors:

- Are policies, procedures, and risk limits for mortgage banking operations adequate?

- Are internal controls adequate?
- Are the audit or independent review functions adequate?
- Are information and communication systems adequate and accurate?
- Does management use appropriate strategies to manage liquidity and limit interest rate risk exposure?
- Are warehouse loans sold in a timely manner?
- Is the mortgage banking department's financial performance acceptable?
- Are foreclosures handled properly to limit reputation and legal risk?
- Do the Board and senior management effectively supervise the mortgage banking area?

Suggested procedures for each decision factor are outlined in the modules. Examiners should follow procedures to the extent necessary to adequately address each decision factor.

If necessary, the Mortgage Banking Expanded Analysis ED Module should be used to target deficiencies or other concerns noted during the review. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis. When performing an Expanded Analysis, examiners should consider the materiality and impact of deficiencies on both the supervision of mortgage banking operations and the bank's overall condition.

APPENDIX A: EXAMINER RESOURCES

- Mortgage Banking ED Module – Core Analysis (Abbreviated)
- Mortgage Banking ED Module – Core Analysis
- Mortgage Banking ED Module – Expanded Analysis
- FRB Commercial Bank Examination Manual Section 2044.1-2044.3 – Loan Portfolio Management - Mortgage Banking
- FRB Commercial Bank Holding Company Supervision Manual Section 3070.0 – Mortgage Banking
- FRB Commercial Bank Holding Company Supervision Manual Section 3071.0 - Mortgage Banking — Derivative Commitments to Originate and Sell Mortgage Loans
- FRB Commercial Bank Holding Company Supervision Manual Section 3072.0 – Activities Related to Extending Credit
- FRB Commercial Bank Holding Company Supervision Manual Section 3080.0 – Servicing Loans and Section 3084.0 – Asset Management, Asset Servicing, and Collection Activities

ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

Policy Number	95-1
Effective Date	07/19/95
Supersedes	
Approval	03/20/25

SUBJECT: **Mortgage Banking Activities**

APPENDIX B: REGULATORY GUIDANCE

- Mortgage Banking Activities (FDIC FIL-15-2003, FRB SR 03-4)
  - Attachment: Interagency Advisory on Mortgage Banking Activities
- Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (FDIC FIL-39-2005, FRB SR 05-10)
  - Attachment: Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans
- Servicing for Mortage Loans: Loss Mitigation Strategies (FDIC FIL-76-2007, FRB SR 07-16)
  - Attachment: Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages
- Supplemental Information for Loss Mitigation Strategies (FDIC FIL-77-2007)
- Working With Residential Borrowers (FDIC FIL-35-2007, FRB SR 07-6)
  - Attachment: Statement on Working With Mortgage Borrowers
- Interagency Guidance on Nontraditional Mortgage Product Risks, and Addendum to Credit Risk Management Guidance for Home Equity Lending (FDIC FIL-89-2006, FRB SR 06-15)
  - Attachment: Statement on Interagency Guidance on Nontraditional Mortgage Product Risks
  - Addendum to Credit Risk Management Guidance for Home Equity Lending
- Subprime Mortgage Lending (FDIC FIL-62-2007, FRB SR 07-12)
  - Attachment: Statement on Subprime Mortgage Lending

APPENDIX C: ACCOUNTING GUIDANCE

The following is a list of Regulatory Accounting Principles and GAAP governing the mortgage banking industry.

- Call Report Instructions Schedule RC – Balance Sheet
- Call Report Instructions Schedule RC-M – Memorandum
- Call Report Instructions Schedule RC-G – Other Liabilities
- Call Report Instructions Schedule RC-P – Closed-End 1-4 Family Residential Mortgage Banking Activities
- Call Report Instructions Schedule RC-R – Regulatory Capital
- Call Report Instructions Schedule RC-S – Servicing, Securitization, and Asset Sale Activities

- Call Report Instructions Schedule RC-I – Income Statement
- Call Report Instructions Glossary (Refer to Entries for "Servicing Assets and Liabilities" and "Transfers of Financial Assets")
- FASB ASC Topic 325, "Investments, Other" (formerly EITF 99-20 – Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets)
- FASB ASC Topic 948, "Financial Services – Mortgage Banking" (formerly SFAS 65)
- FASB ASC Topic 860-50, "Transfers and Servicing: Accounting for Transfers of Financial Assets" (formerly SFAS 125, 140, 156, & 166)
- FASB ASC Topic 820, "Fair Value Measurements" (formerly SFAS 157)"
  - FASB Accounting Standards Update No. 2022-03 (Amendment)
- FASB ASC Topic 815, "Derivatives and Hedging" (formerly SFAS 133 & 149)
  - FASB Accounting Standards Update No. 2022-01 (Amendment)
- FASB ASC Topic 310, "Receivables" (formerly SFAS 91)
- FASB ASC Topic 320, "Investments – Debt and Equity Securities" (formerly SFAS 115)
- FASB ASC Topic 450, "Contingencies" (formerly SFAS 5)