
Asset-Backed Securitization Program

Examination Objectives

To determine the level of risk exposure presented by asset securitization activities and evaluate that exposure's impact on the overall financial condition of the thrift, including the impact on capital requirements and financial performance.

To determine whether the thrift is properly identifying, measuring, monitoring, and controlling the risks associated with its securitization activities.

To determine whether the thrift's strategic or business plan for asset securitization adequately addresses resource needs, capital requirements, and profitability objectives.

To determine the adequacy of asset securitization policies, practices, procedures, objectives, internal controls, and audit functions over securitization activities and valuations.

To determine that securitization activities are properly managed within the context of the thrift's overall risk management process.

To determine the quality of operations and the adequacy of Management Information Systems (MIS).

To determine compliance with applicable laws, rulings, regulations, and accounting practices.

To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient, or when you note violations of law, rulings, or regulations.

Examination Procedures

Securitization activities present unique and sometimes complex risks. The level and type of securitization activity varies significantly among institutions. To support examination flexibility and efficiency in this environment, the examination procedures are organized as follows:

The examination procedures in the first overview section will help you determine how the thrift securitizes assets and the general level of management and board oversight. The procedures in the functions section supplement the overview section and you will typically use them for more in-depth reviews of operational areas. The procedures in Overall Conclusions will ensure that you meet the objectives of these procedures.

Many of the steps in these procedures require you to gather information from or review information with examiners in other areas, particularly those responsible for originating assets used in securitized pools (e.g., retail consumer lending, mortgage banking, credit card lending). To avoid duplicating examination procedures already being performed in these areas, you should discuss and share examination data related to asset securitization with examiners from these other areas before beginning these procedures.

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You should cross-reference information obtained from other areas in your examination work papers. When information is not available from other examiners, you should request it directly from the thrift.

Given the complexity and level of risks presented by securitization activities, the retail specialist or senior field staff examining the securitization activities of an institution should closely coordinate their activities with the examiner-in-charge (EIC). The final decision on the scope of the examination and the most appropriate way to obtain information rests with the EIC.

Overview

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1. Obtain and review the following documents:

- Previous examination findings related to asset securitization and management's response to those findings.
- The most recent regulatory profile detailing the securitization activity and current risk profile of the thrift institution.
- Most recent internal/external audits addressing asset securitization and management's response to significant deficiencies.
- Recent monitoring reports (e.g., financial analysis reports, etc.).
- Scope memorandum issued by the EIC.
- Strategic or business plan for asset securitization.
- All written thrift policies or procedures related to asset securitization.
- A description of risk monitoring system for securitization activities and a copy of all related MIS reports, including tracking reports, exposure reports, valuation reports, and profitability analyses, etc.
- A summary or outline of all outstanding asset-backed issuances. Include the following information for each outstanding security in your work paper file:
 - The origination date, original deal amount, current outstanding balance, legal maturity, expected maturity, maturity type (hard bullet, soft bullet, controlled amortization, etc.), revolving period dates, current coupon rates, gross yield, loss rate, base rate, excess spread amounts (one month and three month), monthly payment rates, and the existence of any interest rate caps.

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- The amount and form of credit enhancements on an issuance-by-issuance basis (overcollateralization, cash collateral accounts, spread accounts, etc.).
 - Performance triggers relating to early amortization events or credit enhancement levels.
 - Copies of (or access to) pooling and servicing agreements and/or series supplements for major asset types securitized or those targeted at this exam.
 - Information detailing the potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets.
 - Copies of the compensation programs, including incentive plans, for personnel involved in securitization activities.
 - Current organizational chart for the asset securitization unit.
 - A list of board and executive or senior management committees that supervise the asset securitization function, including a list of members and meeting schedules. In addition, minutes documenting meetings held since the last examination should be available for review.
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2. Determine whether any material changes have occurred since the last review regarding originations and purchases, servicing, or managing securitized portfolios.
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3. Based on results from the previous steps and discussions with the EIC and other appropriate supervisors, determine the scope and objectives of the examination including which of the following examination procedures are necessary to meet examination objectives. You should tailor the procedures to the specific activities and risks faced by the thrift institution.
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4. As examination procedures are performed, test for compliance with established policies and confirm the existence of appropriate internal controls. Identify any area that has inadequate supervision or poses undue risk, and discuss the need to perform additional or expanded procedures with the EIC.

Management Oversight

5. Review the thrift's securitization business plan. Determine it is appropriate for the securitization activities of the thrift and that it has been reviewed by management and approved by the board of directors.

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6. Consider whether the business plan is reasonable and achievable in light of the thrift's capital position, size, and expertise of staff, market conditions, and current economic forecasts.

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7. Determine whether the thrift has and is following adequate policies and operating procedures for securitization activities. At a minimum, policies should address:
- Permissible securitization activities including individual responsibilities, and limits.
 - Authority levels and responsibility designations covering:
 - Transaction approvals and cancellations.
 - Segregation of duties.
 - Counterparty approvals for all outside entities the thrift is doing business with (originators, servicers, packagers, trustees, credit enhancers, underwriters, and investors).
 - Systemic transaction monitoring.

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- Pricing approvals.
- Risk exposure limits by:
 - Type of assets under securitization.
 - Individual transaction dollar size.
 - Aggregate transactions outstanding (because of the moral recourse implicit in the thrift institution's name on the securities).
 - Geographic concentrations of transactions (individually and in aggregate).
 - Maturities of transactions (particularly important in evergreen deals, that is, credit cards and home equity lines).
 - Originators (for purchased assets), credit enhancers, trustees, and servicers.
- Quality standards for all transactions in which the thrift plans to participate. Standards should extend to all counterparties conducting business with the thrift institution.
- Minimum MIS reports to be presented to senior management and the board or appropriate committees. (During reviews of applicable meeting minutes, ascertain which reports are presented and the depth of discussions held).

8. Review the organizational structure and determine who is responsible for coordinating securitization activities.

- Determine whether the board of directors or appropriate committee and management have a separate securitization steering committee. If so, review committee minutes for significant information.
- Determine who is responsible for major decisions and how final decisions are executed.

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9. Assess the expertise and experience of management responsible for securitization activities. Conduct interviews and review personnel files and resumes to determine whether management and other key staff members possess appropriate experience or technical training to perform their assigned functions.

10. Review incentive plans covering personnel involved in the securitization process.

- Determine that management approves incentive plans and orients plans toward quality execution and long term profitability rather than high volume, short term asset production and sales.
- Ensure that senior management and the board of directors are aware of any substantial payments or bonuses made under these plans.

11. Evaluate the pricing system used in all aspects of securitization. Determine whether decision makers use an effective pricing system to determine whether prospective transactions will be profitable and monitor cash flows and the profitability of ongoing securitizations.

Risk Management

12. Determine whether the risk management process is effective and based on timely and accurate information. Evaluate its adequacy in managing significant risks in each area of the securitization process.

- Ascertain whether management has identified all significant risks in each of the thrift's planned roles.
 - Determine how management monitors and controls these risks.
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13. Determine that appropriate legal counsel has reviewed the thrift's obligations from securitization activities and all pertinent legal documents.

- Also, ensure that an independent party checks the financial and statistical information in the prospectus for accuracy.

14. Determine that the scope of credit and compliance reviews includes loans originated for securitization or purchased for that purpose.

- Ascertain appropriateness of scope, frequency, independence, and competency of reviews in view of the thrift's activity volume and risk exposure.
- Credit and compliance reviews should include:
 - Loans on the thrift's books and not yet securitized.
 - Loans in process of being securitized.
 - Completed deals that bear the thrift institution's name or in which the thrift has ongoing responsibilities (servicer, trustee, etc.).
 - How the securitization process affects the overall credit quality of the nonsecuritized portfolio.

Portfolio Management

15. Determine whether management's assessment of the quality of loan origination and credit risk management includes all managed assets (receivables in securitization programs and on-balance-sheet assets). This assessment should include reports detailing both on-balance-sheet assets and off-balance-sheet assets. The assessment should include:

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- A review of the number and dollar volume of existing past-due loans, early payment defaults, and repurchased loans from securitized asset pools. The review should also compare the thrift's performance to industry and peer group averages.
- An analysis of the cause of delinquencies and repurchases.
- The effect on delinquencies and losses of altered underwriting practices, new origination sources, and new products.
- Determination of whether repurchases or other workout actions compromised the sales status of problem credits or related assets.
- Credit quality trends of each overall portfolio (e.g., score distribution).

16. Determine whether the thrift performs periodic stress tests of securitized asset pools. Determine whether these tests:

- Consider the appropriate variables affecting performance according to asset or pool type.
- Are conducted well in advance of approaching designated early amortization triggers.
- Are adequately documented.
- Reveal the financial impact of adjusting the asset capitalized on the balance sheet.

17. If third parties provide credit or liquidity enhancements for thrift-sponsored asset-backed securities, determine whether their credit rating has been downgraded recently or whether their credit quality has deteriorated. If so, determine what actions the thrift has taken to mitigate the effects of these events.

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18. Assess whether the institution has adequately integrated securitization activities into liquidity planning. Consider whether:
- The cash flows from scheduled maturities of revolving asset-backed securities are coordinated to minimize potential liquidity concerns.
 - The impact of unexpected funding requirements due to early amortization events are factored into contingency funding plans for liquidity.
 - The effect of not being able to securitize additional asset pools are factored into liquidity concerns.
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Internal and External Audit

19. Review the thrift's internal audit program for securitization activities. Determine whether it includes objectives, written procedures, an audit schedule, and reporting systems that are appropriate in view of the thrift's volume of activity and risk exposure.
- Review the education, experience, and ongoing training of the internal audit staff and evaluate its independence and expertise in auditing securitization activities.
 - Determine whether comprehensive audits of all securitization areas are conducted in a timely manner. Ensure that the scope of internal audit includes:
 - An evaluation of compliance with pooling and servicing agreement requirements.
 - Periodic verification of the accuracy of both internal and external portfolio performance reports.
 - A determination of the accuracy of other internally generated reports that are provided to senior management and the board of directors.
 - Review management's responses to audit reports for timeliness and implementation of corrective action when appropriate.
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20. Review the most recent engagement letter, external audit report, and management letter of the external auditors that address the institution's securitization activities. Determine:
- To what extent the external auditors rely on the internal audit staff and the internal audit report.
 - Whether the external auditor rendered an opinion on the effectiveness of internal controls for the major products or services related to securitization.
 - Whether management promptly and effectively responds to the external auditor's concerns and recommendations. Assess whether management makes changes to operating and administrative procedures that are appropriate responses to report findings.
 - The level of testing the external auditors performed on the various capitalized assets values, and including the periodic impairment analysis and methodologies associated with the audit process.

Management Information Systems

21. Review management information systems to determine whether they provide appropriate information for monitoring securitization activities.
- Evaluate reports produced for each capacity in which the thrift is involved, including:
 - Tracking reports to monitor overall securitization activity.
 - Performance reports by portfolio and specific product type. Reports should reflect performance of both assets in securitized pools and total managed assets. Reports should include:
 - Credit quality (e.g., delinquencies, losses, portfolio aging, accounts re-aged).
 - Profitability (by individual transaction and product type).

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- Actual performance compared with expected performance (portfolio yields, other fee income, monthly principal payment rates, purchase rates, charge-offs, etc.).
- Cost to service.
- Evaluate whether:
 - The frequency and detail of report generation is commensurate with volume and risk exposure.
 - Reports are distributed to, and reviewed by, appropriate management, board committees, or both.

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22. Determine whether investor reporting is accurate and timely. Compare internal performance reports with those provided to investors. Determine the controls used by the institution to insure accurate reporting. *Note:* Examiners can supplement this procedure by comparing internal reports with information reported by external sources (such as Bloomberg, Fitch, and Moody's). Bring discrepancies to management's attention immediately.
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Accounting and Risk-Based Capital

23. Determine whether the thrift is classifying securitization transactions appropriately as "sales" or "financings," and that the thrift has a system to ensure that independent personnel review transactions and evaluate and concur with accounting treatment.
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24. For transactions that qualify for sales treatment under FAS 140, review the written policies and procedures to determine whether they:
- Allocate the previous book-carrying amount between the assets sold and the retained interests based on their fair market values on the date of transfer.

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- Adjust the net proceeds received in the exchange by recording, on the balance sheet, the fair market value of any guarantees, recourse obligations, or derivatives such as put options, forward commitments, interest rate swaps, or currency swaps.
- Recognize gain or loss only on assets sold.
- Continue to carry on the balance sheet any retained interest in the transferred assets. Such balance sheet items should include servicing assets, accrued interest receivable, beneficial debt or equity interests in the special purpose entity, or retained undivided interests.

25. Determine whether the asset values and periodic impairment analyses for servicing assets and rights to future excess interest (IO strips) are consistent with FAS 140 and regulatory accounting requirements.

- Determine whether the thrift has a reasonable method for determining fair market value of the assets.
- Determine whether recorded servicing and IO strip asset values are reviewed periodically and adjusted for changes in market conditions.
- For servicing assets, verify that:
 - Servicing assets are appropriately stratified by predominant risk characteristics (e.g., asset type, interest rate, date of origination, or geographic location).
 - All impairments are recognized through a valuation allowance to the servicing asset.
 - Impairment is assessed at least quarterly.
 - Assumptions and calculations are documented and consistent with industry norms.
 - Servicing assets are not recorded at a value greater than their original allocated cost.

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- Servicing fees are at market terms and the relationship is profitable to the thrift.
- Compare actual servicing costs to contract rates and determine if a servicing liability should be recorded (Servicing Costs are greater than Adequate Compensation “the amount of benefit of servicing that would fairly compensate a substitute servicer”).
- For IO strip assets, verify that:
 - Valuation considers changes in expected cash flows due to current and projected volatility of interest rates, default rates, and prepayment rates.
 - IO strips are recorded at fair market value consistent with available-for-sale or trading securities.
 - The fair value is based on the assumptions including forecasted excess spread (gross yield, less investor coupon, less servicing cost, less credit losses), discount rate, receivable life, and the amount of assets securitized.
- Determine that servicing assets and IO strips are accorded appropriate risk-based capital treatment.

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26. For revolving trusts, review procedures for accounting for new sales of receivables to the trust.
- Verify that accrued interest on receivables sold is accounted for properly and does not contain a possible recourse provision.
 - Determine whether gain or loss is properly booked.
 - Sample and/or determine the initial credit quality versus the current credit quality of the securitized assets.
 - Determine if the assets being transferred to the master trust are lowering the remaining credit quality of the on-book portfolio.
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27. Determine whether the thrift maintains capital reserves for securitized assets in accordance with OTS policy and capital regulations. Determine whether the method for calculating the reserves is reasonable. Please refer to the discussion in Appendix B.

Recourse Transactions

28. Determine whether the thrift transfers loans with recourse. If so, determine whether:
- Written policies guide management with respect to the type and amount of recourse it can offer.
 - Adequate management information systems exist to track all recourse obligations.
 - Asset sales with recourse are reported appropriately in Thrift Financial Report.
 - The thrift's systems prevent it from making payments greater than its contractual obligation to purchasers if recourse is limited.

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29. Determine whether the thrift has developed written standards for refinancing, renewing, or restructuring loans previously sold in asset-backed securities transactions. The written standards should:
- Distinguish a borrower's valid desire to reduce an interest rate through renewal or refinancing from an attempt to salvage weak credits through renewal, refinancing, or restructuring.
 - Prevent the thrift from repurchasing distressed loans from the securitized credit pool and disguising their delinquency in the thrift's loan portfolio.
 - Determine the extent and reason for all repurchases of assets transferred or sold.
 - Compare the actual repurchases to the contractual obligation to repurchase the receivable.

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Securitization Functions

The following guidelines supplement the procedures in the Overview Section. You will often perform these procedures by product (loan) type and you should coordinate them with other examination areas to avoid duplication of effort.

Originations

30. Determine whether senior management or the board is directly involved in decisions concerning the quality and types of assets that are to be securitized as well as those to be retained on the balance sheet. Ensure that written policies:

- Outline objectives relating to securitization activities.
- Establish limits or guidelines for:
 - Quality of loans originated.
 - Maturity of loans originated.
 - Geographic dispersion of loans.
 - Acceptable range of loan yields.
 - Credit quality.
 - Acceptable types of collateral.
 - Types of loans.

31. Determine whether the credit standards for loans to be securitized are the same as the ones for loans to be retained.

- If not, ascertain whether management consciously made this decision and that it is clearly stated in the securitization business plan.
- If higher quality loans are to be securitized in order to gain initial market acceptance, determine whether the thrift limits the amount of lower quality assets it

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originates or retains. Also, determine whether the allowance for loan and lease losses (ALLL) and capital are adjusted for the higher proportion of risk in total assets. In addition, ensure that the ALLL is not based solely on historical trends but rather based on projected loss rates given the planned portfolio quality shifts.

- Determine whether there are sufficient administrative and collection personnel on hand to properly administer and collect lower quality credits and anticipated volume of problem loans.
- Ensure that the same level of collection effort is expended for both nonsecuritized and securitized portfolios. If collection efforts are different, determine the impact on the thrift's nonsecuritized portfolio.

32. Ensure that there is a complete separation of duties between the credit approval process and loan sales/securitization effort. Determine whether lending personnel are solely responsible for:

- The granting or denial of credit to customers.
- Credit approvals of resale counterparties.

33. Ensure that loans to be sold or securitized are segregated or otherwise identified on the books of the originating thrift. Also, determine that the thrift is following appropriate accounting standards regarding market valuation procedures on assets held for sale.

34. If loans are granted or denied based on a credit scoring system, ascertain whether the system was developed based on empirically derived data. Ensure that it is periodically revalidated.

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Purchased Loans

35. Determine whether the thrift has written procedures on acquiring portfolios for possible securitization. If so, determine whether the procedures are adequate given the volume and complexity of the potential purchases.

36. Evaluate management's method of determining whether prospective asset purchases meet the quality standards represented by the seller. Ensure that the process considers whether purchased assets are compatible with the thrift's data systems, administration and collection systems, credit review talent, and compliance standards, particularly consumer protection laws.

37. Evaluate the credit quality of the loans purchased to the bank's current credit standards. If the acquired portfolio is of lower credit quality or does not meet the thrift's current credit standards, ensure proper approvals from both senior management and the board were obtained.

38. If the thrift has recently purchased a portfolio for use in a securitization transaction, review the due diligence work papers to assess their adequacy and compliance with policy.

39. Determine whether the thrift conducts post-purchase reviews on acquired portfolios and, if so, what procedures are used. Identify who receives the results and whether appropriate follow-up action is taken (changes in quality standards, due diligence procedures, termination of counterparty relationships, etc.). In addition, determine if the thrift effectively tracks the performance of the acquired portfolio.

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40. Ensure that operating systems segregate or otherwise identify loans being held for resale. Review accounting practices to ensure appropriate treatment of assets held for resale.

41. Evaluate the measures taken to control pipeline exposure.

- If presales are routine, determine whether credit approval and diversification standards for purchasers are administered by people who are independent of the asset purchasing and packaging processes.
- Evaluate the reasonableness of limits on inventory positions that are not presold or hedged.
- If assets held for resale are required to be hedged, ensure that controls over hedging include:
 - An approved list of hedging instruments.
 - Minimum acceptable correlation between the assets held for sale and the hedging vehicle.
 - Maximum exposure limits to unhedged loan commitments under various interest rate simulations.
 - Credit limits on forward sale exposure to a single counterparty
 - A prohibition against speculation.
 - Acceptable reporting systems for hedging transactions.

Servicing

42. Determine whether written policies are in place for servicing activities that:

- Outline objectives for the servicing department.

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- Specify procedures for valuing retained servicing rights.
 - Require legal counsel to review each transaction for conflicts of interest when the thrift institution serves in multiple capacities.
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43. Determine whether MIS reports for the servicing operation provide adequate information to monitor servicing activities.
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44. Evaluate management's planning process for future servicing activities.
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45. Determine whether the thrift has contracted for an appropriate amount of errors and omissions insurance to cover the risks associated with the added transaction volumes from securitization activities.
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46. Determine whether internal or external auditors review the servicing function. Determine whether they:
- Verify loan balances.
 - Verify notes, mortgages, security interests, collateral, etc., with outside custodians.
 - Review loan collection and repossession activities to determine that the servicer:
 - Promptly identifies problem loans.
 - Charges off loans in a timely manner.
 - Follows written guidelines for extensions, renegotiations, and renewal of loans.
 - Clears stale items from suspense accounts in a timely manner.

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- Accounts for servicing fees properly (by amortizing excess servicing fees, for example).
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Collections

47. Review policies and procedures for collecting delinquent loans.
- Determine whether collection efforts are consistent with pooling and servicing agreement guidelines.
 - Determine whether the thrift documents all attempts to collect past-due payments, including the date(s) of borrower contact, the nature of communication, and the borrower's response/comment.
 - Evaluate methods used by management to ensure that collection procedures comply with applicable state and federal laws and regulations.
 - Evaluate any collection procedures, that are different between the pooling and servicing agreement and the thrift's standard practices.
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Overall Conclusions

48. Prepare a summary memorandum detailing the results of the asset securitization examination. Address the following:
- Adequacy of risk management systems, including the thrift institution's ability to identify, measure, monitor, and control the risks of securitization.
 - Adequacy of the strategic plan or business plan for asset securitization.
 - Adequacy of policies and operating procedures and adherence thereto.
 - Quality and depth of management supervision and operating personnel.

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- Adequacy of management information systems.
- Propriety of accounting systems and regulatory reporting.
- Compliance with applicable laws, rulings, and regulations.
- Adequacy of audit, compliance, and credit reviews.
- Recommended corrective action regarding deficient policies, procedures, or practices and other concerns.
- Commitments received from management to address concerns.
- The impact of securitization activities on reputation risk, strategic risk, credit risk, transaction risk, operational risk, liquidity risk, and compliance risk.
- The impact of securitization activities on the thrift institution's earnings and capital given the potential risk associated with capitalized assets. Further, assess core operating income verses securitization income flows.
- The thrift institution's future prospects based on current securitization market trends.
- Other matters of significance.

49. Discuss examination findings and conclusions with the EIC. Based on this discussion, set up a meeting with thrift management to share findings and obtain any necessary commitments for corrective action.

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

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