Mortgage Banking — Secondary Marketing Program

Examination Objectives

Determine if secondary marketing policies, procedures, and practices are adequate to effectively hedge the pipeline and warehouse at reasonable risk levels.

Determine the amount of mortgage sales involving recourse or partial recourse.

Determine the adequacy of tracking systems to monitor pipeline and warehouse mortgages and their changing effect on the overall IRR of the thrift.

Examination Procedures

Perform the following examination steps to ensure that the mortgage banking activities do not pose concerns that historically have indicated trouble. Those steps that do not apply may be omitted; however, a notation should be made as to why they do not apply.

Level I

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1. Determine if the board has adopted written polices and procedures governing:

   - Separation of mortgages awaiting sale from those going to the thrift portfolio;
   - Tracking and obtaining missing mortgage documents;
   - Responsibilities for sale and delivery of mortgages;
   - Generation and review of reports for: (1) warehouse reconciliation; (2) inventory aging and turnover; and (3) fallout;
   - Employees authorized to engage in trading and hedging activities;
   - Hedging strategies and if they are supported by correlation analysis;
   - Acceptable hedging instruments and policies for linking hedges to specific mortgages or pools;
   - Position, hedging, and loss limits for individual employees and the entire operation;

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- The basis risk incurred as a result of hedging products;
- The formal process for granting exceptions to policies and limits; and
- Management's regular review of reports on pipeline, warehouse, and hedging activities.

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

3. Obtain lists of all mortgage sales transactions for the previous twelve months and determine:

   - If mortgages are sold with full or partial recourse provisions, or other special features such as guaranteed yields;
   - The amount of credit risk caused by these sales and the amount of the actual losses; and
   - If these recourse sales are properly reported, identified, and accounted for on internal documents.

4. Determine the types of mortgages originated that are sold to the thrift and those that are sold to investors. Determine if sales to the thrift match investment needs and historical purchase types and amounts. Examine procedures for transferring mortgages from the held-for-sale portfolio to the held-for-investment portfolio to ensure that the thrift is not originating and keeping unsalable mortgages (i.e., below the standards of the secondary marketing organizations).

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5. Review the most recent audits from FNMA, FHLMC, GNMA, HUD, and any private conduits to determine if those organizations have concerns or if remedial action has been taken by them to correct origination, marketing, shipping, or other errors or problems.

6. Determine management's strategy for funding its mortgage pipeline and warehouse:

   - For external credit agreements or lines of credit, review the rates and terms, documentation requirements, and funding mechanics; and

   - If credit arrangements are with an affiliate, ensure that all credit agreements are well documented and are consistent with Sections 23A and 23B of the Federal Reserve Act.

7. Determine the methods used to price mortgages originated for sale. Review the profitability objectives of the secondary marketing division and determine if its mortgage pricing is consistent with such goals.

8. For thrifts required to submit Schedule CMR of the TFR, compare the most recent filing to the thrift's internal mortgage pipeline reports for the same day:

   - Verify notional amounts, origination/discount fees, and rates for optional commitments to originate mortgages. (These should have contract codes 1002 through 1016 on the Off-Balance-Sheet Position Report of CMR, and should include only those mortgages for which the borrower is not obligated to take the mortgage and for which a rate-lock has been offered.)

   - For firm commitments to purchase, sell, or originate mortgages (contract codes 2002 through 2076), verify notional amounts, rates, and prices. (These items should include any forward commitments used for pipeline hedging);

   - Optional commitments to purchase or sell mortgages or MBSs (including exchange-traded or over-the-counter calls and puts on MBSs) should be coded 3002 through

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3076 on schedule CMR. Verify notional amounts, days until expiration, coupon or pass-through rates, and prices; and

- If futures or options on futures on non-mortgage instruments are used for pipeline hedging, ensure that these instruments are also entered on schedule CMR (consult the CMR instructions, if needed, and verify entries).

9. Review the most recent OTS IRR Exposure Report and determine the impact of pipeline activities on the thrift's balance sheet. Compare the OTS pipeline sensitivity estimates to the thrift's internal sensitivity analysis.

10. Determine if the exposure (or coverage) rate limits approved by the board have been followed in practice. Determine if the exposure rate and any changes are coordinated with the thrift's overall risk management.

11. Determine if there is a policy limiting the total amount receivable from any one investor. Does the thrift diversify its risk by dealing with various investors?

12. Evaluate the overall policies, procedures, and controls for secondary marketing activities to determine if:

    - Commitments to deliver mortgages are periodically compared to volume authorizations for each investor;
    - Profit and loss records for individual transactions are periodically reconciled to general ledger accounts;
    - Post-closing documentation tracking systems are in place; and
    - Procedures are in place to ensure that mortgage pools are certified in a timely manner.

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13. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Level II

14. Determine if risk limits for individuals and the entire operation are reasonable and supported by written analyses. Determine if the amount of risk approved by the board for the secondary marketing area is safe and sound for the size and capital level of the thrift.

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15. If the pipeline is hedged, examine the methods for determining hedge ratios and evaluate whether they are adequate. If fallout assumptions are used in hedging, determine how fallout projections are made (e.g., whether historic fallout has been tracked).

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

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17. Review the daily mark-to-market procedures and assess the adequacy of the methods used to determine the gains or losses on pipeline activities.

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

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19. Make a determination of whether the secondary marketing policies, procedures, and practices are adequate to protect the mortgage banking operation and the thrift. If not, determine corrective measures needed.

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20. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

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