INTRODUCTION AND OVERVIEW

The process of producing mortgages is usually referred to as production. It consists of two broad types, retail origination and wholesale or correspondent lending. Retail origination generally refers to retail lending directly to borrowers and consists of marketing to attract borrowers, taking the borrower's loan application, processing to obtain needed documentation, underwriting to ensure that the mortgage meets investor's standards, and finally closing where all documents are signed and the mortgage funds are disbursed. (Quality control is checked prior to closing for each mortgage and on a test sample basis after closing.)

During all of the origination stages, potential mortgages are referred to as being in the pipeline. Once mortgages leave the pipeline they either go directly to the thrift's investment portfolio or enter the warehouse where they are marketed in the secondary-mortgage market and shipped to the buyer. Successful mortgage originators must be efficient in their operations because the origination process itself has little significant profit. Most mortgage bankers profit either from the sale of the servicing or by building up a large servicing portfolio. (See Section 572, Profitability.)

Wholesale or correspondent production usually refers to the process of buying mortgages and their servicing from other originators and has two broad categories. The first is to buy closed mortgages, individually as they are closed or in bulk, and the second is called table funding mortgages. For purchases and table funding the buyer normally pays for both the individual mortgage and a servicing release or purchase fee for the servicing rights.

Table funding is the process of buying the originations of independent mortgage brokers by funding their mortgages at the closing and paying them a servicing release fee. (See Section 573, Accounting, for other table funding requirements.) The payment of a servicing release fee results in a significantly higher sales price for the originator/seller than the sale of the mortgage alone. The buyer, on the other hand, pays more for the mortgage and its servicing than for a retail origination, but does not have any origination costs.

Wholesale or correspondent production has a major accounting advantage over retail originations. Under generally accepted accounting principles (GAAP), mortgage originators can book only the excess portion of the value of servicing rights for mortgages originated directly with the borrowers. (The "normal servicing fee" portion is an off-balance sheet asset.) If the servicing rights are purchased, however, the entire purchase price or value of the servicing can be booked as an asset. (See Section 573, Accounting.)

For mortgage brokers the extra income from selling the servicing with the mortgages allows them to concentrate on originations. Most mortgage brokerage firms, but not all, specialize in mortgage originations while leaving the more clerical function of servicing to the larger servicing organizations. Mortgage brokers were not common until the late 1980s, but today they originate a large percentage of all new originations.

Retail Origination

The retail origination process should be viewed as a factory producing good quality mortgages that ideally have the highest possible resale value in the secondary mortgage market. Using standard FNMA/FHLMC approved forms and underwriting according to those organization's standards adds value to conventional mortgages because FNMA/FHLMC eligible mortgages are much more marketable. In fact, many thrifts go through the additional process of pooling and swapping their conventional mortgages for FNMA MBSs or FHLMC PCs and swapping their FHA/VA mortgages for GNMA MBSs to add value and marketability, even if the mortgages are intended for the thrift's investment portfolio. Should the investment needs of the thrift change FNMA

MBSs, FHLMC PCs, and GNMA MBSs are much more salable and will bring higher prices than private placements. (See Section 542, Mortgage-Backed Securities.)

Primary Marketing. Competition in the primary or retail mortgage production business is fierce and it forces most firms to offer very competitive interest rates and fees. Often the difference between success and failure is decided by customer service and quality control. Good customer service brings more business even if rates are the same and good quality control means more buyers who are willing to pay higher prices.

Application. Once a customer has responded to advertisements or marketing efforts through real estate brokers and makes an appointment to apply for a mortgage, the lender begins the application process. The application step involves filling in the mortgage application form giving all the information necessary to be able to properly evaluate the customer's and the property's qualifications for the mortgage sought. This includes type of mortgage and terms sought, property information, address and prior addresses, job information and salary history, other personal information, details of the proposed purchase, credit information, and a detailed financial statement showing all assets and liabilities. Standard application forms approved by FNMA/FHLMC are usually used for conventional mortgages and FHA or VA forms are used for those mortgages.

At the time of application, the applicant signs the completed application and authorizations for the originator to verify in writing his or her employment, salary, credit history, and deposits of money to be used in the proposed purchase, if applicable. Most lenders also collect an application fee to cover the cost of the appraisal and credit report. Also, at the time of application most lenders perform a very rough underwriting process to make sure that the borrower generally qualifies for the mortgage. Applicants that clearly do not qualify, for whatever reason, are usually discouraged from applying and paying the appraisal and credit report fees.

Processing. This includes sending out and following up for return of the written forms to verify employment, salary, and deposits. Also, a written credit report is obtained as well as any other documentation needed to support the application, such as copies of recent income tax returns. Another important step is requesting an appraisal, and a survey when appropriate, of the property to be purchased. A detailed system of procedures should be in place to facilitate the rapid processing of all mortgages using standard documentation approved by FNMA/FHLMC or the FHA/VA. Most processing delays occur as a result of the slow return of one or more of these documents.

Underwriting. The underwriting step includes evaluating all of the information gathered to decide if the requested mortgage qualifies according to the standards of the intended investor; usually FNMA/FHLMC for conventional conforming mortgages or FHA or VA for those mortgages. Generally, the proposed housing costs to income ratio should not be more than 28% and the proposed ratio of all debt payments to income should not be over 36%. If the mortgage amount is over 80% of the proposed purchase price or loan to value (LTV) ratio, private mortgage insurance (PMI) is usually required by FNMA/FHLMC and it must be approved in advance by one of the PMI companies. PMI premiums are charged to the borrower both at closing and on a monthly basis, and are usually added to the proposed mortgage payments in calculating ratios. Conventional mortgages up to 95% LTV are generally permitted by FNMA/FHLMC when the additional exposure to the lender is covered by higher amounts of PMI. However, FNMA and FHLMC both feel that high LTV ratios are the single largest contributor to mortgage defaults and thus they have stricter underwriting requirements for 95% LTV mortgages.

Proposed FHA/VA properties must be appraised and their mortgages must be underwritten and approved by those agencies prior to closing. Generally FHA will insure a higher LTV ratio than conventional mortgages, often as high as 97%, but it charges a fee at closing and usually a monthly mortgage insurance premium (MMI or MIP). VA guarantees mortgages up to 100% LTV and does not charge the veteran for this service.

Once an application has been approved by everyone required, it enters the closing phase. If, however, the application is denied, a formal disclosure and notification to the applicant must be made. Credit denial letters must state the reasons for denial and the source of the information that caused denial. (See RESPA in the Compliance Handbook.)

Closing. Once the applicant has been approved, the mortgage enters the closing process. First, a title search of the property to be purchased or refinanced and other needed legal assistance are arranged. Mortgage document preparation is then performed by or coordinated with the closing attorney who usually prepares the closing statement, when needed. A preclosing checklist should be utilized by the originator or attorney to catch missing or incorrect documents before any funds are disbursed.

On the closing date, all documents are executed including the purchase deed by the seller and the mortgage, note, closing statements, and all supporting documents by the buyer/borrower. The mortgage is then funded and funds are distributed to all appropriate parties including sending the deed and mortgage to the register's office for recording. Also, a computer servicing file is established if this has not already been done during the origination process. In addition, an escrow account for the payment of taxes and insurance meeting RESPA limits and state payment of interest requirements is established. Until the recorded mortgage is returned to the originator, the mortgage remains incomplete and the disbursed loan funds are referred to as loans in process.

Warehouse. Once the mortgage has returned from the register's office the mortgage servicing file, tax and insurance files, and microfilm records are all established. The mortgage file is not complete, however, until the final title insurance policy is received from the title insurance company insuring that the lender has a first (or second, when appropriate) mortgage. At this point the originator executes its strategy of either keeping the mortgage in its own portfolio, selling it into the secondary market but retaining the servicing, or selling both the mortgage and its servicing. (See Section 572, Profitability.) If the decision is to sell the mortgage, it leaves the mortgage originator's pipeline and enters the warehouse while it is marketed in the secondary mortgage market. (See Section 575, Secondary Marketing.)

Shipping. Once sale in the secondary mortgage market is finalized, the mortgage is shipped to the buyer or closing agent. After copies of all documents are made for its files, the originator packages all of the original mortgage documents with copies of other supporting documents and delivers these to the buyer or in some cases the new servicer.

Low-Doc or No-Doc Mortgages. Low-documentation mortgages are sometimes made available to borrowers with high down payments and correspondingly low LTV ratios. The processing for these mortgages omits many of the written verification and documentation procedures of normal mortgage processing. No-documentation mortgages omit virtually all of these documentation steps. Experience has shown that the increased down payment needed to qualify for these mortgages is not always adequate to ensure quality and, therefore, such mortgages generally have a reduced market value.

Multifamily and Commercial Mortgages. These mortgages are usually originated only for specific investor purchase commitments. This is because terms and conditions vary so widely within the industry and because the danger of being left with large unsalable mortgages presents enormous risk. Additionally, most of these large mortgages are closed simultaneously with the investor purchase and funding so that the originator takes no closing or warehouse risks.

Wholesale or Correspondent Production

The critical two issues for the wholesale mortgage buyer or wholesaler, whether the mortgages are purchased individually or in bulk, are to buy mortgages that meet their mortgage banking strategy and to ensure that those mortgages are of adequate quality to meet investors' requirements.

Approval of Outside Originators. Prior to purchasing mortgages from an originator that is new to the thrift, certain basic steps should be performed. The thrift should:

- Check with other purchasers as to the quality of their mortgages;
- Review their financial and operating statements;
- Check their good standing with FNMA, FHLMC, GNMA, and HUD (when applicable);
- Check their delinquency, default, and foreclosure rates and trends;
- Look for documentation, underwriting, or repurchase problems; and
- Check for any non-delivery histories or other problems.

In addition to these checks, formal purchase and sale agreements should be executed between the thrift and its prospective outside originators governing all aspects of the mortgages to be purchased, due diligence procedures, quality control, and the details of the proposed sales. These agreements should also provide the thrift with repurchase protection from the seller for mortgages with missing documentation, underwriting or servicing errors, and delinquency at the time of sale. A failure to follow these basic safeguards has resulted in large losses in the past for some thrifts.

Bulk Purchases. For bulk purchases of existing mortgage portfolios the buyer usually performs due diligence procedures on the mortgages being purchased. This generally occurs after the purchase is negotiated, but prior to its closing. Due diligence procedures vary widely, but the sample checked should use procedures that: (1) are similar to the post-closing quality control checks used in the origination process to check individual mortgages; (2) check historical delinquencies, foreclosures, and prepayment rates, as well as other general problems; and (3) check the quality of the servicer to spot areas of neglect and inadequate servicing.

Individual or Flow Purchases. Mortgages that are purchased individually or in small groups as they are produced are called flow purchases. The resulting servicing after the individual mortgages are sold is called flow servicing. Such mortgages should be reunderwritten at delivery and before funding by the thrift; or if that is not possible, they should be reunderwritten shortly after purchase and the seller held responsible for errors and defects.

Table Funded Purchases. These mortgages are new and they are purchased individually, therefore, the thrift should reunderwite them prior to funding or soon thereafter. Although table funded servicing is a common practice today, GAAP only recognized the practice of separately booking the servicing released fee as the servicing purchase price in the Fall of 1992. EITF No. 92-10 gives several important requirements that must be met for the servicing release fee to be treated as the servicing purchase price; the most important of these being originator independence and sales to other buyers. (See Section 573, Accounting.)

In general the quality of mortgages purchased from mortgage brokers and other sources has become an issue for mortgage bankers and for FNMA and FHLMC. Statistics have shown that mortgages originated by some, but not all, of these sources have not been of the same quality as those originated by in-house lenders. The risk of mortgage defects, underwriting errors, and poor quality mortgages increases for mortgages purchased to the extent that the wholesale purchaser relies on another company's employees to correctly process and underwrite mortgages. Wholesalers should be aware that FNMA and FHLMC look to the seller/servicer and not the originator if problems or errors in origination are discovered.

Quality Control

In order for the quality control function to be effective, standardized checklists, procedures, tests, and necessary corrective actions must receive management's full support and attention. A reputation as a lender producing incomplete or erroneous files, nonconforming mortgages, or high levels of delinquency and foreclosures will eventually lose the originator business, revenue, and possibly investor approval.

Prefunding. The originator should emphasize quality control throughout the mortgage origination process. The most important of these checks should be the prefunding checklists that should be used regularly to check for missing documents and conformance with the major underwriting requirements. Different types of checklists should be used before the files go to the closing attorney and just prior to closing, when applicable. Special attention should be given to mortgages originated by personnel paid by commission since these tend to have higher rates of underwriting problems.

Post-Closing. Post-closing quality control is the final step to verify that the mortgage origination is routinely complying with all documentation, consumer protection, legal, and investor requirements in originating mortgages. In order to ensure adequate quality control checks that also meet investor's requirements, statistically random samples meeting FNMA/FHLMC standards should be developed on each month's production and those samples reviewed to determine quality and conformance with investor requirements. FNMA/FHLMC generally require a 10% post-closing sample of production, but this is the minimum acceptable. Other quality control requirements and those of other investors should also be taken into consideration.

Purchases and Table Funded Mortgages. Bulk purchases without thorough preclosing due diligence checks should be subjected to more intensive sampling and fraud checks than mortgages originated in house because of the additional risks imposed by unknown origination employees. Table funded mortgages should also be subject to extra quality control measures on individual purchases such as performing prefunding underwriting and checklists, increasing the post-closing sampling percentage, and increasing the fraud reviews. Repurchase agreements from sellers for mortgage underwriting or documentation defects should not be the sole basis of purchase or table funding quality control.

Reporting and Fraud Reviews. The quality control group must be independent and report directly to senior management since it reviews the functions of all other areas. Regular reports to senior management should disclose noted areas of operational deficiencies at all steps in the origination process, and management should follow up with corrective efforts. Also, the quality control group should review applications and closed mortgages for fraud and make criminal referrals regarding discovery of any fraud. Quality control personnel should create regular management reports on checks for fraud or investigations in that area.

Regulatory Concerns

The primary regulatory concerns of mortgage production based on OTS experience to date are:

Lack of Accurate and Timely Pipeline Data. In order to properly plan for IRR, secondary marketing, production capacity, and quality control, management must have accurate up-to-date information on the pipeline in each phase of the production cycle.

Operational Risks. This refers to thrifts that become excessively reliant on origination income or to thrift's that have an excessive fixed investment in mortgage originations or both. Since mortgage banking is highly cyclical, such thrifts are excessively vulnerable to drops in the overall level of originations.

Nonconforming Mortgages. By originating mortgages that do not meet FNMA/FHLMC requirements, even if those mortgages are for the thrift's investment portfolio, the originator runs the risk of not being able to sell the mortgages if investment or secondary marketing needs change rapidly. If nonconforming mortgages are, as a practice, made for the thrift's investment portfolio, then the entire thrift's mortgage portfolio is worth significantly less than would be the case for conforming mortgages.

Poor Mortgage Quality or Quality Control. Thrift's that produce mortgages with consistently higher rates of missing documentation, errors in underwriting, or above average default rates will be forced to accept lower prices for their mortgages or will lose the ability to sell their mortgages at any price. Failure to test an adequate percentage of mortgage production, to report deficiencies to management, or to take corrective measures is a major regulatory concern.

Book Values. Since mortgages held for sale must be marked to market value, the warehouse held for sale versus portfolio investment distinction is important. Some thrifts attempt to avoid the mark-to-market requirements for warehouse mortgages by falsely classifying almost all of their mortgages as portfolio investments. To check for this practice, the level of mortgages reported in the warehouse awaiting sale should be compared to, and should equal approximately the amount needed to support historical sales amounts. Also, examiners should verify that unsalable or below-market mortgages put into the thrift's investment portfolio are transferred to the thrift's portfolio at no more than their market value. (See Section 573, Accounting.)

Inadequate Separation of Portfolio and Mortgage Banking Activities. These two activities must be separated to achieve their different objectives and to determine both the fixed and marginal costs of origination for both operations. While it is possible to have one mortgage production area used by both operations, if this approach is used, the investment needs of the thrift's portfolio must be determined, tracked, and documented separately. Also, the investment needs of the portfolio should not govern mortgage banking originations.

Below Market and Unresponsive Pricing. The incremental costs of maintaining or increasing market share by originating mortgages at below-market interest rates should be considered origination costs even though they show up as losses on sale. Normally such costs far outweigh the benefits. Also, retail interest rates that are not quickly changed to correspond to secondary market changes can produce additional secondary marketing losses.

Long Interest-Rate Lock-In Periods. Since IRR is created from the date that the interest rate on a new mortgage is locked in for the borrower until closing, the longer this period the greater the potential for IRR losses. Because IRR for mortgages in the pipeline is so large, it should be hedged or covered by forward commitments to limit the worst case loss potential.

Failure to Investigate, Monitor, and Underwrite Mortgage Sellers. Since buyers of mortgages are exposed to losses from underwriting, processing, closing, and servicing of mortgages by the originators, these areas must be constantly monitored. Adequate due diligence and prepurchase underwriting should be employed to spot problems before purchase.

Conclusion

The consistent production of high quality mortgages that meet the investment and secondary marketing strategies of the thrift is the primary goal of the production function. Production of mortgages is also the basis for all mortgage banking activities and to some extent the quality of the mortgages produced affects the success of secondary marketing, servicing, accounting, and ultimately, profitability.

REFERENCES

Financial Accounting Standards Board (FASB), Emerging Issues Task Force (EITF)

No. 92-10	Loan Acquisitions Involving Table Funding Arrangements