WHAT'S NEW IN THIS REVISED SECTION

Section 604(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, 124 Stat. 1601 (2010), (Dodd-Frank Act), added the "...risk to the stability of the United States banking or financial system..." to the example listing of possible adverse effects. The amendment is included below. See 12 U.S.C. 1843(j)(2)(A).

The Bank Holding Company Act of 1956 (BHC Act) was enacted to limit the expansion of banking institutions into nonbanking activities. A bank holding company was defined in the BHC Act as an entity that owned or controlled 25 percent or more of the voting shares of two or more banks; companies owning only one bank were exempted from regulation under the BHC Act.

During the 1960s, the number of commercial enterprises that purchased one bank, engaged in nonbanking activities, and remained exempt from regulation grew dramatically. As a result of this change in the structure of bank ownership, Congress enacted the Bank Holding Company Act Amendments of 1970. Of these amendments, the most significant is the extension of the act to grant to the Federal Reserve Board the authority to regulate the activities of one-bank holding companies.

In 1978, Congress passed the International Banking Act (IBA). Section 8 of the IBA expanded the nonbanking prohibitions of the BHC Act to foreign banks that engage in the business of banking in the United States directly through a branch or agency or indirectly through a subsidiary commercial lending company. This expanded the nonbanking restrictions beyond simply covering foreign banks that own or control U.S. banks or bank holding companies. However, section 2(h) of the BHC Act provides foreign organizations that are principally engaged in the business of banking outside the United States with exemptions from the nonbanking prohibitions of the BHC Act. Further exemptions have been granted by the Board's discretionary authority under section 4(c)(9) when such exemptions were in the public interest and were consistent with the purposes of the BHC Act.

Under section 4(c) of the BHC Act, Congress exempted a limited number of investments from the general prohibition against owning or controlling shares of nonbank concerns. Section 4(c)(8) permitted investment in shares of any company the activities of which the Board after due notice and opportunity for hearing has determined—pursuant to section 225.28 of Regulation Y or Board order issued prior to November 12, 1999—to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The act also provided that any bank holding company might apply to the Board for permission to engage in an activity that had not yet been determined to be permissible if the applicant was of the opinion that the activity in its particular circumstances was closely related to banking or managing or controlling banks. Section 225.28(b) of the Board's Regulation Y lists permissible nonbanking activities that the Board has deemed to meet these criteria. (See appendix 1.) The list of permissible nonbanking activities has been expanded at various times.

The Board also has permitted by order, on an individual basis, certain activities that it has considered to be closely related to banking under section 4(c)(8) of the BHC Act. In doing so, the Board did not expand the list of permissible activities under section 225.28(b) of Regulation Y. (For a list of such activities, see appendix 2.)

In determining whether the performance of a nonbank activity by a bank holding company or the acquisition of a nonbank firm by a bank holding company was a proper incident to banking, the Board applies a ''public interest test.'' The Board must consider whether performance of a nonbank activity by a bank holding company or a subsidiary of such company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, or risk to the stability of the United States banking or financial system. (See 12 U.S.C. 1843(j)(2)(A).)

An interpretation of Regulation Y (12 C.F.R. 225.126) dated April 28, 1972, and amended September 20, 1972, listed activities that the Board determined do not satisfy the ''so closely related'' test under section 4(c)(8). The Board subsequently determined that a number of other activities do not satisfy the closely related test. (For a complete list of these impermissible activities, see appendix 3, and, for a brief

description of a selected number of the activities denied by the Board, see section 3700.0 et seq.)

As the primary regulator for bank holding companies and their directly held nonbank subsidiaries, the Federal Reserve System conducts inspections of their operations, financial condition, and compliance with appropriate banking and other related statutes and regulations. Inspection personnel are called upon to evaluate the current condition of the organizations, as well as their future prospects.

On August 10, 1987, the Competitive Equality Banking Act of 1987 was signed into law. This act redefined the definition of "bank" in section 2 of the BHC Act so that an FDIC-insured institution is deemed a bank. An "insured bank" is defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)).

State-Authorized Activities of Savings Banks

A special rule was established for qualified savings banks (state-chartered, FDIC-insured institutions organized before March 5, 1987) that are subject to the BHC Act. (See section 2090.7.) In accordance with section 3 of the BHC Act, a qualified savings bank may engage in any nonbanking activity, except insurance activities, either directly or through a subsidiary, that it is permitted to conduct directly as a state-chartered savings bank, even if those activities are not otherwise permissible for bank holding companies. To engage in those activities, however, a qualified savings bank must remain a savings bank and a subsidiary of a savings bank holding company (a company that controls one or more qualified savings banks whose total aggregate assets, upon formation and at all times thereafter, constitute at least 70 percent of the assets of the holding company). With respect to insurance activities, qualified savings banks may engage in underwriting and selling savings bank life insurance if the savings bank is located in Connecticut, Massachusetts, or New York, and if certain other conditions are met.

BHCs Engaging in Nonbanking Activities in Foreign Countries

A bank holding company has greater leeway to perform nonbanking activities abroad than in the United States in that it may engage in nonbanking activities abroad that would not be permissible in the United States. However, activities abroad are subject to limitations. Section 211.8 of Regulation K requires a bank holding company to limit its direct and indirect activities abroad to those usual in connection with banking and financial activities and to necessary related activities. Section 211.10 also lists particular activities that are permissible abroad and provides rules regarding when a bank holding company must submit an application to engage in such activities directly or through investments.

Edge Act or Agreement Corporations

A bank holding company may own an Edge Act or agreement corporation. The Federal Reserve Act and Regulation K govern the permissible activities of Edge Act or agreement corporations. An Edge Act or agreement corporation is an international banking vehicle that may only engage in listed or approved activities that are incidental to international or foreign business. (See 12 C.F.R. 211.6) The restriction generally permits an Edge Act or agreement corporation to engage only in international banking or financial activities. (See 12 C.F.R. 211.8.)

Companies that own only an Edge Act or agreement corporation. Any company, other than a bank, that acquired an Edge Act or agreement corporation after March 5, 1987, must conform its activities to section 4 of the BHC Act.

Underwriting and Dealing in Debt and Equity Securities

Beginning in January 1989, certain nonbanking subsidiaries of bank holding companies were approved to underwrite and deal in debt or equity securities (excluding open-end investment companies), subject to the prohibition on affiliation with an organization dealing in securities under section 20 of the Glass-Steagall Act. (See 1989 FRB 192.) The Board delayed commencement of the activity by each applicant until it determined that the applicant had established the necessary managerial and operational infrastructure to commence the expanded under-

writing and dealing activity and to comply with the Board order. The applicant's capital plan had to be determined to be adequate along with the necessary policies and procedures needed to comply with the Board's order. The Board's order requires that loans to and capital investments in the underwriting subsidiary be deducted from the bank holding company's capital, as provided for in the Board's capital adequacy guidelines. The Board further confirmed that the activities could not be conducted in any other subsidiary other than the Board-approved section 20 subsidiary. (See section 3600.21.4.)

As for underwriting and dealing in equity securities, the Board stated in the order that it would review within a year whether applicants could commence the activity. The first Board authorization to commence underwriting and dealing in equity securities was given on September 20, 1990, subject to the commitments given by the bank holding company in connection with its respective Board order, including its commitment to maintain the capital of its section 20 subsidiary at levels necessary to support its activities and commensurate with industry standards, and to increase the capital of the section 20 subsidiary accordingly as it grew.

Modifications to the Board's Orders Authorizing BHC Subsidiaries to Underwrite and Deal in Bank-Ineligible Securities Consistent with Section 20 of the Glass-Steagall Act

The Board announced its approval of modifications to its previous section 20 authorizations by order on September 21, 1989 (1989 FRB 751). The modifications (1) raised from 5 percent to 10 percent (currently 25 percent) the revenue limit on the amount of total revenues a section 20 subsidiary might derive from bank-ineligible securities underwriting and dealing activities, and (2) permitted underwriting and dealing in the securities of affiliates, consistent with section 20 of the Glass-Steagall Act, if the securities were rated by an unaffiliated, nationally recognized statistical rating organization or were issued or guaranteed by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC), or the Government National Mortgage Association (GNMA), or if they represented interests in such obligations.

Acting as Agent in the Private Placement of All Types of Securities and Acting as Riskless Principal in Buying and Selling Securities

In another Board order, the Board authorized a bank holding company to transfer its private-placement activities from its commercial bank subsidiary to its section 20 subsidiary. The section 20 subsidiary would act as agent in the private placement of all types of securities, including the provision of related advisory services, and would buy all types of securities on the order of investors as a "riskless principal." The Board concluded that the section 20 subsidiary's private placement of debt and equity securities within the limits proposed did not involve the underwriting or public sale of securities for the purposes of section 20 of the Glass-Steagall Act. The revenues derived therefrom should not be subject to the 25 percent revenue limitation placed on bank-ineligible securities activities. (See section 3230.4.)

Foreign Banks Authorized to Operate Section 20 Subsidiaries to Underwrite and Deal in Corporate Debt, Commercial Paper, and Other Securities

In a Board order (1990 FRB 158), the Board authorized a foreign bank to operate a section 20 subsidiary under the bank to underwrite and deal in corporate debt, commercial paper, and other securities. (Securities issued by open-end investment companies are not included.) The foreign bank operated outside the United States but owned a subsidiary bank in the United States. To achieve equality between the domestic and foreign banking operations in the United States and in an effort to negate any advantages that a foreign bank might have over a domestic bank, the Board considered the foreign bank as a bank holding company even though the bank was not part of a bank holding company structure. In so doing, the Board imposed restrictions on the section 20 subsidiary. The foreign bank might fund the section 20 subsidiary, but that action required prior Board approval. In addition, the section 20 subsidiary might not borrow from its parent bank. Any loans to, transfers of assets to, or investments in the section 20 subsidiary also required Board approval. (See 1990 FRB 158, 455, 554, 568, 573, 652, and 683.)

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

FIRREA became law on August 9, 1989. The law revised section 4(c)(8) of the BHC Act and authorized the Board to approve applications from bank holding companies for the acquisitions of savings associations. The Board thus revised section 225.28(b)(4)(i) of Regulation Y to include as a permissible nonbanking activity the owning, controlling, or operating of a savings association, if the savings association engaged only in deposit-taking, lending, and other activities permissible for bank holding companies. The legislation required the Board to remove tandem restrictions found in previous Board orders that were not prohibited by FIRREA and, in approving applications, to confine limitations on transactions between the savings association and its bank holding company affiliates to those required by sections 23A and 23B of the Federal Reserve Act. FIRREA made sections 23A and 23B applicable to savings associations as though they were member banks. Two exceptions apply: (1) no extensions of credit may be granted by a savings association to an affiliate unless the affiliate is engaged only in activities permissible for bank holding companies under the BHC Act, and (2) savings associations may not purchase or invest in securities of an affiliate other than shares of a subsidiary. The legislation also provided for a ''sister-bank'' exemption from the provisions of sections 23A and 23B of the Federal Reserve Act. (See sections 2020.1.1.6 and 2090.8.1.)

1992 Revisions to the Regulation Y List of Nonbanking Activities—the ''Laundry List''

During 1992, the Board initiated several actions that affected certain nonbanking activities. The first action, effective May 18, 1992, amended section 225.28(b) of Regulation Y with regard to tangible personal property leases. Subject to the stated limitations, a bank holding company can rely on estimated residual values of up to 100 percent of the acquisition costs of the leased property in order to recover the bank holding company's leasing costs. Previously, the nonbanking activity had only been approved by Board order. (See the initial Board order at 1990 FRB 462 and the subsequent Board orders at 1990 FRB 960 and 1991 FRB 187 and 490.)

The Board issued a revised interpretive rule, effective August 10, 1992, regarding investment advisory activities of bank holding companies to expressly provide that a bank holding company or its nonbank subsidiary may act as agent for customers in the brokerage of shares of an investment company advised by the holding company or any of its subsidiaries. In addition, the revision provided that a bank holding company or its nonbank subsidiary may provide investment advice to customers regarding the purchase or sale of shares of an investment company advised by an affiliate. In both instances, the Board requires certain disclosures to be made to address potential conflicts of interest or adverse effects. (See 12 C.F.R. 225.125(h) of Regulation Y.)

Effective September 10, 1992, the Board added two nonbanking activities to Regulation Y that were previously approved by Board order. The two activities dealt with full brokerage services and financial advisory services. (See 12 C.F.R. 225.28(b)(6) and (7).)

Comprehensive Revision of Regulation Y

In August 1996, the Board proposed comprehensive revisions to Regulation Y that were designed to significantly reduce regulatory burden, improve efficiency, and eliminate unwarranted constraints on credit availability. The proposal followed a Board review of its regulations that was required by the Riegle Community Development and Regulatory Improvement Act of 1994. The changes (1) removed a number of restrictions on the permissible nonbanking activities of BHCs, (2) expanded and reorganized the regulatory list of permissible nonbanking activities to include numerous nonbanking activities that had been previously approved only by Board order,[1] (3) streamlined the application/notice process for BHCs and the procedures governing change in bank control notices, and (4) revised the tying rules to enhance banking organizations' ability to provide customer discounts on services. Included were changes that streamlined the procedures for well-run BHCs to seek Federal Reserve System approval to acquire additional banks within certain limits. The Board approved these revisions to Regulation Y, effective April 21, 1997.

1. See subsection 3000.0.2, appendix 1. See also section 225.28(b) of Regulation Y. In addition to these activities, other activities have been approved by Board order. For a list of those activities, see subsection 3000.0.3, appendix 2.

Limitation on Board-Approved Nonbanking Activities

The Gramm-Leach-Bliley Act (the GLB Act) amended the BHC Act to limit bank holding companies that are not financial holding companies to engaging only in ''activities which had been determined by the Board by regulation or order under section 4(c)(8) of the BHC Act and section 225.28 of Regulation Y before November 12, 1999 (the approval date of the GLB Act), to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board)'' (12 U.S.C. 1843(c)(8)). Prior to November 12, 1999, the Board had determined that ''[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board'' is closely related to banking. Accordingly, the Board retains authority after the GLB Act to define the scope of this section 4(c)(8) activity and to modify the terms and conditions that apply to the activity.

Financial Holding Companies

The GLB Act, approved in November 1999, amended section 4 of the BHC Act and expanded the powers of qualifying BHCs and foreign banks that elect to become financial holding companies (FHCs). An FHC is defined in the GLB Act as a BHC that meets certain eligibility requirements. The law repealed those provisions of the Glass-Steagall Act and the BHC Act that restricted the ability of BHCs to affiliate with securities firms and insurance companies. For a bank holding company to become an FHC and be eligible to engage in new activities authorized under the GLB Act, the GLB Act requires that all depository institutions controlled by the BHC be well capitalized and well managed. With regard to a foreign bank that operates a branch or agency or that owns or controls a commercial lending company in the United States, the GLB Act requires the Board to apply comparable capital and management standards that give due regard to the principle of national treatment and equality of competitive opportunity.

Qualifying BHCs that elect to become FHCs can engage in a broad array of financially related activities, including (1) securities underwriting and dealing, (2) insurance agency and insurance underwriting activities, and (3) merchant banking activities. With respect to merchant banking, the GLB Act (1) permits an FHC to retain a merchant banking investment only as long as necessary to dispose of the investment on a reasonable basis consistent with the financial viability of its merchant banking activities, and (2) provides that an FHC may not routinely manage or operate a company held as a merchant banking investment except as necessary to obtain a reasonable return on the investment.

The statute also sets forth parameters for the relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with regulators of depository institutions and functional regulators, such as those for nonbanking or nonfinancial activities such as insurance, securities, and commodities activities.

An FHC may engage in any other activities that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities. An FHC may also engage in any nonfinancial activity that the Board determines (1) is complementary to a financial activity and (2) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The activities of BHCs and foreign banks that are not FHCs continue to be limited to activities currently authorized under section 4(c) of the BHC Act to be closely related to banking and permissible for BHCs. No additional activities may be found to be so closely related to banking as to be a proper incident thereto after November 11, 1999, thus limiting the ability of BHCs and foreign banks that are not FHCs to expand their activities.

In this manual, the sections in the 3900 series have been designated for FHCs. Those sections discuss FHC qualification requirements (domestic and foreign); permissible nonbanking FHC activities designated by statute (for example, merchant banking activities) or regulation, including activities jointly approved by the Board and the Secretary of the Treasury; and the supervisory approach and guidance for FHCs.

To implement the provisions of the GLB Act that govern FHCs, the Board amended Regulation Y by adding subpart I for FHCs. The provisions of an interim rule became effective March 11, 2000, and the Board approved a final rule effective December 21, 2000. Key provisions of the final rule are discussed within the 3900 sections of this manual. With respect to permissible activities of FHCs, the rule includes activities that previously were determined to be closely related to banking under section 225.28 of Regu-

lation Y, activities that are usual in connection with transactions of banking abroad (including those in section 211.10 of Regulation K), and other activities defined as financial in nature by the GLB Act.

3000.0.1 CATEGORIES OF NONBANKING ACTIVITIES

Section 4(c)(8) of the BHC Act authorizes bank holding companies to engage directly or through a subsidiary in activities that the Board determined before November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board and the courts established the following guidelines for determining whether a nonbanking activity is closely related to banking:[2]

1. whether banks have generally provided the service
2. whether banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed service
3. whether banks generally provide services that are so integrally related to the proposed service as to require their provision in specialized form

In addition, before November 12, 1999, the Board considered other factors in deciding what activities were closely related to banking.[3] For those activities found to be closely related to banking or to managing or controlling banks, the Board also must find that the proposed activity is a ''proper incident'' to banking and that performance of an activity by a bank holding company could reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices). The following describes three categories of bank holding company nonbanking activities:

1. those that have been found to be permissible and are listed in Regulation Y, the so-called laundry list activities (see appendix 1)
2. those that are permissible by Board order only (see appendix 2)
3. those that have been denied by the Board (see appendix 3)

2. *National Courier Association v. Board of Governors,* 516 F. 2d 1229 (D.C. Cir. 1975).

3. *Alabama Association of Insurance Agents v. Board of Governors,* 533 F.2d 224 (5th Cir. 1976), *cert. denied,* 435 U.S. 904 (1978).

3000.0.2 APPENDIX 1—Activities Approved by the Board as Being Considered "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act (Section 225.28(b) of Regulation Y)

Permitted by Regulation[1]	*Year Added to Regulation Y*
Note: The bulleted items in this appendix are provided for historical reference only. The narrative before the bulleted items reflects the current Regulation Y authorization.	
1. Extending credit and servicing loans	1971
Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit, and accepting drafts) for the company's account or the account of others.	
2. Activities related to extending credit[2]	
a. Appraising	
(1) Real estate appraising	1980
(2) Personal property appraising	1986
b. Arranging commercial real estate equity financing	1983
c. Check-guaranty services	1986
d. Collection agency services	1986
e. Credit bureau services	1986
f. Asset management, servicing, and collection activities	1997
g. Acquiring debt in default	1995
h. Real estate settlement servicing	1997
3. Leasing personal or real property or acting as agent, broker, or adviser in leasing such property	
• Personal property leasing[3]	1971
• Real property leasing	1974
4. Operating nonbank depository institutions	
a. Owning, controlling, or operating an industrial bank, Morris Plan bank, or industrial loan company so long as the institution is not a bank	1971
b. Owning, controlling, or operating a savings association, if the savings association engages in deposit-taking activities, lending, and other activities that are permissible for bank holding companies	1989
5. Trust company functions or activities	1971
6. Financial and investment advisory activities: acting as an investment adviser or financial adviser to any person, including (without limiting these activities in any way)—	1971

Permitted by Regulation[1]	*Year Added to Regulation Y*
a. Serving as an investment adviser to an investment company registered under the Investment Company Act of 1940, including sponsoring, organizing, and managing a closed-end investment company	1972
• Investment or financial advising	1971
• Advisory services to open-end (mutual fund) investment companies	1972
b. Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies	1984
c. Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, reorganizations, recapitalizations, capital structurings, financing transactions, and similar transactions,[4] and conducting financial feasibility studies[5]	1992
• Financial futures and options on futures	1986
d. Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments	1992
• Financial futures and options on futures	1986
• Providing financial advice to—	
— state and local governments and	1973
— foreign governments, including foreign municipalities and agencies of foreign governments, such as with respect to the issuance of their securities	1992
• Inclusion of any investment or financial advisory activity without restriction	1997
• Discretionary investment advice to be provided to any person (includes investment advice regarding derivative transactions to institutional or retail customers as an investment, commodity trading, or other adviser) regarding contracts related to financial or nonfinancial assets (such advice is no longer restricted to institutional customers)	1997
• Financial and investment advice (or any permissible nonbanking activity) can be provided in any combination of permissible nonbanking activities listed in Regulation Y	1997
e. Providing educational courses and instructional materials to consumers on individual financial-management matters	1986
f. Providing tax-planning and tax-preparation services	1986
7. Agency transactional services for customer investments (principal positions)	
a. Securities brokerage services (including securities clearing and/or securities execution services on an exchange) for the account of customers and does not include securities underwriting or dealing	
(1) Securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or	1982
(2) In combination with advisory services and incidental activities (including related securities credit activities and custodial services)	1992
b. Riskless-principal transactions	1997
c. Private-placement services	1997
d. Futures commission merchant activities	1984
• A nonbanking subsidiary may act as an FCM with respect to any exchange-traded futures contract and options on a futures contract based on a financial or nonfinancial commodity	1997

Permitted by Regulation[1]	*Year Added to Regulation Y*
e. Other transactional services such as providing to customers as agent transactional services with respect to the following:	1997
(1) Swaps and similar transactions	
(2) Investment transactions as principal[6]	
(3) Transactions permissible for a state member bank	
(4) Any other transaction involving a forward contract, an option, futures, an option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange	
8. Investment transactions as principal	
a. Underwriting and dealing in government obligations and money market instruments	1984
b. Investing and trading activities. Engaging as principal in the following:	
(1) Foreign exchange	1984
(2) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security, if the transaction meets certain requirements (A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.)	1997
(3) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement	1997
9. Management consulting and counseling activities	
a. Providing management consulting advice on any matter (financial, economic, accounting, or audit) to any other company[7]	
• Unaffiliated banks (depository institutions)	1974
• Nonbank depository institutions	1982
• Other unaffiliated depository institutions	1997
• Any financial, economic, account, or audit matter to any other company	1997
b. Employee benefits consulting services	1997
c. Career counseling services	1997
10. Support services	
a. Courier services	1973
b. Printing and selling MICR-encoded checks and related documents	1997
11. Insurance agency and underwriting	
a. Credit insurance: acting as principal, agent, or broker for insurance (including home mortgage redemption insurance)	
• Acting as insurance agent or broker primarily in connection with credit extensions[8]	1971
• Underwriting credit life and credit accident and health insurance related to an extension of credit	1972

Permitted by Regulation[1]	*Year Added to Regulation Y*
b. Finance company subsidiary: insurance agent or broker for extension of credit by finance company subsidiary	1982
c. Insurance agency activities in small towns	1984
d. Insurance agency activities conducted on May 1, 1982	1984
e. Supervision of retail insurance agents	1984
f. Insurance agency activities by small bank holding companies	1984
g. Insurance agency activities conducted before 1971	1984
12. Community development	
a. Financing and investment in community development activities	1971
b. Advisory and related services designed to promote community welfare	1997
13. Issuance and sale of payment instruments	
a. Issuance and sale of retail money orders	1984
b. Sale of savings bonds	1979
c. Issuance and sale of traveler's checks	1981
14. Data processing	
a. Providing data processing and data transmission services; facilities (including data processing and data transmission hardware,[9] software, documentation, or operating personnel); databases; advice; and access to services, facilities, or databases by any technological means	
• Providing bookkeeping and data processing	1971
• Data processing and transmission services	1982
• Providing data processing and transmission advice to anyone on processing and transmitting banking, financial, and economic data	1997
b. Conducting data processing and data transmission activities not described in "a." that are *not* financial, banking, or economic[10]	1997

1. See section 225.28(b) of Regulation Y for the details of the regulatory authorizations.

2. A Board staff opinion, issued July 9, 2002, concluded that a BHC's certain proposed flood zone–determination services are usual in connection with making mortgage loans and that these activities are within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y.

3. The provision of higher residual value leasing for tangible personal property was added to Regulation Y in 1992, including acting as agent, broker, or adviser in leasing such property.

4. The words "and similar transactions" were added in 1997.

5. Feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice.

6. Transactions described in section 225.28(b)(8) of Regulation Y.

7. Management consulting services may be provided to other customers not described in section 225.28(b)(9) of the rule, but the revenues derived therefrom are subject to a 30 percent annual revenue limitation.

8. Scope narrowed to conform to court decisions in 1979 and 1981; in 1982, it was further narrowed by title VI of the Garn–St Germain Depository Institutions Act.

9. Beginning in April 1997, the general-purpose hardware may not constitute more than 30 percent (previously 10 percent) of the cost of any package offering.

10. The total revenue may not exceed 30 percent (increased to 49 percent, effective January 8, 2004) of the company's total annual revenues derived from data processing, data storage, and data transmission activities.

3000.0.3 APPENDIX 2—Activities Considered "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act

Permitted by Order on an Individual Basis	*Year Approved*	*Manual Section 3600.*
1. Operating a "pool-reserve plan" for the pooling of loss reserves of banks with respect to loans to small businesses	1971	1
2. Operating an article XII New York investment company	1977	5.1
3. Underwriting and dealing in commercial paper to a limited extent	1987	21.1
4. Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage-related securities, and commercial paper	1987	21.2
5. Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage-related securities, consumer receivable–related securities, and commercial paper	1987	21.3
6. Issuing and selling mortgage-related securities backed by the guarantees of the Government National Mortgage Association	1988	23
7. Engaging in title insurance agency activities (approved under exemption G of the Garn–St Germain Depository Institutions Act of 1982)	1988	17.1
8. Underwriting and dealing in, to a limited extent, corporate debt and equity securities	1989	21.4
9. Acting as a sales-tax refund agent	1990	24.1
10. Providing real estate settlement activities through a permissible title insurance agency (exemption G companies only)	1990	26
11. Providing administrative and certain other services to mutual funds	1993	27
12. Acting as a dealer-manager in connection with cash-tender and exchange-offer transactions	1993	21.5
13. Privately placing limited partnership interests	1994	8
14. Engaging in real estate title abstracting	1995	30
15. Providing employment histories to third parties	1995	29
16. Underwriting "private ownership" industrial development bonds by a section 20 company	1995	21.6
17. Serving as a commodity pool operator of investment funds engaged in purchasing and selling futures and options on futures on certain financial and nonfinancial commodities	1996	13.1

Permitted by Order on an Individual Basis	*Year Approved*	*Manual Section 3600.*
18. Development of broader marketing plans and advertising, sales literature, and marketing materials for mutual funds (see 1997 FRB 678)	1997	28
19. Sale of government services involving (see 1998 FRB 481)—	1998	25
a. postage stamps and postage-paid envelopes b. public transportation tickets and tokens c. vehicle registration services (including the sale and distribution of license plates and license tags for motor vehicles) d. notary public services		
20. Operating a securities exchange	1999	6
21. Acting as a certification authority for digital signatures	1999	7

3000.0.4 APPENDIX 3—Activities Considered Not to Be "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act

Activities Denied by the Board	*Year Denied*
1. Insurance premium funding ("equity funding") (combined sales of mutual funds and insurance)	1971
2. Underwriting general life insurance not related to credit extension	1971
3. Real estate brokerage	1972
4. Land investment and development	1972
5. Real estate syndication	1972
6. General management consulting	1972
7. Property management	1972
8. Trading in platinum and palladium coin and bullion [1]	1973
9. Armored car service [2]	1973
10. Sale of level term credit life insurance	1974
11. Underwriting mortgage guarantee insurance	1974
12. Computer output microfilm services [3]	1975
13. Operating a travel agency	1976
14. Underwriting property and casualty insurance	1978
15. Real estate advisory activities	1980
16. Certain contract key entry services	1980
17. Offering investment notes with transactional features	1982
18. Engaging in "pit arbitrage" spread transactions on commodities exchanges to generate trading profits	1982
19. Engaging in the publication and sale of personnel tests and related materials	1984
20. Providing credit ratings on bonds, preferred stock, and commercial paper	1984
21. Providing independent expert actuarial opinions of a general nature for purposes such as divorce action and personal injury litigation	1984
22. Acting as a specialist in foreign-currency options on a securities exchange	1985

Activities Denied by the Board	*Year Denied*
23. Title insurance activities (See the Board letter dated March 17, 1986, re: Independence Bancorp, Inc. and the Board order at 1989 FRB 31)	
24. Acting as a broker for customers in the purchase and sale of forward contracts based on certain financial and nonfinancial commodities, and acting as the primary clearing firm for professional floor traders[4]	1991

1. Authorized by the Board in 1995 FRB 190 (platinum) and 1996 FRB 571 (palladium).

2. On June 18, 1990, the Board determined that the activity of providing armored car services to the general public is closely related to banking (see 1990 FRB 676). In order for the Board to approve a nonbank activity for a bank holding company, the Board must also find that the activity is a "proper incident thereto." On February 10, 1993, the Board denied the application (1993 FRB 352), finding that the proposed transactions posed potential violations of section 23B of the Federal Reserve Act and that the applicant had failed to prove that the activity is a proper incident to banking.

3. The Board's interpretation of Regulation Y at 12 C.F.R. 225.123 was amended on November 25, 1987, by deleting item (e)(4) relating to the impermissibility of the activity (see 52 *Federal Register* 45160–45161 and 1987 FRB 933).

4. The Board subsequently approved this activity by Board order. (See 1997 FRB 138.)

As an FDIC insured institution, a savings bank qualifies as a "bank" under section 2(c) of the BHC Act, as amended by section 101(a) of the Competitive Equality Banking Act of 1987 ("CEBA"). CEBA amended the BHC Act, in section 3(f), stating that any qualified savings bank, which is a subsidiary of a bank holding company, could engage directly, or through a subsidiary, in any nonbanking activity, except for certain insurance activities, that it is permitted to engage in by State law—including activities which are not otherwise permitted for bank holding companies under section 4(c)(8) of the BHC Act. In order for a qualified savings bank, that is a subsidiary of a bank holding company, to engage in such activities, however, the bank holding company must be a savings bank holding company as defined in section 2(1) of the BHC Act, in other words, 70 percent of the assets of the bank holding company must consist of one or more savings banks at the time of formation.

Insurance activities of any qualified savings bank which is a subsidiary of a bank holding company are limited to the insurance activities allowed under section 4(c)(8) of the BHC Act. A qualified savings bank that was authorized to engage in the sale or underwriting of savings bank life insurance, as of March 5, 1987, can sell or underwrite such insurance directly, provided that it is permitted to underwrite and engage in the sale of savings bank life insurance as that activity is authorized for savings banks by state law, and is located in Massachusetts, Connecticut, or New York. Should the bank holding company parent of the qualified savings bank cease to be a savings bank holding company, the savings bank must cease engaging in these activities within two years.

In a separate application a nonoperating company, which was formed for the purpose of acquiring a savings bank, insured by the Federal Deposit Insurance Corporation, applied for the Board's approval to become a bank holding company pursuant to section 3(a)(1) of the Bank Holding Company Act, acquiring all of the voting shares of the savings bank. The savings bank engages through subsidiaries in real estate investment and development activities authorized pursuant to State law.

As part of the Board's analysis in this case, including its evaluation of the capital and financial resources of the bank holding company and the bank involved, the Board considered the risk to the Applicant and to the savings bank of the real estate development activities to be conducted by the savings bank through its nonbank subsidiaries. The Board expressed serious reservations with regard to this application and similar applications by bank holding companies to acquire savings banks engaged directly or through subsidiaries in real estate development activities. In the Board's view the conduct of real estate development activities through a holding company subsidiary rather than a bank subsidiary would provide more effective corporate separateness.

The Board approved the application by Order on October 30, 1987 (1987 FRB 925), relying on the Applicant's commitments.

Section 2(c)(2)(F) of the BHC Act (Credit Card Bank Exemption from the Definition of a Bank) Section 3005.0

WHAT'S NEW IN THIS SECTION

Effective January 2006, this section has been revised to incorporate a table of Laws, Regulations, Interpretations, and Orders concerning a credit card bank exemption found in section 2(c)(2)(F) of the Bank Holding Company Act. (See the discussion below of the Board staff legal interpretation dated February 18, 2005.)

3005.0.1 SECTION 2(c)(2)

Section 2(c)(2) of the Bank Holding Company Act (the BHC Act) provides 10 exemptions from the definition of a bank for purposes of the BHC Act. Section 2(c)(2)(F) sets forth the criteria that an institution must meet in order to qualify for the so-called credit card bank exemption. The credit card bank exemption applies to any ''institution, including an institution that accepts collateral for extensions of credit by holding deposits under $100,000, and by other means which—

1. engages only in credit card operations;
2. does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others;
3. does not accept any savings or time deposit of less than $100,000;
4. maintains only one office that accepts deposits; and
5. does not engage in the business of making commercial loans.''[1]

3005.0.2 SECTION 2(c)(2)(F)

On February 18, 2005, Board staff issued an interpretation in response to a bank's (MB Bank's) legal counsel, who had requested a determination that (1) MB Bank would qualify for the ''credit card bank exemption'' from the definition of bank in section 2(c)(2)(F) of the BHC Act and that (2) no application to the Board would be required under the BHC Act either for the proposed acquisition of control of MB Bank (the acquisition) by Financial Group (a joint venture), or for the proposed redemption of shares of common stock of MB Bank's parent, MB BHC—a bank holding company for the purposes of the BHC Act—in connection with the acquisition.

Financial Group proposed to acquire substantially all of the outstanding stock of MB BHC and, indirectly, MB Bank. Prior to the acquisition, MB Bank planned to convert itself to a depository institution that would qualify for the credit card bank exemption under the BHC Act. Before the acquisition, but after MB Bank's conversion to a credit card bank, MB BHC also proposed to redeem approximately 50 percent of its common stock.

To comply with the provisions of the credit card bank exemption under the BHC Act, other representations and commitments were made by and on behalf of MB Bank and MB BHC. Under these commitments, MB Bank would—

1. engage only in credit card operations[2] as of and after the acquisition, including selling advertising space in monthly statements mailed to account holders (''statement stuffers'');
2. provide, as agent, limited debt-protection services to its credit card customers—services in which, for a fee, customers can receive debt relief from MB Bank during certain unexpected hardships (the limited debt-protection coverage provides for the payment of MB Bank's outstanding credit card balance in the event of the borrower's death, disability, or involuntary unemployment); and
3. not engage in the business of making commercial loans as of and after the acquisition.

MB Bank also agreed to cease providing certain ancillary services within three months of the acquisition by (1) selling a credit report–monitoring service offered by an unaffiliated third party and (2) selling a membership-based roadside-assistance product offered by an unaffiliated third party. In addition, MB Bank committed to restricting the scope of its deposit operations as of, and after, the acquisition to comply with the credit card bank exemption provisions of the BHC Act. MB Bank agreed to not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others.

1. 12 U.S.C. 1841(c)(2)(F).

2. The Senate report accompanying S. 790 states that the ''engage only in credit card operations'' language was intended to limit a qualifying institution to engage ''only in the business of issuing and processing credit cards for individuals and in transactions that are necessary and incident to that business.''

Moreover, except for deposits that serve as collateral for MB Bank's credit card loans (collateral deposits), MB Bank will not accept savings or time deposits of less than $100,000. MB Bank also represented that each collateral deposit held by MB Bank will be no greater than the amount of the relevant customer's line of credit with the bank. Any deposit not conforming to the credit card bank exemption requirements or the representations and commitments within the letter of interpretation and not transferred to an unaffiliated third party prior to the acquisition would be liquidated by MB Bank prior to the acquisition through a wire transfer to the relevant depositor. MB Bank would maintain only one office that accepts deposits.

At the time of the determination request, MB Bank was issuing debit cards and holding related deposits that were not permissible for a depository institution that qualifies for the credit card bank exemption under the BHC Act. Therefore, to qualify for the credit card bank exemption, MB Bank committed to transferring, before the acquisition, its current debit card accounts and related deposits to another bank (the issuing bank), which would issue new debit cards under the issuing bank's name to the current holders of MB Bank's debit card accounts. MB Bank also committed that it would cease all debit card–related activity, including origination, servicing, and marketing services provided to the issuing bank, within three months of the acquisition. MB Bank would also cease engaging in any account-servicing activities for debit card or credit card accounts of affiliated or unaffiliated banks within three months of the acquisition (except on a temporary basis in connection with acquisitions of credit card accounts by MB Bank from other credit card lenders).

Various other specific representations and commitments regarding MB Bank's investment activity were also made, including a commitment to divest within two years of the acquisition certain reverse-mortgage-loan participations. Based on all the facts of record and subject to the commitments and representations stated in the Board staff's February 18, 2005, interpretation and in letters to the Board's Legal Division, the Board's Legal Division informed MB Bank's legal counsel that it would not recommend that the Board find MB Bank to be a bank for purposes of the BHC Act as of and after the acquisition, or that the Board require Financial Group or its parent companies to file an application with the Board under section 3 of the BHC Act for the acquisition. Because MB Bank would cease to be a bank, the Board also determined that it would not require MB BHC to provide notice to the Board to redeem MB Bank shares pursuant to 12 C.F.R. 225(4)(b).

3005.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Credit card bank exemption under section 2(c)(2)(F) of the BHC Act	1841(c)(2)(F)	225.104	Staff interpretation dated February 18 2005	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3010.0.1 INTRODUCTION

The prohibitions against a bank holding company having or acquiring nonbank interests do not apply to bank holding companies meeting the requirements of section 4(c)(i) and (ii) of the Act.

3010.0.2 LABOR, AGRICULTURAL OR HORTICULTURAL ORGANIZATIONS

Section 4(c)(i)—"Any company that was on January 4, 1977, both a bank holding company and a labor, agricultural or horticultural organization exempt from taxation under section 501 of the Internal Revenue Code of 1954, or . . . any labor, agricultural or horticultural organization to which all or substantially all of the assets of such company are hereafter transferred."

Exemption under this section was amended when the Financial Institutions Regulatory and Interest Rate Control Act of 1978 became effective early in 1979. The effect of the amendment was to repeal exemption under this section for labor, agricultural or horticultural organizations becoming BHCs after *January 4, 1977,* except for those organizations becoming BHCs by means of acquiring all or substantially all of the assets of a company that was both a BHC and a labor, agricultural or horticultural oganization exempt from taxation on January 4, 1977. In order for a holding company to be entitled to this exemption, net income derived from the organization cannot inure to the benefit of any individual. Organizations must be formed primarily for the betterment of the working conditions of the labor organization's members, or improvement in the grade of agricultural or horticultural products for an agricultural or horticultural organization. The growing of products for profit by agricultural or horticultural organizations would disqualify them for exemption. Thus the phrase "any labor, agricultural or horticultural organization" is intended to include only such organizations that are also exempt from taxation under section 501 of the Internal Revenue Code of 1954.

In order for a labor, agricultural or horticultural organization to receive exemption from taxation under section 501(c)(5) of the Internal Revenue Code of 1954, it must file an application (form 1024) with the IRS. In response to the application, the organization receives a determination letter which should be reviewed to assure that exemption was allowed and to verify the date the company became exempt under section 501. The date of exemption is determined as follows. A company which files for exemption within 18 months after its organization is considered exempt as of the date of its organization. The date of IRS approval is the date of exemption if application for exemption is filed more than 18 months after organization. The date of exemption must be no later than January 4, 1977, for the company to be entitled to exemption from section 4 of the Act. The fact that an organization pays income taxes annually does not disallow its exemption under section 501 of the tax code. Despite its tax exemption, an organization is subject to tax on its unrelated business income.

3010.0.3 FAMILY-OWNED COMPANIES

Section 4(c)(ii)—"A company covered in 1970 more than 85 percentum of the voting stock of which was collectively owned on June 30, 1968, and continuously thereafter, directly or indirectly, by or for members of the same family, or their spouses, who are lineal descendants of common ancestors."

The phrase "voting stock" does not limit the form of an organization to an incorporated entity. Exemption under this section extends to other forms of business associations which meet the definition of a company. For example, for a partnership, the 85 percent rule applies to "general partnership interest" and for a trust which meets the definition of a company, the 85 percent rule applies to "beneficial ownership." A company must continue to control the same subsidiary bank that it controlled on June 30, 1968, to retain its exemption under this section. Lineal descendants of common ancestors include descendants by half as well as full blood and legally adopted children.

In January 1980, the Board approved an application of a one-bank holding company covered by the exemption in 4(c)(ii) to acquire an additional bank, but stated that the holding company could no longer rely on that section for conducting its nonbanking activities. Based upon its review of the legislative intent of Congress in providing this exemption, it was the Board's judgment that the exceptionally broad exemp-

tion afforded by section 4(c)(ii) must be limited to family-owned one-bank holding companies that are not engaged in the management of banks. Moreover, in the Board's view, upon the acquisition of an additional bank, a one-bank holding company that is exempt under section 4(c)(ii) of the Act, would become engaged in the management of banks, and would thereby terminate its eligibility for the exemption. In addition, the Board believed that to permit unsupervised nonbank expansion by a multibank holding company would constitute an evasion of the Act, which the Board is authorized to prevent pursuant to section 5(b) of the Act.

3010.0.4 INSPECTION OBJECTIVES

1. To verify that a holding company qualifies for exemption from the prohibitions of section 4 by virtue of either section 4(c)(i) or 4(c)(ii).
2. Review the activities conducted by a company qualifying for an exemption under section 4(c)(ii) of the BHC Act, which may be faced with revocation of the exemption, and determine if there may be eligibility for permanent grandfathering under section 4(a)(2) of the BHC Act.

3010.0.5 INSPECTION PROCEDURES

1. Although bank holding companies qualifying for a section 4(c)(i) or 4(c)(ii) exemption are not routinely inspected on a periodic basis, when inspected their exempt status should be verified. All nonbank activities of exempt organizations should be examined in the inspection. The nature of all such activities and the dates they were commenced should be documented in the work papers to establish their current permissibility in the event the organization should lose its exemption from section 4.

2. For BHCs exempt under section 4(c)(i), the examiner should ascertain the date the company became exempt under section 501 of the tax code. Also, the stock books of the subsidiary bank or other pertinent documents should be reviewed to assure that the company was a BHC on January 4, 1977.

3. When verifying a company's exemption under section 4(c)(ii), the stock records of the subsidiary bank and the stock records, partnership agreements, trust agreements and other records of the bank holding company should be reviewed to assure that the following conditions have been satisfied:

a. 25 percent or more of the voting stock of the subsidiary bank has been continuously owned by the BHC since June 30, 1968;

b. Members of the same family have continuously held an 85 percent or more interest in the holding company since June 30, 1968.

3010.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Acquisition of an additional bank by a company exempt under 4(c)(ii)				1980 FRB 165
"Successor" to a Company Exempt under 4(c)(ii)				1980 FRB 349

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3020.0.1 INTRODUCTION

By virtue of section 4(c)(1) of the Act, a bank holding company may invest, without supervisory approval, in the shares of companies engaged in activities that Congress felt were incidental to the business of banking. The following activities are permissible investments for bank holding companies under this section.

3020.0.2 PROVIDING BANKING QUARTERS

Section 4(c)(1)(A) provides that a BHC may invest in a company engaged in holding or operating properties used wholly or substantially by any banking subsidiary of such bank holding company in the operations of such banking subsidiary or acquired for such future use.

Normally, bank utilization of 50 percent or more of the property would meet the requirements of this section. Investments in property where usage of such property by subsidiary banks is less than 50 percent will be reviewed on an *ad hoc* basis to determine its permissibility under this section. Future needs of the bank holding company and its bank subsidiaries will be considered when reviewing these cases.

In acquiring property, a bank holding company must have definite plans for use of the property as a subsidiary bank's premises within a reasonable period of time. Property may not be acquired and indefinitely warehoused until a need develops for the property.

This section of the BHC Act does not provide the authority for a BHC to invest in the shares of a company engaged in holding or operating properties used by nonbank subsidiaries. Directly holding or operating properties used by a nonbank subsidiary is considered an incidental activity necessary to carry on the main business activity of the subsidiary and thus is exempt under section 4(a)(2)(A) of the Act and section 225.22(a)(2)(vi) of Regulation Y.

3020.0.3 SAFE DEPOSIT BUSINESS

Section 4(c)(1)(B) of the Act provides that a holding company may invest in the shares of a company whose activities are limited to conducting a safe deposit business. Refer to Section 225.22(b) of Regulation Y.

3020.0.4 FURNISHING SERVICES TO BANKING SUBSIDIARIES

Section 4(c)(1)(C) of the BHC Act provides that a BHC may invest in a company which furnishes services to or performs services for the bank holding company or its banking subsidiaries. Section 225.22(a) of Regulation Y provides that a bank holding company may, without the Board's prior approval, furnish services to or perform services for its banking and nonbanking subsidiaries either directly or indirectly through a subsidiary. Generally, a BHC may only provide services related to the internal operations of the BHC or its subsidiaries. A bank holding company or its subsidiaries may not rely on the servicing exemption to deal with the public as principal, but may deal with outside parties provided they are acting only as agent for the holding company or its subsidiaries.

The term ''services'' implies servicing operations a bank may carry on itself, but which the BHC chooses to have done through a nonbank subsidiary. Section 225.22(a)(2) states that services for the internal operations of the bank holding company or its subsidiaries include: accounting, auditing, appraising, advertising, public relations, data processing, data transmission services, data bases or facilities, personnel services, courier services, holding or operating property used wholly or substantially by a subsidiary in its operations or for its future use, and selling, purchasing or underwriting insurance such as blanket bond insurance, group insurance for employees, and property and casualty insurance. For the later insurance activities, bank holding companies are permitted under the servicing exemption to act as agent or to underwrite insurance on their own risks (e.g. blanket bond insurance or employee group insurance plans). Refer to section 225.22(a)(2) of Regulation Y for other services permissible for the internal operations of the BHC or its subsidiaries.

The servicing exemption extends to services that are normally performed by a bank for its customers or correspondent banks. These activities generally include computerized billing, payroll, accounting, financial records maintenance and other similar data processing services as long as the subsidiary bank is permitted under applicable State or federal law to provide the service. These services may be provided only

upon request by the customers to the subsidiary bank. Furthermore, the contractual arrangements must be made between the customer and the bank. The company can service existing service contracts the bank has originated but is prohibited from purchasing the contracts or entering into contracts to provide services directly to the public.

The purchasing of participations by the parent in loans from subsidiary banks generally is not considered an exempt activity under the authority of sections 4(a)(2) or 4(c)(1). Holding companies that engage in the purchase of participations from their subsidiary banks should file an application pursuant to Section 4(c)(8) of the BHC Act. Purchasing participations in loans for the purpose of providing liquidity or acquiring a portion of a line of credit to facilitate the needs of the bank's customers (overlines) provides a service or benefit to the bank and is considered an acceptable purchase under the services exemption. In all cases where a participation in a loan is purchased, the loan must be made in the name of the bank and serviced by the respective bank. The purchasing of a loan for reasons other than those set forth above may be viewed as a direct lending activity.

3020.0.5 FURNISHING SERVICES TO NONBANK SUBSIDIARIES

The Bank Holding Company Act of 1956 prohibited a BHC itself from engaging in any business except (1) banking, (2) managing or controlling banks, and (3) furnishing services to its bank subsidiaries. In 1970, Congress amended section 4 of the BHC Act to expressly authorize a BHC to furnish services to or perform services for its nonbank subsidiaries as well as its bank subsidiaries under exemption A of section 4(a)(2). While section 4(c)(1) authorizes a BHC to invest in shares of a company engaged in certain activities, exemption A provides the authority for a BHC to engage in those activities directly.

The Board issued an interpretation (12 C.F.R. 225.141), effective August 1980, which stated that it will permit, without any regulatory approval, a bank holding company to form a wholly-owned subsidiary to perform servicing activities for both banking and nonbanking subsidiaries that the holding company itself could perform directly or through a department or a division under section 4(a)(2)(A) of the BHC Act. In addition, an approved section 4(c)(8) company may form a wholly-owned subsidiary to engage in activities that such company could itself engage in.

3020.0.6 LIQUIDATING ASSETS

Section 4(c)(1)(D) provides that a BHC may own shares of a company which engages in liquidating assets acquired from such BHC (not including its nonbank subsidiaries) or its banking subsidiaries or which were acquired from any other source prior to May 9, 1956, or the date on which such company became a BHC, whichever is later.

Assets acquired for liquidation by a section 4(c)(1)(D) subsidiary are subject to the same time limitations as shares acquired D.P.C. pursuant to section 4(c)(2) of the Act.

BHCs seeking to hold the shares of a liquidating or nominee subsidiary organized to dispose of assets acquired D.P.C. by a BHC nonbank subsidiary, can rely on the Board's August 1980 interpretation permitting, without prior regulatory approval, a BHC to form a subsidiary to perform activities which itself could perform under exemption A of section 4(a)(2).

3020.0.7 INSPECTION OBJECTIVES

1. To determine whether the activities conducted by companies in which the BHC has a greater than 5 percent investment in the company and for which the BHC claims exemption under section 4(c)(1) of the BHC Act, are the types of permissible activities contemplated by that section—activities claimed under the premises exemption under 4(c)(1)(A), the safe deposit business exemption under 4(c)(1)(B), the services exemption under (4)(c)(1)(C), or the liquidating subsidiary exemption (4)(c)(1)(D).

3020.0.8 INSPECTION PROCEDURES

The inspection of a nonbank subsidiary exempt under section 4(c)(1) of the Act should center on a review of the activities to assure that those activities are the types permissible under section 4(c)(1) subsections A, B, C and D.

3020.0.8.1 Section 4(c)(1)(A)—Bank Premises

The following procedural steps should be performed in connection with an inspection of a bank premises company.

1. Obtain a list of all real estate held by the company including the following information:
   a. Property description and location;
   b. Date acquired;
   c. Current utilization;
   d. Extent of utilization by banking subsidiaries and others indicating percentage of square feet leased to subsidiaries.
2. When use of the property by a subsidiary bank(s) is less than 50 percent, discuss future plans for the use of the property with management. Note any related discussion contained in the minutes of directors' and committee meetings, and action taken to date to implement these plans. Lease agreements with other tenants should be reviewed to determine the term of a lease including options to renew.
3. Evaluate the permissibility of holding each property under the premises exemption.
4. Review and evaluate other activities engaged in and assets held by the company to establish their permissibility under the premises exemption. Such activities could include leasing property and providing a general maintenance service to other tenants.

3020.0.8.2 Section 4(c)(1)(B)—Safe Deposit Business

Activities exempt under this section are restricted to conducting a safe deposit business. All activities engaged in and assets held by companies for which the BHC is claiming exemption under this section should be reviewed and evaluated to determine their permissibility under this exception.

3020.0.8.3 Section 4(c)(1)(C)—Services

The following procedural steps should be performed when inspecting service companies.

1. List and describe all services provided to subsidiaries in the inspection report.
2. Review and evaluate the types of services provided to the banking and nonbanking subsidiaries to determine their permissibility.
3. Obtain from management any written bank holding company policies concerning the provision of services and the assessment of fees or discuss with management the basis on which service fees are established.
4. Comment on the reasonableness of fees relative to the fair market value, cost, volume, or quality of such services rendered.
5. Indicate if all service contracts have been approved by each subsidiary's board of directors.
6. When reviewing services provided to banking subsidiaries for their customers:
   a. List and describe all services provided;
   b. Determine that the company is operating as an adjunct to its affiliated banks for the purpose of facilitating the bank's operations, and not as a separate, self-contained organization;
   c. Review contractual arrangements to assure that the company has not purchased any service contracts from a subsidiary bank and has not entered directly into agreements to provide services to any party other than the bank;
   d. Review and evaluate all services to determine whether they are services that the subsidiary bank is permitted to provide under applicable State or federal law.

3020.0.8.4 Section 4(c)(1)(D)—Liquidating Subsidiary

The following procedural steps should be followed in connection with an inspection of a liquidation company in which the BHC holds an investment.

1. Obtain a list of all assets acquired by the company for the purpose of liquidation including the following information:
   a. Asset description and location;
   b. Date acquired;
   c. Source of acquisition;
   d. Liquidation plans, including timetable and selling price;
   e. Cost of assets and book value, including detail on any improvements.
2. Verify that assets acquired from sources other than the parent or its subsidiary banks were acquired prior to May 9, 1956, or the date on which the holding company became a BHC, whichever is later.
3. Verify that assets acquired for liquidation did not originate in a nonbank subsidiary. If a section 4(c)(1)(D) liquidating subsidiary is holding a material amount of assets acquired from a nonbank subsidiary, discuss the propriety of these holdings with the Reserve Bank office staff and, if necessary, Board staff in the Division of Banking Supervision and Regulation or the Legal Division.
4. Review the bank holding company's policies, practices and procedures concerning the liquidation of assets and determine if the subsidiary is in compliance with the time limits indicated above.
5. Discuss with management and note the

liquidation plans and progress to date in liquidating assets that have been held in excess of 12 months. Note any related discussion found in the minutes of directors' and committee meetings.

6. Comment on whether management is making a *bona fide* effort to dispose of all assets for fair value.

7. Check improvements made to property by the company to assure that the nature and use of the asset has not substantially changed. The investment of funds to change substantially the nature of the asset (such as undeveloped real estate) to increase its value would generally be viewed as engaging in real estate development, an activity which is not permissible.

3020.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Purchase of instalment paper for subsidiary banks as furnishing of services		225.104	4–192	
Furnishing insurance not "services"		225.109	4–193	
Services for banks that are not subsidiaries		225.113	4–194	
Computer services for customers of subsidiary banks		225.118	4–195	
Applicability of Bank Service Corp. Act in certain BHC situations		225.115	4–174.1	
Mortgage company services		225.122	4–196	
Insurance and sale of short-term debt obligations by BHCs		250.221, 225.130	4–867	
Operations subsidiaries of a BHC		225.141		
Shares held by a subsidiary bank in a bank premises company and the applicability of section 4(c)(1)(A)		225.101(g) 225.141	4–185	
Investment in an asset liquidation subsidiary	1843(c)(1)(D)			
Providing services to bank and nonbank subsidiaries	1843(a)(2)(A)	225.22(a)		
BHC dealing for a BHC's own account in futures, and options on futures, on gold and silver bullion to limit price risks in trading				1987 FRB 61
BHC subsidiaries performing services that BHC could itself perform				1980 FRB 774

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Approved 4(c)(8) subsidiary forming an operations subsidiary to perform activities it could itself perform				1979 FRB 566 footnote 1

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(2) of the Bank Holding Company Act permits a bank holding company or any of its subsidiaries to acquire shares in satisfaction of debts previously contracted (DPC) in good faith. The shares must be disposed of within two years from the date they were acquired, except that the Board is authorized upon application of a company to grant additional exemptions if, in its judgment, the extension would not be detrimental to the public interest and either the bank holding company has made a good faith attempt to dispose of those shares during the five-year period, or the disposal of the shares would have been detrimental to the company. The aggregate duration of the extensions cannot extend beyond 10 years.

Even though the statute refers specifically to shares, the Board has taken the position, in section 225.22(d) of its Regulation Y and in an interpretation (12 C.F.R. 225.140), that the congressional policy evidenced by section 4(c)(2) should apply to DPC acquisitions of other assets, other than shares (assets), and real estate by bank holding companies and their nonbanking subsidiaries. Section 225.22(d)(1) provides the same holding periods (including provision for extensions) for other DPC assets or real estate as are provided by statute for DPC shares.

Regulation Y, section 225.22(d), addresses nonbanking acquisitions that do not require prior Board approval. With respect to DPC acquisitions, voting securities, or other assets or real estate acquired by foreclosure or otherwise, in the ordinary course of collection of a debt previously contracted (DPC property) in good faith, Regulation Y does not require the Board's prior approval if the DPC property is divested within two years of acquisition. Regulation Y further states that the Board may, upon request, extend the two-year period for up to three additional years. Further, the Board may permit additional extensions for up to five years (for a total of 10 years). This provision applies to shares, real estate, or other assets in which the holding company demonstrates that each extension would not be detrimental to the public interest and either the bank holding company has made good faith attempts to dispose of such shares, real estate, or other assets, or the disposal of the shares, real estate, or others assets during the initial period would have been detrimental to the company. Transfers within the bank holding company system do not extend any period for divestiture of the property.

Under the Board's delegated authority, the Reserve Banks may approve a BHC's requests for extensions beyond the two-year divestiture period.[1] In accordance with a Board interpretation (12 C.F.R. 225.138), extensions should not be granted except under compelling circumstances, and periodic progress reports on divestiture plans are generally required. When these permissible extension periods expire, the Board no longer has discretion to grant further extensions. A BHC would be in violation of the act if shares, other assets, or real estate acquired DPC is not disposed of within the prescribed time frame.

In July 1980, the Board issued an interpretation of Regulation Y (12 C.F.R. 225.140) that provided for a possible approval for an additional five-year period for the divestiture of real estate acquired DPC. With respect to DPC real estate, this interpretation requires that (1) the value of the real estate on the books of the company be written down to fair market value, (2) the carrying costs cannot be significant in relation to the overall financial position of the company, and (3) the company must make good faith efforts to effect divestiture. Fair market value should be derived from appraisals, comparable sales, or some other reasonable method. Companies holding real estate for this extended period are expected to make active efforts to dispose of it, and they should advise the Reserve Bank regularly concerning their ongoing efforts.

In accordance with the Board's interpretation (12 C.F.R. 225.140), after two years from the date of acquisition of DPC assets, the holding company is to report annually to the Federal Reserve on its efforts to accomplish divestiture of the assets. The Reserve Bank will monitor the efforts of the company to effect an orderly divestiture. Divestiture may be ordered before the end of the authorized holding period (beyond the initial two-year period that requires no Board authorization) if supervisory concerns warrant such action.

Section 4(c)(1)(D) allows a bank holding company to establish a subsidiary to hold real estate acquired by itself or by any of its banking subsidiaries for debts previously contracted, for the purpose of disposing of the real estate in an orderly manner. Permissible activities of this

1. Each Federal Reserve Bank has been delegated the authority (12 C.F.R. 265.2(f)(12)) to extend the time within which a bank holding company or any of its subsidiaries must divest itself of interests acquired in satisfaction of a debt previously contracted.

liquidating subsidiary include completion of a real estate development project and other activities necessary to make the real estate saleable. The ''date of acquisition'' is the date the bank holding company (or subsidiary of the bank holding company) acquired the DPC asset. Section 4(c)(1)(D) may not be used to extend the time under which a bank holding company may indirectly hold DPC property under section 4(c)(2). In most cases where a subsidiary bank has held property for the statutory holding period, a BHC may not shift the property to another subsidiary or to the parent to avoid disposing of the property. However, due to the complexity and potential impact on the organization of a forced divestment at the end of the holding period, inspection personnel and Reserve Bank staff are encouraged to discuss the situation with Board staff to tailor the supervisory response to the particular situation.

With respect to the transfer by a subsidiary of other DPC shares, other assets, or real estate to another company in the holding company system, including a section 4(c)(1)(D) liquidating subsidiary, or to the holding company itself, such transfers would not alter the original divestiture period applicable to such shares or assets at the time of their acquisition. Moreover, to ensure that assets are not carried at inflated values for extended periods of time, the Board expects, in the case of all such intercompany transfers, that the shares or assets will be transferred at a value no greater than the fair market value at the time of transfer and that the transfer will be made in a normal arm's-length transaction. With regard to DPC assets (except for DPC shares as described above) acquired by a banking subsidiary of a holding company, as long as the assets continue to be held by the bank itself, the Board will regard them as being solely within the authority of the primary supervisor of the bank.

Section 4(c)(3) of the Bank Holding Company Act permits a bank holding company to acquire shares or real estate from any of its subsidiaries if a subsidiary had been requested to dispose of the shares by any federal or state authority having power to examine the respective subsidiary. The Board does not have authority to extend the two-year disposition period under section 4(c)(3) of the act. Section 4(c)(3) may not be used to extend the statutory period in which a bank must dispose of DPC assets (10 years in the case of DPC real estate assets, five years for all other).

3030.0.1 EXEMPTION TO SECTION 4(c)(2) DISPOSITION REQUIREMENTS OF DPC SHARES

Section 4(c)(5) of the Bank Holding Company Act allows a bank to own shares in certain nonbanking companies, specifically, the kinds and amounts eligible for investment by national banking associations under the provisions of section 5136 of the Revised Statutes (see section 3050.0 for a detailed explanation of section 4(c)(5)). The exemption provided by section 4(c)(5) covers any shares, including shares acquired DPC, that meet the conditions set forth in that exemption. Therefore, DPC shares held by a banking subsidiary of a bank holding company which meet section 4(c)(5) conditions are not subject to the disposition requirement prescribed in section 4(c)(2); however, such shares would continue to be subject to requirements for disposition as may be prescribed by provisions of any other applicable banking laws or by the appropriate bank supervisory authorities.

Section 4(c)(6) of the act allows a bank holding company to own shares, including those acquired DPC, of any nonbank company that does not exceed 5 percent of the outstanding voting shares of such company. The Board has expressed an opinion (12 C.F.R. 225.101(f)) that any shares acquired DPC under this section, whether by a holding company or a bank subsidiary, are not subject to the disposition requirements of section 4(c)(2) of the act.

Real property is often shown on an entity's books as other real estate (ORE). Possession of ORE usually results from a distressed loan collateralized by a lien on real estate. In addition, in attempting to salvage other types of credit, an entity may have obtained title to real property through process of law or by voluntary deed. Acquisition costs for other real estate acquired for debts previously contracted usually consist of the principal amount that was due on the defaulted loan at the time the entity took possession, unpaid interest, legal fees and other foreclosure costs, accrued and unpaid taxes, and mechanic's liens. Property acquired DPC may be recorded on the company's books by capitalizing the loan amount and acquisition costs. Advances to complete the project can be included in the capitalized investment if the ORE is an unfinished project. The fact that the additional investment is being used to improve the property and make the property more saleable should be evident.

A company owning a DPC asset should maintain records documenting its efforts to dispose

of the asset. Because an ORE asset is normally a nonliquid, nonproductive asset of uncertain value, a company should attempt to dispose of the asset at the earliest date possible. Unless special circumstances are present, a company should sell the ORE asset when a price offer sufficient to cover the acquisition, investment, and carrying costs is obtained.

3030.0.2 INSPECTION OBJECTIVES

1. To determine compliance with applicable laws, rulings, and regulations, and to initiate corrective action when violations appear in these areas.

2. To determine whether policies, practices, and internal controls regarding DPC shares, other assets, or real estate are adequate and to recommend correction when deficiencies are noted.

3. To evaluate the quality of DPC shares, other assets, or real estate and the progress toward their disposition.

4. To determine whether the DPC shares, other assets, or real estate acquired are recorded at fair market value.

3030.0.3 INSPECTION PROCEDURES

1. During the preinspection review, compile a list of shares, other assets, and real estate known to have been acquired DPC by the bank holding company and its nonbank subsidiaries, as well as a list of shares known to have been acquired DPC by the BHC's bank subsidiaries. Information on this list should include—

a. a description of the shares or asset(s);

b. the fair market value of the shares and asset(s), and the method of valuation, if available;

c. the name of the company owning the shares and asset(s); and

d. the date the shares and asset(s) were acquired.

2. If the shares or asset has been held longer than the initial holding period, determine whether the BHC has requested an extension of time.

3. In the Officer's Questionnaire, request a list of DPC shares, other assets, or real estate owned by the holding company and its nonbanking subsidiaries, and a list of DPC shares owned by the holding company's bank subsidiaries, including a detailed description of the shares or asset, the value of the shares or asset on the entity's books, the date the shares or asset was acquired, and plans for disposal of the shares or asset. In addition, a list of DPC shares, other assets, or real estate which has been disposed of since the previous inspection or within the past year should be obtained. Compare these lists with the list compiled during the preinspection review.

4. Review other real estate owned accounts to evaluate—

a. the fair market value of the property (A qualified appraiser should appraise the property at the time of acquisition, and subsequent timely appraisals should be conducted to determine the current fair market value of the property.);

b. the carrying costs of the property; and

c. the company's efforts to dispose of the property (Information on file should include documentation showing a record of offers made by potential buyers and other information reflecting efforts to sell the property (i.e., advertisement brochures)).

5. Determine whether additional advances have been made on an unfinished project and whether evidence supports that the advances are making the property more saleable.

6. Determine whether a first-lien status exists and whether there are any tax liens or other encumbrances against the property.

7. Discuss DPC shares, other assets, or real estate and their values with management who is familiar with the history and current status of the shares or asset and assign classification, if warranted. A substandard classification may be applied when a company is sustaining losses in maintaining the property, and prospects for sale are not evident or encouraging. A company's acquisition of property through foreclosure often indicates a lack of demand and, as time elapses, the value of the real estate may become more questionable if the lack of demand persists. If the carrying amount of the investment exceeds the estimated value of the property, an adequate allowance reserve for any difference should be established and maintained. Property that is in the process of being sold for an amount in excess of the carrying value should not be classified if it appears that ultimate payment will be forthcoming.

8. List shares, other assets, and real estate acquired DPC under "other assets" in the inspection report. For significant shares and assets, the examiner may choose to present in the inspection report or in the workpapers, whichever is deemed appropriate, the following information:

a. a brief description sufficient to identify the property, the manner in which the property was acquired, and the reasons for its acquisition

b. the value of the shares or assets on the books of the company, the method used to determine the booked value, and whether it is the fair market value

c. a brief statement as to management's efforts to sell the property, its opinion of the likelihood of sale, and the anticipated sales price

d. a summary of the carrying costs subsequent to assumption and income generated from the property

e. the date when the holding company or its subsidiary must dispose of the property or request an extension to continue to hold the DPC shares or asset

f. the amount classified, if appropriate

g. any apparent discrepancies with rules or regulations

3030.0.4 Laws, Regulations, Interpretations, and Orders

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Transactions not requiring Board approval:				
1. Acquisition of securities by a BHC with majority control	1843(c)(2)	225.12(b)		
2. Acquisition of securities by a BHC with majority control		225.12(c)	4–020	1980 FRB 654
Required disposal by Regulatory Agency	1843(c)(3)			
Section 4(c)(5) and 4(c)(6) shares with respect to Section 4(c)(2)		225.101	4–187	
Delegation of Authority to extend time to dispose of DPC shares and assets		265.2(f)(12)		
Policy statement concerning divestitures by BHCs		225.138		
Disposition of property acquired in satisfaction of debts previously contracted		225.22, 225.140		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Federal Reserve issued a policy statement on April 5, 2012, indicating that banking organizations[1] may rent one- to four-family residential "Other Real Estate Owned" (OREO) properties without having to demonstrate continuous active marketing of the properties, provided that suitable policies and procedures are followed.[2] Key risk-management considerations are described for banking organizations that engage in the rental of residential OREO, including compliance with holding-period requirements for OREO, compliance with landlord-tenant and associated requirements, and accounting according to generally accepted accounting principles (GAAP). Rental OREO properties with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return should generally not be classified.

The statement establishes specific supervisory expectations for banking organizations that undertake large-scale residential OREO rentals (generally, 50 properties or more available for rent). Such organizations should have formal policies and procedures governing the operation and administration of OREO rental activities, including property-specific rental plans, policies and procedures for compliance with applicable laws and regulations, a risk-management framework, and oversight of third-party property managers. (See SR-12-5/CA-12-3 and their attachments.)

3032.0.1 POLICY STATEMENT ON RENTAL OF RESIDENTIAL OTHER REAL ESTATE OWNED PROPERTIES

In light of the large volume of distressed residential properties and the indications of higher demand for rental housing in many markets, some banking organizations may choose to make greater use of rental activities in their disposition strategies than in the past. This policy statement reminds banking organizations and examiners that the Federal Reserve's regulations and policies permit the rental of residential OREO properties to third-party tenants as part of an orderly disposition strategy within statutory and regulatory limits.[3]

The general policy of the Federal Reserve is that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date. Consistent with this policy, in light of the extraordinary market conditions that currently prevail, banking organizations may rent residential OREO properties (within statutory and regulatory holding-period limits) without having to demonstrate continuous active marketing of the property, provided that suitable policies and procedures are followed. Under these conditions and circumstances, banking organizations would not contravene supervisory expectations that they show "good-faith efforts" to dispose of OREO by renting the property within the applicable holding period. Moreover, to the extent that OREO rental properties meet the definition of community development under the Community Reinvestment Act (CRA) regulations, they would receive favorable CRA consideration.[4] In all respects, banking organizations that rent OREO properties are expected to comply with all applicable federal, state, and local statutes and regulations.

Home prices have been under considerable downward pressure since the financial crisis began, in part due to the large volume of houses for sale by creditors, whether acquired through foreclosure or voluntary surrender of the property by a seriously delinquent borrower (distressed sales). Creditors, in turn, often seek to liquidate their inventories of such properties quickly. Since 2008, it is estimated that millions of residential properties have passed through lender inventories. These distressed sales represent a significant proportion of all home sales transactions, despite some ebb and flow, and thus are a contributing element to the downward pressure on home prices. With mortgage delinquency rates remaining stubbornly high, the continued inflow of new real estate owned prop-

1. The policy statement applies to state member banks, BHCs, nonbank subsidiaries of BHCs, savings and loan holding companies, non-thrift subsidiaries of savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations (collectively, banking organizations).

2. This policy statement supplements other relevant Federal Reserve guidance, including the Board's policy statement on the disposition of property acquired in satisfaction of debts previously contracted. See 12 CFR 225.140. Also see sections 3020.0.6, 3030.0, and 3090.2.4.6 of this manual and section 2200.0 of the *Commercial Bank Examination Manual.*

3. The term "residential properties" in this policy statement encompasses all one-to-four family properties and does not include multi-family residential or commercial properties.

4. The Federal Reserve's CRA regulations define community development to include activities that provide affordable housing to low- and moderate-income individuals as well as those activities that revitalize or stabilize low- and moderate-income areas (see 12 CFR 228.12(g)(1) and (4)).

erties to the market—expected to be millions more over the coming years—will continue to weigh on house prices for some time.[5]

Banking organizations include their holdings of such properties in OREO on regulatory reports and other financial statements.[6] Existing federal and state laws and regulations limit the amount of time banking organizations may hold OREO property.[7] In addition, there are established supervisory expectations for management of OREO properties and the nature of the efforts banking organizations should make to dispose of these properties during that period.

3032.0.1.1 Risk-Management Considerations for Residential OREO Property Rentals

In all circumstances, the Federal Reserve expects a banking organization considering such rentals to evaluate the overall costs, benefits, and risks of renting. The banking organization's decision to rent OREO might depend significantly on the condition of individual properties, local market conditions for rental and owner-occupied housing, and its capacity to engage in rental activity in a safe and sound manner and consistent with applicable laws and regulations.

Banking organizations should have an operational framework for their residential OREO rental activities that is appropriate to the extent to which they rent OREO properties. In general, banking organizations with relatively small holdings of residential OREO properties—fewer than 50 individual properties rented or available for rent—should use a framework that appropriately records the organizations' rental decisions and transactions as they take place, preserves key documents, and is otherwise sufficient to safeguard and manage the individual OREO assets.[8] In contrast, banking organizations with large inventories of residential OREO properties[9]—50 or more individual properties available for rent or rented—should utilize a framework that systematically documents how they meet the supervisory expectations described in the next section. All banking organizations that rent OREO properties, irrespective of the size of their holdings, should adhere to the guidance set forth in this section.

3032.0.1.1.1 Compliance with Maximum OREO Holding-Period Requirements

Banking organizations should pursue a clear and credible approach for ultimate sale of the rental OREO property within the applicable holding-period limitations. Exit strategies in some cases may include special transaction features to facilitate the sale of OREO, potentially including prudent use of seller-assisted financing or rent-to-own arrangements with tenants.

3032.0.1.1.2 Compliance with Landlord-Tenant and Other Associated Requirements

Banking organizations' residential property rental activities are expected to comply with all applicable federal, state, and local laws and regulations, including landlord-tenant laws; landlord licensing or registration requirements; property maintenance standards; eviction protections (such as under the Protecting Tenants at Foreclosure Act); protections under the Servicemembers Civil Relief Act;[10] and anti-discrimination laws, including the applicable provisions of the Fair Housing Act and the Americans with Disabilities Act. Prior to undertaking the rental of OREO properties,

5. For further discussion of housing market conditions and the obstacles to conversions of OREO properties to rental, see "The U.S. Housing Market: Current Conditions and Policy Considerations," Federal Reserve staff white paper, January 4, 2012 (housing white paper).

6. "Other real estate owned" is comprised of all real estate other than (1) bank premises owned or controlled by the bank and its consolidated subsidiaries and (2) direct and indirect investments in real estate ventures.

7. Generally, the Federal Reserve allows BHCs to hold OREO property for up to five years, with an additional five-year extension subject to certain circumstances (see 12 CFR 225.140). National banks are subject to similar restrictions. State member banks and licensed branches of foreign banks are subject to the holding periods and other limitations on OREO activity established by their respective licensing authorities, which vary. Savings and loan holding companies generally may acquire real estate for rental (see 12 USC 1467a(c)(2) and 12 CFR 238.53(b)).

8. A preliminary analysis of the Consolidated Reports of Condition and Income (Call Report) data suggests that roughly 98 percent of community banks held 50 or fewer residential OREO properties.

9. For purposes of this guidance, the supervisory expectations for OREO rentals and the number of properties available for rent should include those properties for which tenants were already in place at the time of foreclosure or transfer of ownership, and for which tenants are afforded certain protections under the Protecting Tenants at Foreclosure Act of 2009. See the Federal Reserve's *Consumer Compliance Handbook*, section IV, for further information.

10. See CA-09-5, "Information and Examination Procedures for the 'Protecting Tenants at Foreclosure Act of 2009,'" July 30, 2009, and CA-05-3, "Servicemembers Civil Relief Act of 2003," May 6, 2005.

banking organizations should determine whether such activities are legally permissible under applicable laws, including state laws. When applicable, banking organizations should review homeowner and condominium association bylaws and local zoning laws for prohibitions on renting a property. Banking organizations may use third-party vendors to manage properties but should provide necessary oversight to ensure that property managers fully understand and comply with these federal, state, and local requirements.

3032.0.1.1.3 Other Considerations

Banking organizations should account for OREO assets in accordance with GAAP and applicable regulatory reporting instructions.[11] Banking organizations should also provide the appropriate classification treatment for their residential OREO holdings. Residential OREO is typically treated as a substandard asset, as defined by the interagency classification guidelines. (See section 5010.10.1 which discusses the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts, as revised June 15, 2004.) It sets forth the definitions of the classification categories and the specific examination procedures and information that are to be used for classifying bank assets, including securities. (See SR-04-9.) See also section 2060.1 of the *Commercial Bank Examination Manual*. Residential properties, however, with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return[12] should generally not be classified.

3032.0.1.2 Specific Expectations for Large-Scale Residential OREO Rentals

Banking organizations with large inventories of residential OREO properties that decide to engage in rental activities should have in place a documented rental strategy, including formal policies and procedures for OREO rental activities, and a documented operational framework. Policies and procedures should clearly describe how the banking organization will comply with all applicable laws and regulations. Policies and procedures should include processes for determining whether the properties meet local building code requirements and are otherwise habitable, and whether improvements to the properties are needed in order to market them for rent. In addition, policies and procedures should establish operational standards for the banking organization's rental activities, including that adequate insurance policies are in place, that property and other tax obligations are met on a timely basis, and that expenditures on improvements are appropriate to the value of the property and to prevailing norms in the local market.

Policies and procedures should also require plans for rental of residential OREO properties, down to the individual property level, that cover the full holding period from the time the bank received title to ultimate sale by the bank. Plans should identify which properties would be eligible for rental. Plans also should establish criteria by which properties are chosen for marketing as rental properties, and the process by which rental decisions should be made and implemented. Plans should describe the general conditions under which the organization believes a rental approach is likely to be successful, including appropriate consideration of rental market and economic conditions in respective local markets.

Finally, policies and procedures should address all risk-management issues that arise in renting residential OREO properties. Some risk elements parallel those found in other banking activities, for example, the credit risk associated with tenants' potential failure to make timely

11. See the instructions for the Call Report as to the reporting of OREO transactions and to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C). See more generally this manual's section 2200.1, "Other Real Estate Owned."

12. Whether a rate of return is reasonable depends on a number of considerations including local market conditions, the time horizon of the rental, and the nature of the property. Commonly used measures include a capitalization rate (known as a "cap rate," which generally is the expected annual cash flows from renting the property relative to the price at which the property holder could expect to sell it in the owner-occupied market), as discussed in the housing white paper, or other measures of internal rate of return. Depending on the circumstances and risks associated with the property, valid indications that a level of return is reasonable could include (but would not be limited to) comparisons with normal returns for single-family rentals in the relevant local market; rates of return on other similar local real estate investments; or cap rates or other measures of internal rate of return on investments with similar risk profiles. For example, in many markets a cap rate above 8 percent would likely represent a reasonable rate of return. Large one-time expenditures that are idiosyncratic to a given year but are normal to residential properties over their lifetime, such as replacement cost for worn-out appliances, should generally not be the reason that a property would be classified. Costs of improvement should be treated as capital expenditures with a corresponding effect on properties' carrying value to the extent the improvements improve the properties' values.

rent payments, or potential conflict of interest issues such as the use of a firm by a banking organization to both provide information on a property's value and list that property for sale on behalf of the banking organization. Other risks unique to such rental include

- dealing with vacancy, marketing, and re-rental of previously occupied properties;[13]
- liability risk arising from rental activities, along with the use and management of liability insurance or other approaches to mitigate that liability and risk; and
- legal requirements arising from the potential need to take action against tenants for rent delinquency, potentially including eviction. Such requirements may include notice periods.

Banking organizations may need to develop new policies and risk-management processes to address properly these categories of risk.

In many cases, banking organizations will use third-party vendors (for example, real estate agents or professional property managers) to manage their OREO properties. Policies and procedures should provide that such individuals or organizations have appropriate expertise in property management, be in sound financial condition, and have a good track record in managing similar properties. Policies and procedures should also call for contracts with such vendors to carry appropriate terms and provide, among other key elements, for adequate management information systems and reporting to the banking organization, including rent rolls (along with actual lease agreements), maintenance logs, and security deposits and charges to these deposits. Banking organizations should provide for adequate oversight of vendors.[14]

3032.0.1.3 Additional Materials for Reference

- Accounting Standards Codification (ASC) 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings").
- ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets").
- ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement.
- The disposition of other real estate is addressed in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within FAS 66, "Accounting for Sales of Real Estate"), which includes specific criteria for the recognition of profit.
- SR-10-16, "Interagency Appraisal and Evaluation Guidelines," December 2, 2010 and this manual's section 4140.1. For the sale of OREO property with a value of $250,000 or less, a BHC or state member bank may obtain an evaluation in lieu of an appraisal.
- SR-95-16, "Real Estate Appraisal Requirements for Other Real Estate Owned (OREO)," March 28, 1995.

13. Various jurisdictions may apply specific requirements to landlords in their marketing and re-rental activities (for example, an obligation to offer potential tenants an initial lease term of two years).

14. See Federal Financial Institutions Examination Council statement on *Risk Management of Outsourced Technology Services* (November 28, 2000, SR-00-17 and the appendix of section 4060.1 of the *Commercial Bank Examination Manual*), which provides illustrative guidance on constructing outsourcing risk assessments, due diligence in selecting a service provider, contract review, and monitoring of a third party that provides services to a regulated institution.

Section 4(c)(4) of the Bank Holding Company Act (the act) provides that nonbank shares held or acquired by a bank in good faith in a fiduciary capacity are exempt from the general prohibitions of section 4 of the act. This exemption is provided to allow banks to continue their normal fiduciary operations without significant interference and without being subject to the limitations of the Bank Holding Company Act. Without this exemption, a subsidiary bank could act as trustee for up to only 5 percent of a nonbank company's shares, as provided by section 4(c)(6) of the act.

Certain exceptions were included within the body of the section 4(c)(4) exemption to prevent use of the trust vehicle to circumvent the intent of the act. The section 4(c)(4) exemption is not applicable when shares acquired are held by a trust that is considered a "company" under section 2(b) of the act. Under section 2(b), a trust is defined as a company if it does not terminate within 25 years or within 21 years and 10 months after the death of individuals living on the effective date of the trust. Such trusts are generally referred to as perpetual trusts and include employee benefits and charitable trusts that can operate in perpetuity.

Another exception to the exemption implies that no more than 5 percent of the shares of a nonbank company may be held by a subsidiary bank as trustee under a trust established for the benefit of the bank itself; the bank's parent company or any of its subsidiaries; or the shareholders or employees of the bank, the parent company, or its subsidiaries, as indicated in section 2(g)(2) of the act. Employee benefit trusts have become a principal source of banks' trust assets. As strictly applied, section 4(c)(4) would limit acquisition of stock of a nonbank company to 5 percent of its shares for employee trust accounts of banks that are subsidiaries of bank holding companies.

3040.0.1 TRANSFER OF SHARES TO A TRUSTEE

Under section 4(c)(4), if a bank holding company transfers nonbank shares to a trustee and the trustee has one or more directors in common with the bank holding company, the nonbank shares are deemed to be controlled by the bank holding company until the Board determines otherwise.

3040.0.2 TRUST COMPANY SUBSIDIARIES

Even though section 4(c)(4) refers to shares held or acquired by a bank in good faith in a fiduciary capacity, the exemption also applies to shares held or acquired in a fiduciary capacity by a trust company subsidiary of a bank holding company.

3040.0.3 QUALIFYING FOREIGN BANKING ORGANIZATION OWNING OR CONTROLLING SHARES OF A COMPANY IN A FIDUCIARY CAPACITY

A foreign bank that maintains branches in the United States is subject to the provisions of the BHC Act in the same manner and to the same extent as a U.S. bank holding company.[1] Section 4 of the BHC Act prohibits a bank holding company and its subsidiaries from owning or controlling nonbanking assets or shares or engaging in any nonbanking activity unless it qualifies for an exemption.[2] Accordingly, such a foreign bank may not own nonbanking assets or shares (such as real estate), directly or through any company it controls, unless it qualifies for an exemption from the nonbanking prohibitions of section 4 of the BHC Act.

Under section 211.23(f)(4) of Regulation K, a qualifying foreign banking organization may "[o]wn or control voting shares of any company in a fiduciary capacity under circumstances that would entitle such shareholding to an exemption under section 4(c)(4) of the [BHC Act] . . ."[3] Section 225.22(d)(3) of the Board's Regulation Y (which implements section 4(c)(4) of the BHC Act) provides that the BHC Act's nonbanking prohibitions shall not apply to "voting securities or assets acquired by a bank or other company (other than a trust that is a company) in good faith in a fiduciary capacity, if the voting securities or assets are . . . held in the ordinary course of business and not acquired for the benefit of the company or its shareholders, employees, or subsidiaries."[4]

1. 12 U.S.C. 3106(a).
2. 12 U.S.C. 1843.
3. 12 C.F.R. 211.23(f)(4).
4. 12 C.F.R. 225.22(d)(3).

Two subsidiaries of the foreign bank CMB AG (the foreign bank) that are located in Germany currently invest in non-U.S. real estate for the benefit of third-party investors. One of the subsidiaries, IGC, manages only retail investment trusts (beneficial interests in which are typically sold widely to retail investors); the other subsidiary, SGC, manages only institutional investment trusts (beneficial interests in which are sold to 30 or fewer institutional investors). Through its legal counsel, the foreign bank requested an interpretation of section 4 of the BHC Act (12 U.S.C. 1843) and section 211.23(f)(4) of the Board's Regulation K (12 C.F.R. 211.23(f)(4)) that would permit its two asset-management subsidiaries, IGC and SGC, to sponsor and manage German-based investment trusts that invest in U.S. real estate.

The powers and duties of the asset-management services provided by IGC and SGC to their investment trusts are governed by the German Investment Law and a trust agreement entered into between IGC or SGC, on the one hand, and the investor, on the other hand (the trust agreement). IGC and SGC are subject to the supervision and regulation of the German bank supervisory authority (BaFin). Compliance by IGC and SGC with the German Investment Law and the trust agreement would be monitored and enforced by BaFin. Amendments in 2002 to the German Investment Law liberalized the ability of companies to sponsor, manage, and serve as distributor for one or more retail or institutional investment trusts, allowing investment in real estate outside the European Economic Area, including in the United States.

In light of the 2002 changes in German law, IGC established a retail investment trust (the retail trust) to invest in real estate located in the United States, Europe, and Asia. In addition, SGC is established as an investment trust for institutional investors (the institutional trust, and, together with the retail trust, the trusts) to invest in U.S. real estate. The trusts proposed to invest in existing commercial real estate properties in major U.S. cities (the properties), but not in undeveloped U.S. real estate. As required by the German Investment Law, title to each of the properties would be held either directly by IGC or SGC or by a special-purpose entity established and controlled by IGC or SGC.

Interests in the trusts would be sold only to non-U.S. persons. All property management, leasing, real estate brokerage, and refurbishment services obtained by the properties would be obtained from parties that are unaffiliated with the foreign bank or any of its subsidiaries. For their services to the trusts, IGC and CGS would receive an annual management fee based primarily on the net asset value of the trusts. The foreign bank's legal counsel contended that the proposed ownership of U.S. real estate by IGC and SGC for the account of the trusts would qualify for the fiduciary exemptions available in Regulation K and Regulation Y.

Under the arrangement, the two subsidiaries are subject to fiduciary duties that closely resemble those of a trustee in the United States. Under the German Investment Law, the investment trusts would not be legal entities separate from the two subsidiaries, IGC and SGC. The foreign bank made several representations and commitments in support of its inquirer's interpretation that the proposed ownership of U.S. real estate by IGC and SGC for the account of the trusts would qualify for the fiduciary exemptions under section 211.23(f)(4) of Regulation K and section 225.22(d)(3) of Regulation Y. In particular, the foreign bank committed that neither it nor its subsidiaries or employee benefit plans would own any beneficial interests in the investment trusts.

Based on all the facts, including all the representations and commitments made by or on behalf of the foreign bank, IGC, and SGC, Board legal staff stated that it would not recommend that the Board disagree with the inquirer's interpretation of the availability of the fiduciary exemptions in section 211.23(f)(4) of Regulation K and section 225.22(d)(3) of Regulation Y to the foreign bank. The fiduciary exemptions in the Board's Regulations K and Y (12 CFR 211.23(f)(4) and 225.22(d)(3)) would, therefore, permit the two subsidiaries of the foreign bank to take title to U.S. real estate on behalf of the investment trusts and for the benefit of the investors in the trusts. (See the Board staff's legal interpretation dated November 24, 2004. See also the summary of the interpretation in the *Federal Reserve Regulatory Service* at 3-744.13 and 4-305.2.)

3040.0.4 OTHER REPORTING REQUIREMENTS

In certain circumstances, holdings in fiduciary capacities of nonbank stock over 5 percent may also trigger reporting requirements under the federal securities laws.

3040.0.5 INSPECTION OBJECTIVES

To determine that nonbank shares held by a bank in a fiduciary capacity are in compliance with section 4(c)(4).

3040.0.6 INSPECTION PROCEDURES

Review the holding company's internal reporting procedures to establish that bank trust departments report 5 percent holdings in nonbank companies. In multibank companies, determine that controls are in place to aggregate nonbank shares held by each bank so that if an aggregate of 5 percent is held, it is reported in the Y-6.

3040.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Interests in nonbanking organizations	1843 1843(c)(4)	225.12(a) 225.22(d)(3)	3–744.13	
A qualifying foreign banking organization may own or control voting shares of any company in a fiduciary capacity		211.23(f)(4)	4–305.2	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Section 4(c)(5) of the Bank Holding Company Act permits (without prior approval) investments by a bank holding company in shares of the kinds and amounts eligible for investment by national banks under the provisions of section 5136 of the Revised Statutes (12 U.S.C. 24(7)).

National banks are prohibited by section 5136 of the Revised Statutes from purchasing and holding shares of any corporation except those corporations whose shares are specifically made eligible by federal statute. This prohibition is made applicable to State member banks by section 9, paragraph 20 of the Federal Reserve Act (12 U.S.C. 335).

In 1968, the Board interpreted section 5136 as permitting a member bank to purchase shares of a corporation engaging in business (at locations the bank is authorized to engage in business) and carrying out functions the bank is empowered to perform directly. Section 5136 is a broad statute with types of permissible activities both explicitly defined and implied indirectly without express definition. Therefore, to limit the need for constant Board interpretation regarding the implied areas of section 5136, the Board curtailed the authority of a bank holding company to acquire shares on the basis of section 4(c)(5) through section 225.22(d) of Regulation Y. As a result, effective June 30, 1971, permissible shares for bank holding company acquisition under section 4(c)(5) are limited to those *explicitly* authorized by any federal statute. Additional reasons for limiting the scope of activities to those explicitly defined by statute, are that section 4(c)(5) acquisitions require neither prior Board approval, nor the opportunity for interested parties to express their views, nor any prior regulatory consideration of anti-trust and related matters.

3050.0.1 COMPANIES IN WHICH BHC'S MAY INVEST

The following is a list of permissible companies expressly authorized by federal statute. The list includes the companies most frequently encountered.

1. Small business investment companies (''SBICs'').
2. Agriculture credit companies.
3. Edge and agreement corporations.
4. Bank premises companies (usually exempt under section 4(c)(1)(A)).
5. Bank service corporations (usually exempt under section 4(c)(1)(C)).
6. Safe deposit companies.
7. Obligations of student loan marketing associations.
8. State housing corporations.

3050.0.2 LIMITATIONS

On most 5136 authorizations, share investments are limited in some form, usually based on a percentage of the bank's capital and surplus. Under section 4(c)(5), a holding company's investment in such shares is also limited by amount and type to those permitted for a national bank to prevent avoidance of these limitations by a bank holding company.

3050.0.3 INSPECTION OBJECTIVES

1. To determine the permissibility of each activity encountered during the inspection which claims a section 4(c)(5) exemption.
2. To determine if the operations and financing of the section 4(c)(5) activity is not to the detriment of the bank(s).

3050.0.4 INSPECTION PROCEDURES

1. Review compliance with section 5136 of the Revised Statutes to determine if the activity is expressly permitted by any federal statute.
2. Determine the financial condition of the activity and its impact on the bank affiliate.

3050.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible investments for a national bank	(Section 5136 of the Revised Statutes)			
Investment in bank premise corporation	371d	250.200	4–185	
Investment in bank service corporation	1861–65	250.301	1–329	
Investment in small business investment corporation (SBIC)	15 USC 682b	225.107 225.111 225.112	4–173 4–175 4–174	
Operating subsidiaries/ loan production offices		250.141	3–415.4	
Section 23A Section 23B	371c 371c	250.240	3–1133 1–206.1	
Mortgage company		225.122	4–196	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3060.0.1 SECTION 4(c)(6)

This section provides an exemption for ownership of shares of any nonbank company that do not exceed 5 percent of the outstanding voting shares of such company. The exemption is designed to permit diversification of investments by a bank holding company and its subsidiaries which do not result in control of a nonbanking organization. The Board has indicated through an interpretation of 12 U.S.C. 225.101, that in its opinion, the 5 percent limitation applies to the aggregate amount of voting stock in a particular nonbank company held by the entire bank holding company organization including the parent company and all of its direct and indirect bank and nonbank subsidiaries. This is to prevent a holding company from acquiring a controlling interest in a nonbank company through ownership of small blocks of stock by numerous subsidiaries in circumvention of the provisions of section 4 of the BHC Act.

3060.0.1.1 D.P.C. Shares

The same interpretation (12 C.F.R. 225.101) also addresses the question of the applicability of section 4(c)(6) to nonbank shares acquired in satisfaction of debts previously contracted (D.P.C.) by a subsidiary bank, any nonbank subsidiaries, or the parent company. In this instance, the Board expressed the opinion that the 5 percent exemption provided by section 4(c)(6) covers any nonbank shares, including those acquired D.P.C. Consequently, shares which meet such conditions are not subject to the disposition requirements of section 4(c)(2) of the Act. It is important to remember that the exemption provided by section 4(c)(6) applies only to shares of any nonbank company. Acquisitions of any bank shares are subject to the provisions contained in section 3(a) of the Act.

Although the 5 percent limitation of this section applies, by its language, to ''voting shares'' rather than ''any class of voting shares'' as used elsewhere in the Act, the Board has indicated in 12 C.F.R. 225.137 that it applies to ''any class of voting shares'' rather than to the aggregate of all classes of voting shares held. Thus section 4(c)(6) is not available to a group of BHCs each owning a ''class of voting securities'' even if each BHC owns less than 5 percent of all shares outstanding. Further, section 4(c)(6) must be viewed as permitting ownership of 5 percent of a company's voting stock only when that ownership does not constitute ''control'' as otherwise defined in section 2 of the Act.

Note that section 4 prohibits engaging in nonbank activities other than those permitted by section 4(c)(8). Thus, if a BHC may be deemed to be ''engaging in an activity'' through the medium of a company in which it owns less than 5 percent of the voting stock it may nevertheless require Board approval, despite the section 4(c)(6) exemption.

3060.0.1.2 Acquisition of Nonbank Interests—Royalties as Compensation

A bank holding company requested an opinion on the permissibility of its subsidiary's receiving limited overriding royalty interests in oil, gas, and other hydrocarbon leasehold interests as partial compensation for investment advisory services in connection with those properties. The bank holding company was not acquiring more than 5 percent interest in any project. The subsidiary was to place the assigned royalties in a compensation plan for assignment to certain professional employees. Neither the subsidiary nor any affiliate were to acquire, hold, locate, sponsor, develop, organize, or manage any other energy property investment or in any other manner control the investment. The subsidiary was to hold interest in energy properties only if the interest had not yet been reassigned to an employee, or if an employee terminates service with the subsidiary and is required to reassign his or her energy properties to the subsidiary. The bank holding company's proposal was consistent with section 4(c)(6) of the Bank Holding Company Act, which exempts passive investments of 5 percent or less from the prohibitions of section 4 of the Bank Holding Company Act.

3060.0.2 SECTION 4(c)(7)

This section provides bank holding companies the opportunity to own, directly or indirectly, shares of an investment company (any amount up to 100 percent of outstanding shares) provided that each of the following conditions is met:

1. The investment company is not itself a bank holding company;
2. The investment company is not engaged in

any business other than investing in securities; and

3. Securities in which the investment company invests do not include more than 5 percent of the outstanding voting securities of any company.

4. As in section 4(c)(6), the 5 percent limitation applies, by its language, to "voting shares" rather than "any class of voting shares," as used elsewhere in the Act. However, the criterion applies to "any class of voting shares" for purposes of this section.

The 5 percent restriction does not prevent an investment company from having direct or indirect subsidiaries of its own, provided that ownership of such subsidiaries is permitted under another provision of the Act. Rather, the limitation is intended to apply only to securities purchased in the ordinary course of investing by the investment company.

The legislative history of this provision of the Act does not provide a clear indication as to the type of institutions encompassed under the term "investment company" as used in this section. It appears, however, that any company primarily engaged in the purchasing and ownership of securities may be regarded as an investment company for purposes of this section. Section 4(c)(7) can be viewed, more or less, as an extension of section 4(c)(6) which permits a bank holding company to directly or indirectly through subsidiaries own up to 5 percent of the voting stock of any nonbank company. In fact, until the Amendments of 1966, the Bank Holding Company Act incorporated both section 4(c)(6) and section 4(c)(7) under one section. From a practical standpoint, the parent company is allowed, under section 4(c)(6), to directly engage in the same activities as an investment company. Accordingly, most holding companies conduct these activities through the parent company, rather than through an investment company subsidiary. Such an arrangement prevents duplicate payment of certain taxes and provides more flexibility for utilizing funds in other areas of the organization.

3060.0.3 INSPECTION OBJECTIVES

3060.0.3.1 Section 4(c)(6)

1. To determine that the investments held pursuant to section 4(c)(6) comply with the Act and 12 C.F.R. 225.101 and 225.137.

2. To determine that no more than 5 percent of the voting shares of any nonbank company (other than those owned pursuant to other provisions of the Act) is held by the bank holding company and its subsidiaries.

3060.0.3.2 Section 4(c)(7)

1. To determine the overall quality of the investments held.

2. To determine the financial impact of the ownership of such shares upon the bank holding company and its subsidiaries.

3. To determine if policies, practices and procedures regarding investments are adequate.

4. To suggest corrective action where necessary in the areas of policies, procedures, or laws and regulations.

3060.0.4 INSPECTION PROCEDURES

3060.0.4.1 Section 4(c)(6)

1. Review investments held to determine that the BHC has a total interest of no more than 5 percent.

2. Determine that 5 percent does not constitute control.

3. Determine that the BHC is not "engaged" in any nonbank activity through its 5 percent ownership.

3060.0.4.2 Section 4(c)(7)

1. Where section 4(c)(7) applies, compare the investment company's general ledgers with statements prepared for the latest FR Y–6.

2. Obtain schedules of investments in voting shares of any companies. Review quality of such shares (utilizing rating service publications, etc.) and check for ownership interests exceeding 5 percent.

3. Review policies (written or oral) regarding purchase and sale of stocks.

4. Obtain and evaluate documentation relating to credit review for securities held. Determine adequacy of procedures to maintain credit updates.

5. Compare carrying value of stocks to current market value to determine market depreciation, if any and determine adequacy of any established reserves.

6. Perform verification procedures, including physical review of stock held in safekeeping, where practical.

7. Determine that purchases and sales of stocks are appropriately approved by directors or designated officers.

8. Review minutes of the board of directors meetings (where an investment company subsidiary is involved).

3060.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
4(c)(6) Applicability to shares acquired D.P.C.		225.101	4–187	
Aggregating shares owned by subsidiaries		225.101	4–187	
Five percent limit on ''any class of voting securities''		225.137	4–189	
Control with less than 5 percent		225.137	4–189	
4(c)(7) Indirect ownership of shares of investment company		225.102	4–188	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2014, this section was revised to include a brief discussion of the December 13, 2013, "Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans" that was issued to clarify the safety and soundness expectations and Community Reinvestment Act (CRA) considerations for regulated institutions engaged in residential mortgage lending. The section references the Consumer Financial Protection Bureau's (CFPB) Ability-to-Repay and Qualified Mortgage Standards Rule that was issued on January 10, 2013 (effective on January 10, 2014). Institutions may issue qualified mortgages or non-qualified mortgages, based on their business strategies and risk appetites. Refer to SR-13-20 and its attachment.

A mortgage banker specializes in the origination, acquisition, and sale of residential real estate loans to permanent investors (the secondary mortgage market). Most mortgage banking firms that are affiliated with banks and bank holding companies primarily originate residential real estate loans, although some firms may engage in interim and other lending secured by real estate. Unlike their nonbank competitors, the vast majority of the loans mortgage banks originate are sold to permanent investors in the secondary mortgage market.

Mortgage banks can retain or sell their loans and sell or retain the servicing of their mortgages. The mortgage banking industry currently offers a wide variety of products, market mechanisms, financing vehicles, and financial strategies due to competitive pressures within the mortgage banking industry and rapid growth in the demand for loans and related securities within the secondary mortgage market. Mortgage bankers use these marketing and financing strategies to differentiate themselves from the competition in terms of interest rates, maturities, down-payment requirements, and product offerings.

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 directly 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.

Originations, secondary market sales, and servicing constitute the primary functional business lines within a typical mortgage company. As an originator of mortgages, the company is responsible for the initial phase of the mortgage, from original contacts with the borrowers to the closing of the loans. At closing, the company disburses its funds and becomes the lender of record. Mortgage loans can also be acquired through a network of correspondent companies. Most mortgage banking companies use a combination of origination and acquisition strategies. The decision about whether to originate or purchase loans also varies over time due to fluctuations in demand and pricing discrepancies.

The secondary marketing department is responsible for selling loans in the secondary market and managing the interest-rate risk associated with loans during the interim period. In most cases, the mortgage company retains the loans until it can find a permanent investor to purchase the loans. The mortgage banker obtains purchase commitments from permanent investors and submits completed loan documentation packages to the investors for their approvals in satisfaction of the commitments.

As part of the overall process, the mortgage banker maintains a relationship with a variety of other permanent investors to whom the originated mortgages are sold. These investors are generally institutional investors such as securities dealers, commercial banks, life insurance companies, pension funds, and other financial and nonfinancial institutions. Some of these investors are restricted by state law, charter, or bylaws as to the type of mortgages and the locations of the property in which they can invest. Accordingly, their purchase commitments should incorporate these limits as well as the price and/or required yield of the mortgage loans or mortgage-backed securities. When these commitments are filled and the mortgages sold to the investors, the mortgage banker may retain the servicing rights to the mortgages it sells to permanent investors or sell the servicing rights in the secondary market.

The servicing department manages the loans that were retained in permanent loan portfolio or those that were sold to another permanent investor. Fees paid for services rendered in administering the mortgage portfolios of investors are a principal source of revenue for most mortgage bankers. In general, the company receives a fee that is usually based on a percent of the unpaid balance of the administered mortgages. In return for the fee, the servicer is responsible for collecting and remitting payments, managing the tax and insurance escrow accounts, inspecting the properties when required, pursuing delinquent borrowers, foreclosing on the mortgages when necessary, and providing accounting support. Considering the services rendered and the generally low fees involved, the servicing portfolio must be sizable for the company to be profitable. The servicing portfolio may represent very little credit risk to the servicer and can be a valuable source of residual income to the company.

The mortgage banking industry is experiencing significant consolidation. To be competitive, participants must maximize economies of scale and efficiencies. Emphasis has been placed on using more efficient systems and technologies that enhance loan processing, underwriting, servicing, and the management of pipeline risk (the interest-rate risk associated with the holding period for the mortgages). Existing mortgage banking firms are larger and operate more efficiently (faster, cheaper, and with higher quality) than they did in the past. Operating efficiencies are achieved through the use of sophisticated information systems, such as electronic data interchange, imaging, optical character recognition, expert systems, and other forms of artificial intelligence.

Within a bank holding company, mortgage banking subsidiaries generally focus on residential mortgage lending. As discussed initially, these mortgage bankers may also engage in other forms of lending. On an industry basis, they extend loans to real estate brokers who buy properties for resale, engage in second mortgage and home improvement lending (usually through dealer agreements), and extend interim loans. Interim loans represent a means of funding a project through one or more phases, with the property and improvements as collateral for the loan. The size of interim loans may range from a single residence under construction to large industrial, commercial, or residential projects. Construction lending and other forms of lending may be provided by other such real estate lending subsidiaries located elsewhere within the bank holding company's organizational structure.

The mortgage banker, as a lender, has the flexibility to fund any and all phases of a project including land acquisition, development, and construction. Land acquisition credit may be extended for the acquisition of more than one parcel of land, which may not necessarily be identified with a specific project. More frequently, acquisition credit is tied into a specific project for which the lender expects to fund more than one phase. In development-phase lending, funds are advanced to ''improve'' the property, bring utilities on-site, cut roadways, and prepare the site for its intended use. Many residential and industrial park projects are funded through this phase, with the sale of individual parcels providing the repayment of the loan. Construction lending funds the project from the foundation to completion. For those loans that fund two or more phases, there may be no clear distinction between the phases as certain elements of each may be underway concurrently.

On large projects funded through completion, such as apartment and office buildings where the construction is to be repaid from a permanent mortgage, the lender will usually require the borrower to obtain a permanent mortgage commitment from a third party. While this ''takeout'' commitment may or may not be arranged through the lender's network of investors, this commitment provides the lender with some assurance of repayment. In some cases, particularly in unsettled market environments, these takeouts are not available, and the lender may issue a ''standby'' commitment. On occasion, no permanent financing will be available upon completion and the lender will extend a ''bridge'' loan for the interim period between project completion and the placement of a permanent mortgage. Making construction loans without takeout commitments from responsible term lenders could expose the construction lender to adverse interest-rate movements as well as the market acceptability of the project. The absence of a takeout can represent a weakness in a loan. The general lack of takeouts in a portfolio should be a criticizable management practice (unless mitigating circumstances prevail) and should be discussed with management.

This section provides inspection guidance and procedures for mortgage banking nonbank subsidiaries of bank holding companies. Except for the limited guidance that pertains only to bank holding companies, they may also serve as examination guidance and procedures for mortgage

banking subsidiaries of state member banks. The way in which these procedures are used should be determined on a case-by-case basis depending on the size of a particular company and its business activities. The information in "Board Oversight and Management," "Financial Analysis," and "Intercompany Transactions" presented in this section is applicable to all mortgage banking reviews. The subsection "Mortgage-Servicing Rights" is recommended for use in companies that have significant risk exposure. The examiner should also target functional areas such as production, marketing, and servicing/loan administration.

3070.0.1 BOARD OVERSIGHT AND MANAGEMENT

The examiner should assess the quality and effectiveness of a mortgage banking company's board of directors (board) and executive management team, the appropriateness of its organizational structure, the nature of its internal control environment, and the effectiveness of internal control programs.[1] Such internal control programs may include internal and external audits, loan review, quality control over mortgage loans originated and/or serviced for investors, compliance, fraud detection, and related employee training programs.

The board and executive management team must be evaluated within the context of the particular circumstances surrounding each mortgage banking company. Since business complexities and operating problems vary according to the institution's size, organizational structure, and business orientation, directors and managers who are competent to effectively discharge their responsibilities under one set of conditions may be less competent as these conditions change.

Board oversight and management should be rated satisfactory, fair, or unsatisfactory based on both objective operating results and more subjective criteria. Performance must be evaluated against virtually all the factors necessary to operate the mortgage banking company's activities in a safe, sound, and prudent manner, including the ability to anticipate and plan for future events that may have a material impact on the company's financial condition. Such a rating should also be considered when assigning a consolidated rating of risk management (see sections 4070.1 (SR-95-51) and 4071.0 (SR-16-11)).

3070.0.1.1 Board Oversight

The mortgage banking company's board provides oversight, governance, and guidance to the executive management team. The board may include executives of the mortgage banking company, executives of the bank holding company and other affiliated companies, and outside directors.

The examiner should determine whether a separate board exists, as well as the identity and qualifications of the members. Minutes of board meetings should be reviewed to determine whether directors are fulfilling their fiduciary responsibilities. At a minimum, directors should—

- select and retain a competent executive management team;
- establish, with management, the company's short- and long-term business objectives and adopt operating policies to achieve those objectives in a safe and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the mortgage banking company's business performance; and
- ensure that the mortgage banking company meets the community's residential mortgage credit needs.

The examiner should assess whether directors exercise independent judgment in evaluating management's actions and competence, attend board and committee meetings regularly, remain well informed regarding the company's activities and the mortgage banking industry overall, and are knowledgeable regarding all applicable state and federal laws and regulations. The examiner should also review the quality of board reporting. 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

1. See section 1010.1 of the *Commercial Bank Examination Manual* and a report, "Internal Control—Integrated Framework," which was issued in September 1992 by the Committee of Sponsoring Organizations of the Treadway Commission, for a more detailed discussion of internal controls. The Treadway Commission report broadly defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

operational area. Directors should also receive information regarding exceptions to established policies and operating procedures, volume-related processing backlogs, and the effectiveness of the internal control programs. Information on hedging products and strategies should be routinely provided to the board and to holding company management. In connection with this portion of the review, examiners should also request and review information regarding all loans to insiders and their related interests to ensure that no preferential transactions have been extended to these parties.

3070.0.1.2 Management

The executive management team generally consists of a president and chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), and senior executives in charge of production, marketing, and servicing/loan administration. Management formulates operating policies and procedures and oversees the day-to-day administration of mortgage banking activities. Management should be evaluated in terms of its technical competence, leadership skills, administrative capabilities, and knowledge of relevant state and federal laws and regulations. The management assessment should evaluate management's attitude toward risk, as evidenced by the type of products that are offered; the existence of effective hedging programs; and/or the degree of reliance that is placed on the resources of affiliate banks, nonbanks, and other entities to support mortgage banking company activities.

Prudent operating policies and procedures that are consistent with the business needs and risk-management practices of the parent bank holding company should be in place for each functional area. An effective risk-management program should also be in place. Without adequate management oversight, excessive errors can occur, fraud or other violations of law may go undetected, and financial information may be reported incorrectly. Any of these events can damage the company's image, impair its access to external funding sources, and jeopardize its ability to originate and sell mortgage loans in the secondary market.

It is management's responsibility to develop and maintain management information systems (MIS), which should be dedicated to obtaining, formatting, manipulating, and presenting data to managers when needed. Such systems should generate accurate financial statements; identify the need for financial, human, technological, and physical resources; and produce timely and useful management exception reports.

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 that helps management anticipate changes in the internal and external environment and respond to changing circumstances. Because losses on the origination of mortgage loans are common in the mortgage banking industry, management should assess the servicing time necessary to recapture costs and achieve required returns. This information is critical to decisions to purchase mortgage-servicing assets, and it should be incorporated into hedging strategies.

The strategic plan should identify the company's strengths and weaknesses, growth targets, and other strategic initiatives (including management's philosophy toward the business, the extent of financial risk-taking, commitments to maintaining procedures and controls in managing the business, and management's commitment to staff development) over a one- to three-year time horizon. Planning efforts should also address system deficiencies and technological advancements within the industry. Without appropriate planning, the company can only react to external events and market forces.

Management should be results-oriented, but not at the expense of sound risk-management practices. Goals and objectives should be specific and measurable. Management should develop a performance measurement system that tracks progress toward achieving both financial and nonfinancial goals.

3070.0.1.3 Organizational Structure

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. The structure should also be reviewed to determine whether the lines of authority are clearly defined, the responsibilities are allocated logically, and management depth is sufficient within each division, department, or functional area.

The president and CEO usually reports directly to the mortgage banking company's board of directors, as well as to an executive management committee at the affiliate bank or the bank holding company level. Other reporting lines

may exist between functional area executives and their counterparts at either a bank affiliate or the holding company level.

3070.0.1.4 Control Environment

Management's attitude toward risk is communicated to employees through the company's corporate culture. In general, the CEO should establish and communicate a corporate culture that promotes safe, sound, and prudent business practices. The corporate culture should provide a positive control environment, set high standards, and reward ethical, desirable behavior.

Management's failure to communicate acceptable standards of behavior may encourage impermissible or high-risk business practices. For instance, compensation programs that are incentive-based may generate poor-quality loans. Below-market pricing strategies or overly aggressive growth targets may further exacerbate asset-quality problems or generate loans in excess of processing and servicing capabilities.

3070.0.1.5 Control Programs

Management controls in a mortgage banking company consist of an internal audit, an external audit, loan review, compliance, quality control over loans originated and/or serviced for investors, fraud detection procedures and related employee training programs, insurance coverage, and legal review. The examiner should review recent reports conducted by internal loan review, state and federal agencies, and private investors to determine the scope of the review, the nature of any problems noted, and the adequacy of management's response.

3070.0.1.5.1 Internal Audit

The internal audit function in a mortgage banking company is responsible for detecting irregularities; determining compliance with applicable laws and regulations; and appraising the soundness and adequacy of accounting, operating, and administrative control systems. Accounting, operating, and administrative control systems are designed to ensure the prompt and accurate recording of transactions and a proper safeguarding of assets.

Internal audit activities may be conducted through a separate department located on-site or through the internal audit department of the bank holding company. Very small financial institutions that do not maintain a separate audit function may rely solely on their external auditor to perform these functions.

Regardless of the organizational structure, internal auditors must be independent of the line areas being reviewed, have access to all company records, and maintain sufficient status and authority within the company. The internal auditors' findings should be reported directly to the board or a designated committee thereof.

The scope, frequency, and coverage provided through the internal audit program should reflect the size and complexity of the institution. The audit schedule should cover underwriting practices and other high-risk areas of mortgage banking, including the most significant balance-sheet accounts, income statement accounts, and internal control systems.

To yield meaningful results, the department must be adequately staffed with individuals who are experienced and knowledgeable about mortgage banking. Audit staff should receive ongoing training and be encouraged to hold professional industry certifications. Internal audit reports should be issued and responded to by line management in a timely fashion. Follow-up procedures should be in place to ensure that corrective measures are taken.

3070.0.1.5.2 External Audit

External auditors generally review and assess the mortgage company's financial condition and the adequacy of internal controls. The engagement letter sets forth the external auditor's responsibilities, scope, and extent of reliance that is placed on the internal audit department with respect to the type of engagement. When an external audit is to be performed, the audit is an examination that is conducted to determine that the present financial condition of the company and the results of operations are fairly stated and are in conformity with generally accepted accounting principles.

Examiners should review the most recent external audit report to determine whether the opinion regarding the company's financial statements and their disclosures was qualified in any manner. If applicable, examiners should note any significant concerns or weaknesses in the company's internal control structure. Examiners should also review management's written response to the audit to determine whether corrective measures were appropriate, complete,

and timely and whether the response reveals any internal control weaknesses.

The reason behind any changes in external audit firms used should be investigated. Unusual items and areas of potential concern should be discussed with management and/or the external auditor. If questions arise during the safety-and-soundness review, the examiner should determine whether the area of concern was considered to be a material item by external auditors, the nature of audit work performed, and the outcome of that review. If questions persist, the examiner may want to request access to specific external audit workpapers.

3070.0.1.5.3 Loan Review

Loan review activities may be conducted at the mortgage banking company or in conjunction with the loan review activities of either an affiliate or the parent bank holding company. In any event, loan review should determine whether mortgage loans that are originated and/or purchased meet underwriting standards as defined in the internal loan policy. Loan review may also sample loans to determine whether they meet underwriting criteria established by investors. The scope of the loan review program should be evaluated. The examiner should also review a copy of the most recent loan review to determine whether problems are identified and addressed in a timely manner.

3070.0.1.5.4 Quality Control

Mortgage banking companies that service loans for investors must also maintain a separate quality control department to test the quality of loans produced and serviced for investors. Investors such as the Government National Mortgage Association (GNMA or Ginnie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and FannieMae 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 10 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. Random samples should include loans originated through the company's own production network, purchased loans, loans for which work was performed by a third party (outsourced), and loans with various product characteristics, such as a high loan-to-value or a convertible feature.

Quality control personnel reverify loan documentation, including the appraisal, down payment, employment, and income information. After each review, the department should issue a comprehensive report detailing specific quality control findings and recommendations. Quality control reviews must be completed within 90 days of closing. Exceptions to company policy or investor underwriting standards should be documented and communicated to executive management. Corrective measures should be initiated promptly.

The quality control function should serve as an early warning system that alerts management to situations that may jeopardize the financial strength, image, or origination and sale capacity of the company. To function as an effective management control, the quality control department should operate independently from the production and servicing/loan administration departments. Quality control should complement, not substitute, work performed by the internal audit and loan review functions.

3070.0.1.5.5 Insurance Program

The insurance program should be reviewed to determine whether coverage adequately protects the mortgage banking company and its affiliates against exposure to undue financial risk. Insurance policies should be reviewed and approved by the board at least annually.

3070.0.1.5.6 Litigation

The legal department should be contacted to determine whether existing or pending litigation exposes the mortgage banking company or its affiliates to undue financial risk. Particular attention should be paid to the status of any actual or pending class action lawsuits of a material nature.

Examiners should also determine whether procedures exist to detect and investigate suspected fraud, either internal or external. In many instances, the legal department coordinates fraud training and investigations, as well as the submission of criminal referral or suspicious activities reports and the initiation of legal action. If a separate fraud division or unit does not exist, examiners should determine whether procedures governing the detection, investigation, and referral of potentially fraudulent situations exist

and function effectively. Examiners should also determine whether management reports adequately detail and track potential exposure.

3070.0.1.5.7 Supervisory Approach for Qualified and Non-Qualified Mortgage Loans

An "Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans," dated December 13, 2013, was issued to clarify the safety-and-soundness expectations and Community Reinvestment Act (CRA) considerations for regulated institutions engaged in residential mortgage lending. The Consumer Financial Protection Bureau's (CFPB) Ability-to-Repay and Qualified Mortgage Standards Rule[1a] was issued on January 10, 2013 (effective on January 10, 2014). Institutions may issue qualified mortgages or non-qualified mortgages, based on their business strategies and risk appetites. Residential mortgage loans will not be subject to safety-and-soundness criticism based on their status as either qualified mortgages or non-qualified mortgages. As for safety-and-soundness expectations, the agencies[1b] continue to expect institutions to underwrite residential mortgage loans in a prudent fashion and to address key risk areas in their residential mortgage lending, including loan terms, borrower qualification standards, loan-to-value limits, documentation requirements, and appropriate portfolio and risk-management practices. Refer to SR-13-20 and its attachment.

3070.0.1.6 Inspection Objectives—Board Management and Oversight

1. To assess the composition, qualifications, and degree of oversight provided by the mortgage company's board and executive management team.
2. To determine whether the organizational structure is appropriate given the nature and scope of the mortgage banking company's operations.
3. To evaluate the reasonableness of the operating budget, long-term business planning, performance measurement systems, and MIS and related management and board reports.
4. To determine the nature of the company's internal control environment and the effectiveness of its system of internal controls, including internal and external audits, loan review, quality control, suspicious activities and fraud detection (including criminal referral and suspicious activities reporting) and related employee training programs, insurance coverage, and pending litigation.

3070.0.1.7 Inspection Procedures—Board Management and Oversight

Board Oversight

1. Review biographies of the board of directors and minutes from board and committee meetings to determine whether directors are qualified and fulfilling their fiduciary responsibilities.
2. Review the most recent package of information that was provided to directors. Do they receive sufficient detail regarding the financial condition, internal controls, and risk-management techniques employed within the company?

Management

1. Review biographies of members of the executive management team to determine their level of experience, technical knowledge, leadership skills, and administrative capabilities. Discuss whether salaries are commensurate with management's experience level and expertise.
2. Evaluate the quality of operating policies and procedures within each division or functional area and the extent to which compliance with such policies and procedures is monitored and reported.
3. Evaluate the output from the planning process, including the most recent operating budget, business plan, and related performance measurement system reports. Determine whether objectives, goals, and growth targets are reasonable.

1a. See the Ability-to-Repay and Qualified Mortgage Standards Rule (the Ability-to-Repay Rule)_ under the Truth in Lending Act (Regulation Z), 78 *Fed. Reg.* 6408 (January 30, 2013), as amended. The Ability-to-Repay Rule requires institutions to make reasonable, good faith determinations that consumers have the ability to repay mortgage loans before extending such loans. In accordance with the rule, a "qualified mortgage" may not have certain features, such as negative amortization, interest-only payments, or certain balloon structures, and must meet limits on points and fees and other underwriting requirements.

1b. The federal banking financial institutions regulatory agencies (the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency).

Organizational Structure

1. Review the organization chart to determine whether the organizational structure is appropriate, as well as the appropriateness of the division of functional responsibilities and the degree of management depth within each division or functional area.

Internal Control Environment

1. Evaluate the nature of the internal control environment and how risk parameters are communicated to employees.

Internal Control Programs

1. Assess the effectiveness of internal controls in identifying and controlling risks. Internal controls include internal and external audits, quality control for mortgage loans, insurance coverage, and fraud detection procedures and related employee training programs.

Internal Audit

1. Determine whether a separate internal audit function exists and, if so, its degree of independence.

2. Review the qualifications of the internal audit manager and his or her staff for mortgage banking and accounting and auditing expertise. Consider the size of the department and its ongoing training programs, as well as the experience levels, educational backgrounds, and professional certifications of the department's staff.

3. Determine the scope and frequency of the internal audit program to ensure that all high-risk areas are reviewed regularly.

4. Review all internal audit reports, management responses to them, and follow-up audit reports for work conducted since the previous inspection.

5. Select a significant sample of internal audit reports and respective workpapers and conduct an intensive review of the internal audit program. Determine that all issues and exceptions were brought forward to the final audit report, the report was presented to the board or a committee thereof, and that any detected and disclosed problems or control weaknesses received appropriate management attention.

6. Evaluate the internal audit department's system for following up on issues and exceptions. Determine whether prompt, satisfactory resolution of issues was effected.

External Audit

1. Review the engagement letter for the most recent external audit to determine the external auditor's scope, responsibilities, and extent of reliance on the internal audit department.

2. Review the most recent external audit report to determine whether the opinion regarding the company's financial condition was qualified in any way and whether any internal control weaknesses were noted. Review the notes to the financial statements for appropriate disclosures.

3. Discuss any unusual items and areas of potential concern with management and/or the external auditor. Determine whether any areas of concern were considered to be material items by the external auditors, based on the nature of audit work performed, management's representations in the management letter, and the outcome of that review. If questions persist, consider the need to request and review specific external audit workpapers.

4. Discuss the reasons for any recent changes in external auditors with management.

Compliance and Disaster Recovery

1. Review the methods used to ensure compliance with state and federal laws and regulations by—

a. interviewing the person who is responsible for compliance to determine the nature of outstanding problems and the adequacy of corrective measures that have been taken, and

b. reviewing the system for logging, tracking, and responding to customer complaints.

2. Determine whether the disaster recovery plan is adequate.

Quality Control

1. Review the quality control department's policies and procedures to determine whether the quality control program meets minimum investor requirements.

2. Review a sample of reports issued by the quality control unit to determine whether they were issued in a timely manner and conclusions were adequately documented.

3. Determine whether quality control results

are relayed to executive management and whether follow-up procedures are adequate.

4. Determine whether the quality control unit is sufficiently staffed and independent.

5. Determine whether quality control outsources work to outside parties. If so, are adequate controls in place to ensure that such outsourcing meets the company's own quality standards?

Insurance

1. Review insurance policies maintained for the mortgage banking company to determine whether coverage is adequate and whether the majority of insurable risks is included, giving consideration to a cost versus benefits analysis.

2. Review board minutes to ascertain the date the board last reviewed and approved the insurance program.

Litigation

1. Review all current and pending litigation of a material nature and determine whether adequate reserves are maintained to cover anticipated financial exposure.

Fraud Detection and Training

1. Determine whether a separate fraud unit exists and whether procedures are in place regarding the detection and investigation of suspected fraudulent activity and the issuance of related management reports.

2. Evaluate the company's early warning system for detecting potential fraud. Is the level of training adequate?

3. Review any criminal referral or suspicious activities forms filed since the prior inspection and discuss their status with management.

3070.0.2 PRODUCTION ACTIVITIES

Loan production covers the process of originating or acquiring loans. Production begins with the initial loan application and ends when a loan has been underwritten and processed, closed, and reviewed by post-closing.

3070.0.2.1 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). Both agencies protect investors holding such securities against losses in the event of a borrower default, thereby slightly reducing investors' required yields. 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 guaranty to give support to a loan for securitization. A certificate of insurance or guaranty may not be needed for a loan to be securitized.[2]

Loans that 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. Conventional loans typically require higher down payments and bear market interest rates. Most lenders that offer programs with smaller down-payment terms require that the borrower purchase private mortgage insurance for the top 5 to 20 percent of the loan principal balance so that a proportionate share of the credit risk is borne by a private mortgage insurance (PMI) company.

The extent of credit risk associated with a loan often depends on the marketing program under which the loan is originated. Marketing programs and participants are described briefly here; for a more detailed description, see ''Marketing Activities'' later in this section.

The market for residential real estate loans is dominated by three government-sponsored entities: the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FannieMae). GNMA is a government agency that guarantees the timely payment of principal and interest on pass-through securities that are backed by pools of FHA-insured or VA-guaranteed mortgages. These guaranties are backed by the full faith and credit of the U.S. government. Although investors will get paid in full, servicers may retain some risk of loss, particularly with respect to VA loans (see subsection 3070.0.4.5 for addi-

2. See the appropriate agency seller/servicer guide for standards and requirements regarding certificates of insurance or guaranty.

tional information on ''VA no-bids'').

Pass-through securities provide for monthly installments of interest at the stated certificate rate plus scheduled principal amortization on specific dates, despite the delinquency status of the underlying loans, as well as any prepayments and additional principal reduction. The issuer collects the mortgage payments and, after retaining servicing and any other specified fees, remits monthly payments to the certificate holders.

Although FHLMC and FannieMae are not extensions of the U.S. government, the market believes that there is an implicit guaranty that their securities will be repaid. FHLMC and FannieMae securitization involves the purchase of conventional loans from lenders and the selling of mortgage-participation certificates, which are similar to GNMA pass-through securities. Participation certificates represent an ownership interest in pools of conventional loans. FHLMC and FannieMae guarantee the monthly pass-through of interest, the scheduled amortization of principal, and the ultimate repayment of principal. Unlike GNMA pass-throughs, however, participation certificates are not backed by the full faith and credit of the U.S. government.

Conventional loans are classified as either conforming or nonconforming. *Conforming* loans must comply with FannieMae's and/or FHLMC's underwriting and documentation guidelines in order to be sold in the secondary market. Conforming mortgages may be sold to FannieMae or FHLMC on either a recourse or nonrecourse basis.

Private pools of *nonconforming* loans that do not meet FannieMae or FHLMC guidelines may be sold in the secondary market under a private label structure. Nonconforming loans are often ''nontraditional'' products such as loans with teaser rates, limited documentation, and graduated payment schedules, as well as ''jumbo'' loans that exceed maximum agency size requirements. To improve salability, pools of nonconforming loans may be insured through third-party credit enhancements (for example, letters of credit) or various senior/subordinate structures. Since the underlying mortgages generally already carry private mortgage insurance, such pools are, in effect, doubly insured.

3070.0.2.2 Production Channels

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. A branch network is relatively costly, since origination costs often exceed the origination fees received from the borrowers.

Wholesale production channels (where contact with the borrower is made by another party) take several forms. Whole loans can be purchased either individually or by using bulk commitments. Bulk commitments either require the correspondent to deliver a set amount of loans (mandatory) or deliver all registered loans that close (best effort or optional).

Loans may be closed in the buyer's own name using its own funds, closed in the seller's name using the buyer's own funds, or closed and funded by the seller with delivery to the buyer within a certain number of days. If the seller closes in its own name, the mortgage and note are generally assigned to the buyer simultaneously upon closing.

Three hybrid production channels are worth mentioning here. Examiners should note that terminology within the industry varies greatly. Under the first method, *table funding*, a mortgage banking company funds loans at closing that have been originated by a correspondent or broker according to the company's own specifications. Historically, the company's ability to record mortgage-servicing rights depended on the degree of independence that was maintained and the extent of risk borne by the originator. See subsection 3070.0.6, on ''Mortgage-Servicing Assets and Liabilities.''

The second hybrid method, *assignment of trade*, involves the bulk purchase of loans and investor commitments to sell the loans in the secondary market. The purchaser bears virtually no market risk under this production method. The third hybrid method, *co-issue*, entails the acquisition of servicing rights only, at the time a security is issued.

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. Approved correspondent lenders should be continually monitored for the quality of the product delivered and the financial ability to repurchase mortgages that do not meet the standard representations and warranties under which the mortgages are sold.

3070.0.2.3 Production Strategies

A successful production strategy combines high credit-quality standards with cost containment and effective marketing. In contrast, an overly aggressive or inappropriate strategy leads to heightened production risk. High-risk production strategies can be evidenced by relaxed credit standards, low documentation requirements, an executive officer's compensation based on volume, an emphasis on high-risk product types or geographic areas, and/or dependence on a limited number of production channels. Examiners are responsible for recognizing and reaching agreement with management to better control such high-risk production strategies where appropriate.

3070.0.2.4 Production Process

There are five principal steps in the retail production process: (1) pipeline entry, (2) processing, (3) underwriting, (4) closing and funding, and (5) post-closing. Each of these functions should be independent from one another and separately supervised to ensure the quality of the loans produced. Each step is briefly discussed below.

1. *Pipeline entry.* A loan has entered the pipeline when a prospective borrower completes a loan application. The applicant authorizes the lender to verify his or her employment, credit history, bank deposits, and other information that evidences repayment capacity.

2. *Processing*. The application is then processed to qualify the applicant and the property for the loan. Processing personnel verify the applicant's employment history and credit information and order an appraisal on the property. Processing activities should be controlled through standardized procedures, checklists, and systems.

3. *Underwriting*. The underwriting unit approves or disapproves applications based on underwriting criteria that are established by the FHA, VA, FannieMae, and FHLMC and by private mortgage insurers and institutional investors. To ensure objectivity, the underwriting unit should not report to management of the production function.

4. *Closing and funding*. After an application has been approved, the lender generally issues a commitment letter to the borrower, which states the interest rate and terms of the loan. At closing, the lender or its agent obtains all the legal and related documents executed by the parties to the sale, disburses the proceeds of the loan, and collects certain funds from the borrower.

5. *Post-closing*. After closing, a post-closing review is performed to ensure that documents were properly executed and underwriting instructions were followed. The post-closing review also identifies any trailing or missing documents that must be tracked and obtained to meet investors' pool certification requirements. Specific agency requirements are detailed in the agency seller/servicer guides. Before the loan is transferred to the delivery or shipping department, processing begins for the final mortgage insurance (from the private mortgage insurer or from the FHA/VA guaranty certificate). Receipt of the actual certificate may take 45 to 60 days or longer. Pool custodians and investors will allow the lender to complete the sale if final documentation, including the insurance certificate, is expected to be received within a reasonable timeframe.

3070.0.2.5 Production Risks

The production process can present risks of both a short- and potentially long-term impact. Operational inefficiencies can result in high management and staff turnover, an inability to meet investor documentation requirements, an increasing number of pools that have not received 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.

Management should be prepared to quickly respond to interest-rate cycles and related volume increases or declines, since failure to act promptly can affect earnings and capital. During the pooling and securitization process, for example, if the number of pools that lack final certification exceed a certain limit, the company may be required to seek financial support in the form of a letter of credit from an affiliate bank or bank holding company to ensure that all required loan documentation is secured in a timely manner. 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 nonreimbursable foreclosure costs, or costs associated with VA ''no-bid'' options.

3070.0.2.6 Overages

In certain instances, originators and loan brokers may have the ability to deviate from mortgage loan prices that are established by the marketing department. An overage exists when a lender permits an originator or broker to impose a higher number of points (or a higher interest rate) on a loan to certain borrowers than is imposed for the same product offered to other borrowers at a given point in time. (See CA-94-6.)

Overages are often used as an incentive to compensate originators or brokers. The amount that is received over the expected price is often shared by the mortgage banking company and the originator or broker. The practice of permitting overages may contribute to or result in lending discrimination under the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHAct).

Examiners should review the mortgage banking company's lending policy and determine whether overages are permitted and whether the practice has resulted in lending discrimination. If a more detailed review of overages is deemed necessary, such review should be performed in conjunction with the appropriate Federal Reserve System's legal and consumer compliance staff.

3070.0.2.7 Inspection Objectives—Production Activities

1. To determine the types of loans offered to borrowers and any significant changes in product mix.
2. To determine whether mortgage loans are securitized; if so, to determine whether mortgage-backed securities are insured or otherwise guaranteed by government-sponsored agencies or private entities.
3. To determine what channels are used to originate loans.
4. To determine if production processes are consistent with operational risk controls and efforts to minimize risk.
5. To determine whether production processes can handle cyclical changes in volume.
6. To determine whether overages are permitted and to assess whether the practice has resulted in lending discrimination.

3070.0.2.8 Inspection Procedures—-Production Activities

General

1. Review organization charts to determine the structure of the production function and its status within the company. Verify that functional units such as underwriting and quality control are independently managed.
2. Determine the types of mortgage products offered and the company's target markets. Evaluate portfolio trends for overreliance on one product type and undue concentrations in one geographic area.
3. Discuss the company's credit culture, compensation methods, and growth targets to determine whether income and loan volume are emphasized over credit quality.
4. Determine whether the level of nonconforming or unsalable loans being originated present undue risk and whether the quality and delinquency trends for such loans are adequately monitored.

Originations

1. Review policies and procedures for retail branch originations. How are originators compensated? Determine whether originators have the authority to alter loan pricing parameters set by the marketing unit.
2. Determine the size of the branch network and its cost structure. Is the network growing or shrinking? How does management plan for anticipated changes in loan volume?
3. Determine if the mortgage banking company is involved in overage activities. If so—

a. determine whether management has developed comprehensive policies and procedures, detailed documentation and tracking reports, accurate financial reporting systems and controls, and comprehensive customer complaint tracking systems to adequately monitor and supervise overage activities;

b. review whether overages are an essential component of the mortgage banking company's earnings and origination activities, and review the percentage of mortgages originated

since the previous inspection that resulted in overages and the average overage per loan;

c. determine if management reviews overage activity for disparate treatment and disparate impact; and

d. determine if overages are a major component of loan officer and/or broker compensation.

4. Review policies and procedures for wholesale purchases. Which production channels are used and how do they work? Channels may include whole loan purchases (production flow), table funding, assignment of trade, or co-issuances (bulk purchases of servicing rights only). For each production channel, review how brokers and correspondents are compensated.

5. Review the method for reviewing and approving brokers and correspondents and specific programs under which wholesale loans are purchased. Is there an approved list of correspondents? How is it updated and how frequently? Determine whether exceptions to this list are made and by whom, and whether controls are in place to prevent unauthorized purchases.

6. Evaluate the process for conducting financial reviews on correspondents. How often are financial statements obtained, and who analyzes them?

7. Determine whether adequate controls are in place to detect changes in the financial condition of a correspondent, test and monitor the quality of loans purchased, and evaluate the correspondent's financial capacity to perform under contractual repurchase obligations.

8. Select a sample of contracts for the largest correspondents for additional review. Do contracts clearly state pricing structures, maximum dollar volumes, recourse arrangements, and whether loans are purchased on a mandatory delivery or a standby basis? Have any legal issues arisen as a result of the contract language? How frequently does management put back loans to its largest correspondents?

9. Determine whether management information systems adequately track approvals and denials by loan type and production channel. Are exceptions to policy adequately tracked and monitored?

Processing

1. Determine whether processing is performed in-house or by another party (a third-party contractor or the originator). Review checklists and procedures for the processing unit and determine whether loan tracking systems are adequate.

2. Review steps that have been taken to address any audit or quality control findings. Determine whether additional corrective actions are necessary.

Underwriting

1. Determine whether underwriting is performed in-house, by third-party underwriters, or by the originator. Is management planning for peak volume periods and are controls over the underwriting process adequate?

2. Review policies and procedures to gain a reasonable assurance that underwriting standards are prudent and comply with investor guidelines. If individual underwriters perform this function, determine whether management has established approval limits, developed exception procedures for loans that are rejected or suspended, and receives reports that track loan quality for each underwriter. If a committee performs the underwriting function, review its charter, composition, and minutes. If a scoring system is used, review credit scoring methodology. Can the system be overridden? If so, by whom?

3. Review a representative sample (preferably a statistical sample) of current loans to test the underwriting policies and procedures and also determine the validity and adequacy of documentation supporting loans held for sale or investment.

4. If an unusual increase in unmarketable loan inventory has been noted, select a small sample of loans in current production for additional review. Does underwriting comply with established guidelines? If a credit scoring system is used, focus on loans that are of the lowest acceptable grade. If deficiencies are noted, consider expanding the review sample.

5. Review loans that were rejected and then approved. Did the proper authority approve such loans, and was management's rationale adequately documented?

Closing/Post-Closing

1. Evaluate procedures, checklists, and systems for closing loans. Are all required documents obtained from the borrower before funds are disbursed? If not, evaluate the appropriateness of suspense items.

2. Determine if a post-closing documentation review process exists to differentiate, track, and

obtain both trailing and missing documents. Assess its effectiveness.

3. Determine if wholesale loans are re-underwritten at delivery. If not, how does management ensure that loans are re-underwritten in accordance with secondary marketing program requirements?

4. Determine the number of pools that lack final pool certification. Has this number exceeded the maximum allowable limit since the previous review? Why has this problem occurred, and what steps are being taken to secure the necessary documentation? Has a letter of credit been posted? Does the situation pose undue financial risk for the company or any of its affiliates?

3070.0.3 MARKETING ACTIVITIES

The marketing department is typically responsible for the development of mortgage products, determination of products to be offered, and the establishment of daily mortgage prices. The marketing department, which is also referred to as secondary marketing, is also responsible for the sale of mortgage loans to investors. Given these roles, the marketing department acts as an intermediary between the borrower and the investor. All of these activities require close coordination to be effective and are appropriately placed within one department.

3070.0.3.1 Oversight

Marketing activities are generally supervised by a marketing committee, which may consist of the chief executive officer, chief operating officer, chief financial officer, and the executive officers responsible for marketing, production, and servicing/loan administration. The marketing committee is responsible for the formulation of marketing policies, departmental operating procedures, pricing strategies, and parameters governing the use of various mortgage-related products and strategies used to hedge the interest-rate risk associated with certain mortgage loans.

3070.0.3.2 Securitization

The marketing department's primary tool in performing its activities involves securitization outlets. Securitization activities are discussed in SR-90-16, which transmitted the following documents: (1) the Examination Guidelines, (2) An Introduction to Asset Securitization, and (3) Accounting Issues Relating to Asset Securitization. There is also a discussion of these activities in the *Commercial Bank Examination Manual*, section 4030.1. 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).

Many approaches are used for securitization, but the great majority of activity occurs with conduits such as GNMA, FHLMC, and Fannie-Mae. Conduits provide many programs that a mortgage originator can use to deliver a mortgage or pools of mortgages in return for cash or securities. To investigate current program requirements and available options, the examiner should consult the seller guidelines issued by the agencies.

The securitization process presents the marketing department with a complex set of options to consider when deciding how to sell the company's loan production for maximum profit. If the company's own servicing valuation differs from pricing offered by the agencies, for instance, the marketing department can use some flexibility in pool formation guidelines to retain or divest servicing cash flows. Recourse to the originator or servicer can be negotiated to reduce agency guaranty fees. Agencies also alter guaranty fees based on different methods of remitting principal and interest payments. Sales to the agencies can be on a best-efforts or mandatory basis. A best-efforts basis is when loan delivery is not required if the loan does not close. Better prices are received for the lender's acceptance of the more rigid performance requirements of mandatory commitments. Master commitment contracts can be reviewed by the examiner to determine negotiated terms.

Although most securitization activity occurs within the programs already mentioned, private security issues are also used. The private issues are used primarily for loans that do not meet the underwriting criteria of the agencies, commonly due to larger than accepted loan amounts (jumbo loans). Nonconforming loan production is usually sold to brokers or security affiliates who have marketed the product to investors, sometimes using complex real estate mortgage investment conduits (REMICs).

3070.0.3.3 Pooling Practices

As an intermediary between the borrower and the investor, marketing personnel coordinate the flow of loan documents from the shipping department to the pool custodian and the ultimate holder. If servicing is retained, the loan will be input into the company's servicing system soon after closing. Staffing levels should be adequate to ensure that processing backlogs are managed and workloads remain reasonable. Temporary help and/or outsourcing may be used during peak volume periods.

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 (unavailable) and trailing (delayed) documentation.

If third-party guaranties 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.

3070.0.3.4 Marketing Risks and Risk Management

3070.0.3.4.1 Techniques

The marketing department manages several risks, which can be categorized as follows:

- unsalability
- pricing
- fallout
- counterparty performance

3070.0.3.4.2 Unsalability

Under most circumstances, a mortgage banking company will originate mortgage products that are acceptable to GNMA, FannieMae, FHLMC, or other major investors. This minimizes the risk that mortgage products originated will not be marketable to investors and have to be retained as a portfolio investment. However, the marketing department may also initiate certain products that are intended for the loan portfolio of the mortgage company or portfolios of bank or nonbank affiliates. In the case of production for bank affiliates, underwriting and pricing arrangements must be structured to ensure compliance with the restrictions imposed by sections 23A and 23B of the Federal Reserve Act. See the subsections on production activities (3070.0.2) and intercompany transactions (3070.0.7).

3070.0.3.4.3 Pricing Risk

The mortgage banking business is volume driven. Because profit margins are thin and fixed costs associated with loan production can be large (especially in the case of a retail origination network), it takes a significant volume of mortgages to generate profits. Mortgage pricing decisions are critical because the price is a major determinant in the volume of mortgages originated.

Pricing strategies can be affected by divisional profit and loss allocations or external industry practices. A neutral price structure sets mortgage prices that are equivalent to the expected price for which the mortgages will be sold to investors, plus a normal servicing spread of 25 to 50 basis points depending on the type of loan. Daily adjustments are usually made to prices to reflect market changes for future settlement of mortgage-backed securities (MBS).

Due to regional or local competition, mortgage banking companies often find it necessary to deviate from a purely neutral pricing strategy to maintain volume in certain markets. However, large deviations from market price in either a lower or even upward direction can have adverse consequences. In addition to causing marketing losses, price cutting could place operational strains on the production and servicing areas. Premium pricing can position the company as a lender of last resort with adverse credit quality implications.

The marketing department attempts to minimize price risk by matching origination pricing with the price it expects to receive from investors. However, estimating the price at which the mortgages can be sold can be difficult because it is determined in large part by external factors such as interest rates. The longer the elapsed time between when the mortgage applicant decides to lock in a loan rate and the time the loan closes, the greater the risk that the prices

for which the mortgages can be sold will change. Some companies encourage customers to "float" their interest rate until closing approaches to reduce the volume and costs of hedging.

3070.0.3.4.4 Fallout

A third type of risk that the marketing department manages relates to pipeline "fallout." This is the risk that the proportion of loans in the rate-committed pipeline that are expected to close will change with a given change in interest rates. As market interest rates decline, fewer mortgages in the pipeline will close because applicants will opt to make new applications at the lower rates. As interest rates rise, the proportion of pipeline loans that will close increases as more applicants choose to lock in rates. Mismatches that occur in the long and short positions can result in financial losses when the institution needs to settle its trades.

3070.0.3.4.5 Hedging Strategies

The most common hedging strategy used to protect the inventory of closed loans and the rate-committed pipeline against adverse interest-rate movements involves the use of mandatory and optional forward sales of MBS. Under this hedging strategy, the inventory and rate-committed pipeline (the long position) are generally covered through short sales (mandatory delivery contracts with settlements corresponding to expected delivery volumes). Put and call options on MBS are sometimes purchased to manage heightened fallout risks during periods of volatile interest-rate fluctuations.

The typical practice is to hedge 100 percent of the closed loan inventory that is marketable. In addition, pipeline loans very near to closing are generally also hedged at or close to 100 percent. However, a significant degree of uncertainty exists as to the amount and timing of 30- and 60-day rate-committed pipeline closings due to interest-rate fluctuations, underwriting delays, and cancellations. To control exposure to rate movements, management must estimate the percentage of the rate-committed pipeline that is expected to close in the current economic environment.

Although estimation techniques vary, data are generally collected on a number of pipeline characteristics such as product type, whether the loan is a purchase or refinance, and whether it is retail- or wholesale-originated. Fallout behavior can vary depending on these and other factors. Based on this information, management then derives an estimated closing percentage that becomes management's operating target for coverage of the rate-protected pipeline.

Marketing personnel often use simulation modeling to assess fallout percentages, assist in balance-sheet valuations, and develop appropriate hedging strategies. Such models may be either purchased from outside vendors or developed in-house, and they vary greatly in their degree of sophistication. In any event, the primary assumptions and inputs to the model should be reasonable, well documented, and reviewed periodically by both the marketing committee and by an independent source such as an internal or external audit. Results from the marketing simulation model should be provided to management through summary reports. Information may also be provided to bank holding company personnel for asset/liability management purposes.

Other products may also be used to hedge inventory loans and the rate-committed pipeline, particularly loans with an adjustable rate feature or other specialized characteristics. The marketing committee should review and approve all specialized hedge products used, the degree of correlation between the hedge product and the underlying position being hedged, and the degree of risk that each strategy or position entails. The accounting department should also determine whether such products qualify for hedge accounting treatment, establish appropriate management reports, and establish accounting policies. See subsection 3070.0.6, "Mortgage-Servicing Rights."

3070.0.3.4.6 Position Reports

To limit risk, the marketing committee should place prudent limits on the amount of exposure that can be incurred through hedging operations. Limits, which may be contained in the marketing policy, might establish a constraint on the size of uncovered long positions, require that coverage be maintained at the marketing committee's current closure estimates, or establish a constraint based on an earnings-at-risk measurement.

Compliance with limits should be monitored through regular position reports, which should be provided to senior management (the marketing committee and perhaps the treasury function

of the parent company, if they participate in decisions or policy enforcement) at least weekly. Position reports should detail the company's long and short positions in relation to limits, as well as unrealized and realized gains and losses on loans and securities. Department managers generally require daily position reports in order to effectively monitor the position. Marketing position reports may not reconcile directly with reports prepared by the accounting department for financial reporting purposes. Significant differences should be investigated.

3070.0.3.4.7 Counterparty Performance

The marketing committee is also generally responsible for managing investor/counterparty performance risk. The marketing committee (or the treasury department of the parent bank holding company) 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. 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.

3070.0.3.5 Inspection Objectives—Marketing Activities

- To review the types of products developed.
- To determine the pricing strategies offered to borrowers and investors.
- To review pipeline fallout estimation techniques.
- To review hedging methods as they relate to loan production.
- To determine whether information systems are adequate for senior management to monitor fallout behavior and hedge performance.

3070.0.3.6 Inspection Procedures—Marketing Activities

Management Oversight

1. Review the composition of the marketing committee and minutes from recent committee meetings to determine the nature and scope of its responsibilities, the frequency of meetings, and the degree to which oversight over marketing activities is provided.

2. Review the marketing policy as it relates to product offerings, pricing strategies, loan sales, and hedging operations. Are all relevant marketing risks identified? Note the date the marketing policy was last reviewed and approved by the board of directors.

3. Determine how management measures and controls interest-rate risk associated with closed loans in inventory and rate-locked loan applications in the pipeline. How are limits established and quantified (i.e., earnings at risk, economic value of equity at risk, percentage of capital, etc.)? Are such limits reasonable? Evaluate management's oversight of asset securitization activities in accordance with SR-90-16, as applicable.

4. Assess the adequacy of management information systems and related management reports that are designed to track compliance with established policy. Determine the extent to which operational practices adhere to policy. How are exceptions handled?

Securitization and Pooling Practices

1. Determine the secondary marketing programs used to sell mortgages to investors and the volume of sales under each program.

2. Discuss the strategies and procedures used for the selection of mortgage loans for pooling, packaging, and sale. Are there quality control procedures in place to ensure that the files of pooled loans contain complete documentation? What impact does strategy have on departmental profitability?

3. Evaluate the company's securitization practices:

- Determine how much risk the company retains and in what form.
- Determine the source, conditions, and costs of third-party guaranties. Verify that the financial condition of all third-party credit enhancers is substantiated.
- Determine the procedures used to obtain final pool certifications from investors (coordinate with the examiner(s) assigned to the production function). Determine the number and volume of securities that lack final certification. Is management doing everything possible to obtain missing documents? Are problems volume-driven or due to a lack of internal controls?

4. Determine whether loans or securities are sold with recourse. If so, are management information systems in place to track recourse obligations? Are analyses of recourse losses conducted by investor and product type? Are reserves held for recourse loans? What is the methodology for determining the adequacy of reserves? Review actual and potential losses. Are reserve levels adequate to cover identified exposure? Is compensation tied to trading profit?

Unsalability

1. Review the marketing policy to determine whether all mortgage products originated by the mortgage company are intended to be salable in the secondary market (for example, do they conform to guidelines issued by GNMA, FannieMae, FHLMC, or other major investors?). How is actual salability monitored?
2. Determine if mortgage loans that are not salable are generated specifically for the permanent investment portfolio of either the mortgage banking company or its bank or nonbank affiliates.
3. Determine who is responsible for the review of temporarily unsalable loans, the frequency of such reviews, the actions taken to correct documentation and/or credit deficiencies, and if internal controls are adequate. This information is needed to ensure that hedge volumes are accurate.

Pricing Strategies

1. Review the current list of mortgage product offerings and the daily price sheet. Are prices determined centrally and are they uniform? Discuss pricing strategies with management to determine whether the company uses a neutral, above-market, or below-market pricing strategy.
2. Ascertain what procedures are in place to ensure that deviations from the approved pricing policies receive the proper degree of scrutiny and approval by senior management. If such discrepancies are common, why is this occurring (competition, compensation schemes, or departmental profitability considerations)? What impact have such deviations had on production volumes and the company's overall profitability?
3. Determine what policies are in effect regarding customer rate-locks. If a rate-lock expires, is it automatically renewed or is it renegotiated at current interest rates? Are the number and dollar volume of loans with expired rate-locks adequately monitored and tracked?

Fallout

1. Discuss the methodology used to predict the volume of applications that are expected to "fall out" of the mortgage pipeline. Is fallout methodology well documented?

ALCO/Simulation Modeling

1. Determine whether the expected fallout ratio is based on intuition, historical data, or an empirical model. Are assumptions reasonable? Are volatility assumptions based on historical performance or on implied volatility levels in the market? Who is responsible for reviewing model assumptions, and are these individuals sufficiently independent from the process itself? Does management also engage in sensitivity analyses to determine the impact interest-rate fluctuations will have on expected fallout levels?
2. Determine to what extent management uses output from these models in business planning, financial management, and budgeting.
3. Assess the degree to which mortgage banking activities are incorporated into the parent company's asset/liability management reports and program.

Hedging Practices

1. Discuss management's philosophy and strategy to determine the amount of interest-rate risk they are willing to accept. How successful has the company's marketing strategy been over the past few years and how is it changing? What are management's primary sources of market information? Are sources sophisticated enough given the size of the company and the scope of its activities?
2. Review the marketing policy to determine products and strategies used to hedge the interest-rate risk associated with inventory loans and rate-locked loan applications in the pipeline. Review actual hedging practices to determine whether they conform with established policy limitations and guidelines. What percentage of closed loans held in inventory and loan applications in the pipeline are matched against specific investor commitments? How are coverage levels determined and how have they changed over

time? Is the basis for this coverage ratio adequately documented? Determine whether the current coverage ratio exposes the company to undue risk associated with potential marketing losses.

3. Determine the adequacy of management's strategies for hedging loans that have special risks (ARMs with interest-rate caps and floors).

4. Ascertain if basis risk exists for any hedging products, whether such risks are significant, and the impact on correlation. How is basis risk identified, monitored, and controlled?

5. Determine whether call options are written to enhance inventory yields. If so, verify that they are written against covered positions. Determine whether management is speculating in any way and whether this activity subjects the company to undue risk.

6. Obtain profit/loss reports on hedging activities. How frequently are they prepared, how are they used, and to whom are they distributed? Evaluate the financial results of the hedging program over the past three years. Is management taking on excessive risk to record profits in this area?

7. Review management reports relating to pipeline and closed-loan hedging operations. Determine whether such reports are complete, accurate, and timely. Do such reports adequately limit excesses, record exception approvals, and detail risk exposures?

8. Review information provided to executive management and the board to determine whether hedging practices are adequately supervised.

Counterparty Risk

1. Review the marketing committee's list of approved brokers and dealers. Have appropriate dealer limits been established and are such limits adhered to? How are exceptions monitored, reported, and controlled?

3070.0.4 SERVICING/LOAN ADMINISTRATION

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 monthly payments from mortgagors, collects and maintains escrow accounts, pays the mortgagors' real estate taxes and insurance premiums, and remits principal and interest payments to the ultimate investors. The servicer also maintains records for the mortgagor, collects late payments on delinquent accounts, inspects property, initiates and conducts foreclosures, and submits regular reports to investors. Such functions and responsibilities should be documented within a formal written servicing agreement.

3070.0.4.1 Revenue Generation

The right to service mortgage loans 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.

Mortgage-servicing revenues are derived from six sources. The primary source is the contractual servicing fee. Because this fee is usually expressed as a fixed percentage of each outstanding mortgage loan's principal balance, servicing-fee revenues decline over time as the loan balance declines.

The second source of servicing income arises from the interest that can be earned by the servicer from the escrow balance that the borrower often maintains with the servicer for the payment of taxes and insurance on the underlying property. This income may vary, however, as some states require that interest payments on escrow balances be paid to the borrower.

The third source of revenue is the float earned on the monthly loan payment. This opportunity for float arises because of the delay permitted between the time the servicer receives the payment and the time that the payment must be remitted to the investor.

The fourth source of revenue consists of income late fees charged to the borrower if the monthly payment is not made on time. A fifth source is income in the form of commissions that many servicers receive from cross-selling credit life and other insurance products to the borrowers. The sixth and last source is when the servicer might generate fee income by selling mailing lists to third parties.

3070.0.4.2 Cost Containment

Long-term profitability is achieved through cost containment, technological improvements, and economies of scale, which reduce the per-unit cost of servicing. Servicing costs vary widely across institutions depending on portfolio char-

acteristics such as product type, loan size and age, delinquency status, and foreclosure statistics. Nevertheless, two efficiency measures frequently used within the industry to measure cost containment are unit-servicing costs and the number of loans serviced per employee. The minimum size of a loan-servicing portfolio needed to achieve economies of scale varies across institutions and depends on portfolio characteristics and the servicer's expertise and technological capabilities.

Servicing data are available through the Mortgage Bankers Association's publication, "Mortgage Banking Performance Report." Based on detailed financial-statement information from a sample of companies, the report presents a compilation of performance data on all aspects of the mortgage banking industry.

3070.0.4.3 Growth Strategies

Many companies have established aggressive growth targets for their servicing portfolios. The size of the portfolio may be increased through originations, purchases of loans (individual or bulk), or purchased servicing rights. Portfolio size is reduced through normal runoff, prepayments, and sales of either loans or servicing rights only. Management's growth strategy should be examined in light of its expertise and systems capabilities.

3070.0.4.4 Servicing Agreements

The servicer generally operates under a written contract with each investor. This contract, also known as a servicing agreement, establishes minimum conditions for the servicer such as its fiduciary responsibilities, audit requirements, and fees. Contracts may be standardized or tailored to the individual investor.

Under most servicing agreements, the servicer warrants that full principal has been advanced, the mortgage is in fact a first mortgage on the property, and that the first mortgage position will be maintained by the servicer. Additional warranties that are either unwritten or implied may create significant exposure for the servicer.

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.

3070.0.4.5 Recourse Obligations

A servicing agreement may contain specific recourse obligations that go beyond the servicer's customary fiduciary obligations. 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. The risk of recourse should also be discussed with management to assess whether the risk is being identified and effectively managed.

The degree of recourse varies by investor. FannieMae offers either "regular" or "special" servicing options. With FannieMae's regular option, the servicer retains all risk of loss from mortgage default. With FannieMae's special servicing option, the mortgage banking company only retains exposure for normal representations and warranties. FHLMC offers similar servicing options. FannieMae and FHLMC generally limit eligibility for the regular servicing option to participants with the knowledge and financial wherewithal to make good on their recourse obligations.

GNMA servicing carries no contractual recourse. However, in the event of mortgage default, the servicer may have exposure to principal loss and other nonreimbursable expenses, particularly with respect to VA-guaranteed loans. If a borrower defaults on a VA-guaranteed loan, the VA can exercise a "no-bid" put option, which allows the VA to pay out its guaranty and leave the property with the servicer for disposition.

When a borrower defaults on a VA-guaranteed loan, the VA makes a calculation that will guide its decision to accept or reject conveyance of the property. The VA's decision to exercise its no-bid option is based on the net value of loan collateral and the VA's guaranteed percentage of the indebtedness. The mortgage servicer, at its option, could pay down the outstanding principal balance on the loan to a point where the VA would not be expected to exercise its no-bid option. Such "buydowns" result in

additional foreclosure losses for the servicer.

The risk-based capital guidelines require a charge to capital when any risk of loss is retained on such recourse obligations. The charge would be at the bank holding company, the bank, or both,[3] depending on ownership of the risk. For this reason, the accuracy of reported recourse obligations should be verified.

3070.0.4.6 Guaranty Fees

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 mortgage banking company (the servicer) and the timing of the cash flows. A smaller guaranty fee is negotiated when the guarantor assumes less risk or receives payments sooner in the remittance cycle. Remittance cycles vary by investor.

The examiner should discuss with servicing personnel the amount of risk that has been taken on by the marketing department in exchange for reduced guaranty fees. Excessive risk accepted by the mortgage banking company should be incorporated into the assessment of management.

3070.0.4.7 Internal Controls

The servicing process begins after the post-closing review has been completed and the loan has been set up on the mortgage banking company's servicing computer system. Servicers are responsible for adequately safekeeping loan documents. Documents must be stored in a secured and protected area such as a fireproof vault. Servicers must also maintain a tracking system for following up on missing documents.

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 discussed and noted. A discussion of the risks within each operational area, as well as the management reports and internal controls, follows.

- *Loan accounting*. Incoming payments may be processed in-house, through a lockbox, or through some combination of both. Payments are deposited into a clearing account and then transferred to the respective investor custodial bank accounts the next day. Investor remittances may be required daily, weekly, monthly, or as funds are received. In certain cases, servicing agreements may specify that payments be sent directly to security holders. Numerous accounts through which incoming and outgoing payments pass should be reconciled daily to avoid costly processing errors. The reconcilement process should be reviewed with management to ensure that reconcilements are performed on a timely basis and without chronic discrepancies.
- *Escrow administration*. In addition to receiving and remitting payments, servicers are also responsible for paying taxes and insurance on the underlying property. Accurate information must be maintained for each loan regarding a legal description of the property; the appropriate taxing authority, due dates, and amounts for taxes owed; and the insurance provider and due dates and amounts for insurance owed. Failure to maintain such information may result in missed tax and insurance payments on the property, which may lead to penalties and/or lapsed insurance coverage. The servicer's record of tax penalties paid over the past several years should be reviewed to determine whether a problem exists in this area.

  Escrow account balances should be adequate to meet expected tax and insurance obligations. If the servicer advances its own funds to cover an escrow overdraft, such payments may be capitalized and recorded as a receivable only if the servicer is to be reimbursed by either the mortgagor or the investor. Escrow receivables should be aged, with stale or otherwise uncollectible receivables charged off.

  Escrow accounts should be analyzed at least annually, with a copy of the analysis sent to the mortgagor. Shortages (overdrafts) may be billed or spread out over 12 months.

3. If at the bank, then it is also consolidated at the bank holding company level.

Overages should be returned to the borrower or handled in a manner consistent with federal and state laws and regulations. For loans that were set up without an escrow account, the examiner should verify that adequate information has been obtained from the mortgagor to ensure that taxes and insurance are current.

- *Investor reporting.* Investor remittance and reporting requirements vary greatly. Remittances are contractually arranged. In some instances, the servicer may be required to advance to investors funds that have not yet been received from the mortgagor (for example, cash advances to ensure timely payment of principal and interest). In such cases, a receivable is created on the balance sheet. Receivables relating to investor remittances should be aged in the same manner as escrow receivables and periodically reviewed by a supervisor. Stale or otherwise deemed uncollectible receivables should be periodically charged off in a timely manner.

  Investor reports should include detailed account reconciliations and information on the mortgagor's name, principal balance outstanding, escrow balance, delinquency status of the account, and any foreclosure activity or transfer to the servicer's other real estate owned account. The quality and accuracy of investor reporting should be periodically reviewed by internal or external auditors.
- *Collections, foreclosures, and other real estate (ORE).* Investor requirements also vary concerning contact with delinquent borrowers, forbearance policies, and reimbursement for foreclosure expenses, ORE write-downs, and related losses. Detailed policies concerning collection efforts and foreclosures should be in place and followed. The property should be inspected regularly to ensure that its condition is adequately monitored. Delinquency and foreclosure statistics should be tracked by product type and originator.

  Foreclosures are generally initiated after three full installments are due and unpaid. The servicer notifies the mortgagor of its intent in writing and refers the case to an attorney. Detailed records should be maintained for all expenses that are incurred. If the loan is insured, claims may ultimately be filed against the FHA, VA, or private mortgage insurance (PMI) company. However, it should be noted that certain interest expenses and collection or foreclosure costs are not reimbursable.[4] These expenses are a cost of doing business that must be factored into the servicing fee charged for providing these services.

  The timeframe for taking title on foreclosed property varies widely and is determined by state law. *Once title is taken, the property should be classified as ORE.* Although all ORE is generally managed through a centralized unit, for accounting purposes, ORE may fall into one of two distinct categories: ORE that is owned by the mortgage banking company, and ORE that is serviced on behalf of the investor. ORE that is owned should reconcile to the balance sheet, whereas ORE that is serviced for others is an off-balance-sheet item. ORE appraisal, valuation, and financing policies should be consistent with regulatory policy. In-substance foreclosures and any troubled debt restructurings should be properly identified and accounted for.
- *Payoffs.* Loans are considered "paid off" when the loan matures, the loan is refinanced, or the property is sold. Prior to payoff, the servicer is responsible for sending payoff instructions to the mortgagor. After a loan has been paid off, the servicer makes a satisfaction remittance to the investor or the pool; obtains documentation; cancels the note; and forwards the satisfied mortgage documentation plus an escrow refund check, if applicable, to the mortgagor. A high level of refinance activity may strain payoff personnel's ability to perform this obligation accurately and promptly. Management reports should monitor the level of payoff activity and alert supervisors to operational backlogs, the need to hire temporary personnel, or the need to outsource work to third parties.
- *Customer service.* Poor service may damage the mortgage banking company's business reputation (reputation risk) and ability to originate, sell, and service loans within the community. Because of name recognition, problems in this area may also adversely affect affiliate banks or the bank holding company and its nonbank companies.

  For this reason, servicers should maintain an adequate system for logging, tracking, and responding to customer inquiries and complaints. Management reports should track the volume and disposition of such inquiries and complaints. Inordinate volumes of complaints may be an indication of operational backlogs, inefficiencies, or mishandling of accounts. If this occurs, corrective measures should be

4. For a detailed list of both reimbursable and nonreimbursable expenses, see the agency seller/servicer guides.

initiated immediately.

3070.0.4.8 Data Security/Contingency Planning

The servicing system should be of a complexity and size necessary to accommodate both the current and the projected volume of transactions. Examiners should obtain information on the servicing system in use and any limitations it might pose in terms of future growth plans.

Procedures for maintaining physical security in the workplace, data security, and file backup also should be discussed with management. A contingency plan should describe the use of alternative backup sites, as well as procedures that would be followed to reconstruct altered or destroyed files. Contingency plans should be reviewed and approved at least annually and tested regularly.

3070.0.4.9 Inspection Objectives—Servicing/Loan Administration

1. To assess the adequacy of management oversight of risk through policies and procedures, management information systems and reports, and other internal and external audits, with respect to the following:

- collecting monthly payments from mortgagors
- reporting loan activity and remitting funds to investors
- monitoring escrow account balances
- disbursing property insurance and real estate tax payments
- monitoring delinquencies, initiating collection activities, and initiating foreclosure proceedings in a timely manner

2. To evaluate the level of risk assumed by the mortgage banking company through servicing recourse arrangements.

3070.0.4.10 Inspection Procedures—Servicing/Loan Administration

Management Assessment

1. Obtain an organization chart for the servicing department and resumes for senior management and key staff members. Evaluate management's qualifications and expertise.

2. Review servicing policies and procedures manuals to determine whether reasonable operating standards have been established for each functional area. Also assess whether management reports adequately monitor compliance with established policies and procedures. Determine how exceptions are identified and addressed.

3. Review internal and external audits, quality control reports, and investor audits to determine whether internal controls are functioning effectively.

4. Evaluate safeguards in place for loan documents and determine if an adequate document tracking system exists.

5. Verify that a disaster recovery plan is in place that covers all in-house servicing functions. Verify that backup systems exist should primary systems fail. Determine if backup systems would provide information to substantiate servicing portfolio asset values.

6. Obtain a list of subservicers and vendors, if any, employed to perform servicing functions.

- Determine if a periodic review of services provided by each subservicer is conducted. In addition, the financial condition of each subservicer should be evaluated at least annually.
- Determine whether a contingent operating plan has been established should subservicers and vendors be unable to perform their contractual obligations.

Profitability Analysis

1. Review business line profitability for the servicing department to identify significant trends and/or areas of potential weakness. Discuss and review key efficiency measures such as unit cost and cost per employee.

2. Analyze servicing income and expenses to determine whether operations are profitable and economies of scale are being achieved in line with industry norms:

- Determine whether all direct and indirect costs are included.
- Compare servicing revenues with costs.
- Assess the impact of any bulk servicing purchases or sales on departmental profitability.
- Analyze efficiency in light of management's growth projections.

3. Review servicing portfolio trends and characteristics, including the following:

- investors (GNMA, FannieMae, FHLMC, private)
- recourse provisions
- loan types (30-year fixed, 15-year fixed, ARM, balloon)
- average loan size
- interest rates (particularly those above market)
- remaining contractual life
- projected life
- geographic distribution of mortgagors
- delinquency statistics
- foreclosure statistics
- number of subserviced loans and servicers

Loan Accounting

1. Review with management the procedures for receiving payments from mortgagors and depositing funds into segregated accounts. Determine that the segregation of duties and other controls over custodian accounts are adequate.

2. Review any outstanding advances to investors. Evaluate the collectibility of advances, the timeliness of charge-offs, and the adequacy of reserves.

3. Determine whether outstanding items related to investor account reconciliations are being resolved in a timely manner. Are reconciliations routinely reviewed and approved by a supervisor?

Escrow Administration

1. Review with management the system in place for ensuring the timely payment of taxes, insurance, and other obligations.

2. Review the servicer's method for analyzing the amount and adequacy of escrow account balances, and evaluate its effectiveness. Assess procedures relating to shortages and overages in escrow accounts:

- Determine whether procedures comply with 12 U.S.C. 2609 (RESPA) and to the extent possible with state laws.
- Determine whether the borrower is sent an analysis statement showing the amount of discrepancy, how it occurred, and an explanation of how it is to be corrected.

3. Determine the volume of loans with no escrow requirement and procedures for ensuring that insurance payments and taxes are current.

4. Determine how escrow funds are invested, assess the appropriateness of the investment vehicles, and review management's analysis of yield on escrow funds.

5. Evaluate whether controls are in place to prevent the use of escrow custodial accounts to meet other obligations.

6. Review outstanding escrow advances, and determine if claims for reimbursement are processed in a timely manner. Evaluate the collectibility of outstanding advances and verify that uncollectible advances are charged off in a timely manner.

Investor Reporting

1. Review the list of investors for which servicing is performed.

2. Review servicing contracts to verify that signed, current contracts exist. Discuss with management the nature of any recourse provisions, forbearance requirements, and nonreimbursable collection and/or foreclosure expenses.

3. Review the most recent investor audit reports on the servicing function. Discuss findings with management and evaluate the adequacy of any actions taken to correct deficiencies.

4. Determine whether any servicing contracts have been terminated for cause or are likely to be lost in the near future. Determine the reason for any termination and the extent of any corrective actions taken.

Collections and Foreclosures

1. Review and assess, on a statistical-sample basis, the accuracy and adequacy of loan delinquency reports by product type and originator. Ascertain the reasons for poor or declining asset quality within the servicing portfolio.

2. Review policies and procedures for collecting late payments.

- Determine when collection efforts start once an account becomes delinquent.
- Verify that all attempts at collecting past-due payments are documented, including each date of communication with borrowers, the nature of the communications, and the customers' replies.

3. Select a sample of files for borrowers who are 120 days or more delinquent and determine whether foreclosure proceedings are instituted in a timely manner.

- Determine if borrowers and investors are appropriately notified of the initiation of foreclosure action.
- Verify that contacts with borrowers are documented.
- Determine whether property inspections are conducted in accordance with policy.
- Verify that foreclosure practices comply with FHA/VA/PMI requirements and guidelines.

4. Determine the average foreclosure costs for each product type. Foreclosure costs include inspections, legal and administrative costs in excess of those defined as normal and customary, VA no-bid, and VA write-downs.

5. Obtain a list of loans in foreclosure in which action has been delayed, and determine if the justifications for delay are reasonable.

6. Determine the number and dollar volume of delinquent loans that were purchased from the servicing portfolio (buyouts or buybacks).

- Assess the impact of repurchases on profitability, the appropriateness of this practice, and the accounting procedures for these loans.

7. Discuss with management the effect that negotiated guaranty fees may have on the level of losses associated with foreclosures.

Payoffs

1. Review procedures for payoffs to determine whether—

- payoff instructions are sent to the mortgagor before payoff;
- satisfaction remittances are made to the investor or to the pool, necessary documentation is obtained, notes are canceled properly, and documentation plus any escrow refund checks are sent to the mortgagor in a timely manner; and
- internal controls are in place to ensure that funds are not misappropriated and employee fraud is detected and reported according to policy.

Other Real Estate

1. Determine the number and dollar volume of ORE by geographic location.

- Compare the volume of ORE with historical levels and the industry average for similar-sized servicers.
- Evaluate the impact of ORE on profitability.
- Review the policies and practices for ORE accounting, property supervision, and marketing. Verify that policies are consistent with investor guidelines and regulatory policies.

2. Determine whether ORE parcels are purchased from the servicing unit by the bank holding company or its affiliates.

- Evaluate the controls in place to limit or prevent this practice and the accounting treatment for such loans.
- Verify that information regarding ORE is properly reported to the parent bank or holding company for consolidation into regulatory reports.

Customer Service

1. Review the system for logging, tracking, and responding to customer complaints. Has the volume of complaints grown? Are complaints addressed promptly with any problems resolved in a timely manner?

2. Review the servicer's customer-complaint file to gain more insight into the nature of the complaints. Do complaints suggest that internal policies and procedures are not being followed or that staffing levels are inadequate?

3070.0.5 FINANCIAL ANALYSIS

This section provides the examiner a framework with which to analyze the financial condition of a mortgage banking company. The analysis begins with a review of the mortgage company's balance sheet and income statement. The financial analysis should incorporate a review of primary balance-sheet and income-statement levels and trends, off-balance-sheet assets and liabilities, asset quality, market share and earnings performance, funding sources, liquidity needs, and capital adequacy. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or its parent bank holding company to undue financial risk should be brought to management's attention and documented in page one, Examiner's Comments and Matters Requiring Special

Board Attention. The examiner should focus on items that are either large relative to the company's operations or that may pose undue financial risk. The examiner should also investigate any trends that appear inconsistent with the mortgage banking company's industry peer group, business orientation (such as wholesale versus retail, originations versus servicing, etc.), and future growth plans or with the current economic and interest-rate environment.

Financial-statement presentation may vary across mortgage banking companies. If questions arise, financial-statement presentation and accounting should be reviewed with the company's internal and/or external accountants for propriety. During the review of the financial statements, the examiner should establish whether regulatory reports are prepared accurately. Banks must conform to the reporting requirements of the Commercial Bank Reports of Condition and Income (call report). Bank holding companies and their direct subsidiaries must conform to generally accepted accounting principles (GAAP). Relevant GAAP statements of the Financial Accounting Standards Board include SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," as amended; SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases"; SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities"; SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities;" and SFAS No. 80, "Accounting for Futures Contracts." Other relevant accounting pronouncements are identified in appendix B, Accounting Literature.

The financial analysis should also include an assessment of asset quality, earnings, liquidity and funding, and capital. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or the parent bank holding company to undue financial risk should be brought to management's attention and discussed in the Examiner's Comments and Matters Requiring Special Board Attention.

3070.0.5.1 Balance Sheet

3070.0.5.1.1 Assets

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, mortgage-servicing assets (MSAs) (including mortgage-servicing rights), reserves for loan and other credit-related losses (contra accounts), other real estate owned (OREO), and other assets.

3070.0.5.1.1.1 Mortgage-Related Securities

The examiner should determine whether the accounting treatment for mortgage-related securities reported on the balance sheet is consistent with SFAS 115. SFAS 115 applies to equity securities having readily determinable fair values and to all debt securities. It does not apply to loans purchased.

Under SFAS 115, at acquisition and at each subsequent reporting date, all debt and equity securities that fall under the scope of the statement should be classified into one of the following categories:

- trading securities
- available-for-sale securities
- held-to-maturity securities

Both debt and equity securities can be assigned to the above first two categories. The third classification can only consist of debt securities.

Trading. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value. Debt securities not held to maturity and equity securities that have readily determinable fair values should be classified as trading securities when (1) they are held for short periods of time and (2) they have been acquired with the expectation of a profit from short-term price differences. Securities that are actively traded should be carried at fair value on the balance sheet, with net unrealized gains or losses included in income.

Available-for-sale. Debt and equity securities having readily determinable fair values that are not otherwise classified, as above, should be categorized as available-for-sale and carried at fair value on the balance sheet. Unrealized holding gains and losses should be reported in a separate component of shareholders' equity and should not be included in income.

Held-to-maturity. For a security to qualify as held-to-maturity under SFAS 115, the mortgage banking company must demonstrate the positive intent and ability to hold it until maturity.

3070.0.5.1.1.2 High-Risk Securities

The examiner should also review any high-risk mortgage securities that are on the balance sheet, such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), CMO and REMIC residuals, and stripped mortgage-backed securities (stripped MBSs). See sections 2126.1 and 2190.0.5.

3070.0.5.1.1.3 Mortgage Loans Held for Sale

The examiner should determine whether the accounting treatment for mortgage loans held for sale is consistent with SFAS 65, as amended. Mortgage loans held for sale shall be reported at the lower of cost or market value, determined as of the balance-sheet date.[5] The amount by which the cost exceeds market value shall be accounted for as a valuation allowance. Changes in the valuation allowance shall be included in net income of the period in which the change occurs.

3070.0.5.1.1.4 Mortgage Loans Held for Investment

Mortgage loans held for investment may include loans that (1) do not meet secondary-market guidelines and are therefore unsalable, (2) loans that were repurchased from an investor due to poor documentation and/or improper servicing, (3) loans put back to the mortgage banking company under recourse agreements, and (4) loans intentionally originated for portfolio.

SFAS 65 states that a mortgage loan transferred to a long-term investment classification shall be transferred at the lower of cost or market value as of the transfer date. The securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan and the purchase of an MBS classified as a trading security at fair value. Any difference between the carrying amount of the loan and its principal balance shall be recognized as an adjustment to yield by the interest method.

A mortgage loan shall not be classified as a long-term investment unless the mortgage banking company has both the intent and the ability to hold the loan for the foreseeable future or until maturity. If the ultimate recovery of the carrying amount of the loan is doubtful and the impairment is considered to be other than temporary, the carrying amount of the loan shall be reduced to its expected collectible amount, which becomes the new cost basis. The difference is recognized as a loss. A recovery of the new cost basis shall only be reported as a gain upon sale, maturity, or disposition of the loan.

3070.0.5.1.2 Liabilities

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.

3070.0.5.1.2.1 Repurchase Agreements

A mortgage banking company may finance its mortgage loans or MBSs held for sale by transferring mortgage loans or MBSs temporarily to banks, nonbanks, or other financial institutions under formal repurchase agreements that indicate that control over the future economic benefits relating to those assets and the risk of market loss are retained by the mortgage banking company.

Repurchase agreements can provide a cost-effective method of holding mortgage-backed securities before their sale to investors. Securities dealers repo the securities for a period of 30 to 180 days at a substantial cost advantage to warehouse facilities. Repurchase agreements involve delivery of the security to the dealer with an agreement to repurchase it on a specified date. Upon receipt, the dealer wires the haircut proceeds to the mortgage company. The mortgage company then reduces the amount of its outstanding warehoused loans. If the repo is being handled by the dealer that is arranging the ultimate sale of the security, the amount of that discount should approximate the discount on the sale. If another dealer is involved in the ultimate sale, the haircut may be greater because the security must be repurchased and redelivered to the second dealer. This may also require a rehousing to provide funds to honor the repurchase commitment. Most warehouse lenders allow traditional warehouse lines to be collateralized by individual mortgages and mortgage-backed securities.

A mortgage banking company may use repurchase agreements in conjunction with sales of

5. According to SFAS 65, as amended, the capitalized costs of acquiring rights to service mortgage loans, associated with the purchase or origination of mortgage loans, shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or market value.

loan pools. The company may use repurchase agreements to pledge mortgage loans and/or MBSs as collateral for borrowings. In return, it receives advanced funds against future deliveries. The lenders are repaid through the sales of MBSs. The amount outstandings bear interest for the number of days the funds are outstanding.

Under repurchase agreements, the same loans or MBSs are generally reacquired when they are sold to permanent investors. Mortgages or MBSs may also be transferred temporarily without a repurchase agreement. However, some type of informal agreement generally exists. Mortgage loans and MBSs held for sale that are transferred under either formal or informal repurchase agreements shall be accounted for as collateralized financing arrangements and reported as either mortgage loans held for sale or MBSs classified as trading securities on the mortgage banking company's balance sheet.

3070.0.5.1.2.2 Commercial Paper

Another source of short-term funding is the issuance of commercial paper. In general, commercial paper represents unsecured notes with maturities up to 270 days from the date of sale. Because of its short maturity, proceeds should be limited to current transactions with short-term maturities. Commercial paper proceeds should not be used to fund loans held for sale for a period greater than one year.

Commercial paper can be less reliable than warehouse lines of credit. If commercial paper funding is used, examiners should review related commercial paper backup lines of credit and ratings issued by credit rating agencies. The reason for any rating changes during the prior year should be investigated. Additional guidance on this topic is set forth in sections 2080.05, 2080.1, and 5010.23.

3070.0.5.1.2.3 Revolving Warehouse Lines of Credit

Short-term revolving warehouse credit lines are often used to fund loans held for sale, which is generally the largest asset on the company's balance sheet. Revolving credit lines may be obtained from an affiliate bank, the parent bank holding company, or an unrelated third party.

The extension of credit for a particular loan is paid off when the mortgage lender sells the mortgage loan to a government-sponsored agency such as GNMA, FannieMae, or FHLMC or to a private investor. Lenders who provide warehouse lines of credit typically enter into a warehouse credit agreement with the borrower. Under the agreement, the warehouse lender agrees to extend credit to the mortgage banking company for the purpose of originating loans. The mortgage banking company agrees to repay each extension of credit within the terms of the agreement. Each extension of credit is secured by placing a lien on the originated mortgage loan. The warehouse lender perfects its security interest by taking possession of the original promissory note executed by the borrower, endorsed "in blank," together with an assignment of the mortgage securing the loan. To further protect its security interest, the warehouse lender usually takes the responsibility of delivering the loan package to the secondary market investor for purchase. The investor, in turn, delivers the purchase price of the mortgage directly to the warehouse borrower (mortgage banking company). Each portion of the warehouse line may be priced separately to reflect various levels of risk and the documentation requirements of each.

The details of all credit lines should be specified in formal, written credit agreements. Revolving credit lines may be either unsecured or secured by a lien on the underlying mortgages. Under most secured lines, a formula is used to calculate the borrowing base, which generally consists of cash, cash equivalents, loans held for sale, securities, and a percentage of the mortgage-servicing portfolio less certain short-term indebtedness. Some credit lines require the maintenance of compensating balances.

Internal credit arrangements (conducted either by a mortgage banking subsidiary of a bank or bank holding company) must comply with sections 23A and 23B of the Federal Reserve Act. See sections 2020.1 and 3070.0.7 of this manual.

Examiners should evaluate the adequacy and efficiency of warehouse funding operations. The examiner should determine whether the warehouse lender is of a sufficient size and whether it is well positioned financially to provide adequate lines of credit, as needed. Examiners should ascertain whether funding must be regularly derived from more than one warehouse lender (including whether the warehouse line has to be participated out to other lenders) and whether the lender has proper internal controls to safeguard collateral documents for pool certification. The examiner should also determine what management's contingency plans are for the use of alternative financing sources beyond

standard warehouse lines of credit for backup financing and lower-cost efficiency purposes. Has management (1) explored variations in existing lines of credit to reduce overall borrowing costs and (2) determined what competitor lenders are paying for similar financing facilities?

Procedures should be in place to monitor compliance with all short-term debt covenants. Covenants may limit servicing of loans with recourse, limit total debt to specified levels, and/or require minimum tangible net worth, leverage, and current ratios. Most credit agreements also limit the borrower's financial flexibility if the company's long-term debt ratings decline or the company becomes unrated or if certain events occur related to securities.

3070.0.5.1.2.4 Long-Term Debt

Longer-term assets are more appropriately funded through the issuance of longer-term liabilities or capital. Toward this end, mortgage banking companies may issue medium- or long-term public debt securities (including warrants to purchase debt securities). Debt may be issued in the form of fixed-rate or floating-rate notes with various repayment or redemption terms. Loan agreements should specify all relevant terms and conditions and may contain debt covenants similar to those found in the warehouse funding arrangements.

Long-term debt may incorporate restrictive covenants which limit the company's activities in certain respects. These covenants may set limits on the amount of senior debt outstanding and the minimum amount of liquid net worth (as defined by the documents), and may limit the proportions of specific categories of assets. Such covenants should be reviewed to make certain that they are not too restrictive and that they permit financial flexibility.

3070.0.5.1.3 Equity Capital

Funding is also provided through equity capital, which may be supplemented by capital contributions from the parent company or the direct issuance of equity securities.

3070.0.5.2 Income Statement

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. The examiner may find that gross gain (loss) on the sale of mortgage loans or securities is reported on the income statement net of loan-origination fees and direct loan-origination costs such as personnel and office expenses.

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. Some companies net amortization of MSAs directly against loan-servicing revenues.

3070.0.5.3 Unique Characteristics

The financial analysis should reflect certain operational characteristics that are unique to the mortgage banking industry. Many of these characteristics are cyclical based on interest rates and economic conditions.

For example, the cost of funding loans in the warehouse is relatively inexpensive during periods of low interest rates, but may increase significantly as interest rates rise. Marketing operations are also highly dependent on the interest-rate cycle. During periods of falling interest rates, the company may experience substantial gains on the sale of mortgage loans and securities to permanent investors. Alternatively, during periods of rising interest rates, the company will usually experience losses on the sale of mortgages and securities. Interest-rate volatility can cause large fluctuations in warehouse funding costs and marketing gains and losses.

The examiner should also consider the impact of current economic conditions on the size and composition of the mortgage banking company's balance sheet. When the economy expands, loan volume increases and the overall size of the balance sheet tends to grow. During recessions, the balance sheet should contract, reflecting the lower demand for new loans. Management's planning efforts should incorporate this type of economic trend analysis in their growth targets. Steady annual growth may or may not be anticipated.

Efficiency measures, such as activity ratios (inventory turnover and efficiency ratios), should be used to determine management's ability to originate and sell loans efficiently. The inventory of loans held for sale is transitory, lasting between 45 to 60 days. A buildup of loans on the balance sheet may indicate processing delays and/or asset-quality problems that may prevent their ultimate sale to permanent investors. Because of the transitory nature of the balance sheet, traditional leverage ratios (asset-to-equity capital) may not be meaningful and should be used sparingly.

Another unique characteristic of a mortgage banking company is the economic value of its mortgage-servicing operations, which constitutes an off-balance-sheet item. Failure to incorporate this economic value into the financial analysis may overstate the degree of financial leverage that is employed within the company.

3070.0.5.4 Asset Quality

The quality of assets that are on the balance sheet is evidenced by the following: compliance with original underwriting standards; the existence of effective loan review and quality control programs; borrower payment and agreement performance; the fair value of MBSs held for sale or investment; the collectibility, independent valuation, nature, volume, and existence of recorded assets; the application of GAAP in accounting for the assets; and the degree of protection afforded by real estate mortgage collateral, including any private mortgage insurance. The value afforded by real estate mortgage collateral includes the extent of compliance with the Federal Reserve Board's real estate appraisal regulations and guidelines. (See section 2231.0.) Asset quality should be analyzed in terms of regional and national economic factors as well as portfolio and managerial factors.

For any review of any loan portfolio, a sampling of real estate appraisals should be included to determine whether the appraisal results reasonably support the amount loaned. If the property appears to be overappraised or if there is a problem with the appraisal (for example, the appraisal is obsolete or the validity of the appraisal is in question), the examiner should consider recommending that a new appraisal be performed.[6] It may be necessary for the examiner to classify the loan (i.e., as a loss) and for the parent holding company to increase its allowance for loan and lease losses.

Bank holding companies and/or their nonbank subsidiaries should be criticized if initial appraised values appear to be inadequate and/or not properly supported by proper documentation. If corrective action is not taken by management, formal enforcement action should be considered. Such actions may require the bank holding company to revamp its appraisal activities and/or collection procedures and, if warranted, to retain the services of an independent appraiser to conduct an evaluation of loan collateral.

With respect to MBSs, the quality characteristics of the underlying mortgage collateral should be considered. If the securities are backed by GNMA, FannieMae, or FHLMC, the rating agencies consider such securities to be the highest quality asset because of their linkage to the federal government. If the collateral consists of unsecuritized mortgages, the examiner should consider the geographic dispersion, type of mortgage and property, underwriting standards, and term to maturity of the underlying pool of mortgage loans. External factors can affect the value of mortgage securities directly, such as the default or downgrading (by a credit rating agency) of a private mortgage insurer.

To a large extent, insurance and guaranties provided by government-sponsored agencies and other third parties (for example, private mortgage, bankruptcy protection, fraud, and mortgage pool insurers, as well as performance bond insurers and other guarantors) mitigate credit risk for an originator; however, the originator still remains responsible for the quality of loans sold to investors for at least the first 90 days, as well as for any loans sold under recourse arrangements. As a servicer, the company also can be held liable if it does not initiate collection and foreclosure actions in strict accordance with investor-servicing agreements. In addition, certain interest losses and expenses relating to collections, foreclosure, and ORE are not fully reimbursable and should be anticipated.

The mortgage banking company must maintain adequate management reports to measure and track the quality of originated, purchased, and serviced assets. Proper administration over loans and other assets held for sale or investment requires the use of aging and other tracking reports. For assets held for sale, the reports should identify loans and other marketable assets,

6. For certain credits, the bank holding company should develop criteria for obtaining reappraisals or revaluations as part of a prudent portfolio review and monitoring program.

other than marketable securities,[7] that have been in this category longer than 60 days. In such instances, a determination should be made as to whether credit quality problems and/or documentation deficiencies exist that will prevent the timely sale of the loan in the secondary market. If problems are not correctable within a reasonable timeframe, the loans and other related assets should be revalued and transferred to the held-for-investment category. Procedures governing the valuation and transfer of poor-quality assets should be in writing and should be followed.

The MIS should also generate for management's review reports on the delinquency status of loans held for investment and loans serviced for investors. Such reports provide an early warning system and an analysis tool to evaluate internal collection activities. If a loan becomes delinquent (30 days or two payments past due), the borrower should be contacted. Collection efforts should be strengthened if the delinquency continues. If the loan becomes severely delinquent, foreclosure proceedings should be initiated consistent with the investor-servicing agreement, and the value of the collateral supporting the loans should be assessed. Anticipated shortfalls should be recognized as losses in a timely manner.

MIS should also include an internal loan-grading system, which tracks the borrower's ability to meet its monthly payment obligations. Although MIS should be tailored to meet management's needs, information should be consistent with loan-grading systems that are used by the controlling bank holding company and federal bank regulatory agencies. Reports should also track collection and foreclosure actions initiated by the servicer and repurchase requests initiated by a permanent investor or other third party.

Examiners should also verify that appraisal practices are consistent with the Board's appraisal regulations,[8] the interagency appraisal and evaluation guidelines (see SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-99-26), and any other state and federal laws and regulations. Mortgage banking companies that are subsidiaries of either state member banks or bank holding companies are subject to the same appraisal standards and requirements as their parent companies.

3070.0.5.4.1 Classification Procedures

The classification process begins with an analysis of delinquent loans. The examiner should begin by obtaining an aged listing of all delinquent loans in the held-for-sale and the held-to-maturity portfolios. Clear-cut shortfalls in property values compared with loan or investment values should usually be classified unless there are mitigating circumstances. Usually loans or investments with doubtful or loss elements have other significant weaknesses that will ordinarily justify a classification of substandard for the remaining balance. Loans secured by collateral such as real estate should be classified in accordance with these guidelines and the applicable classification guidance found in sections 2060.1 and 2090.1 of the *Commercial Bank Examination Manual* and sections 2010.2, 2065.1, 2240.0, and 5010.10 of this manual.

Portions of these loans may warrant a more severe classification if the value of the underlying collateral is insufficient to fully repay the loan. The identification of potential or actual loss exposure may warrant the use of either a split (substandard and loss) or a doubtful rating.

The examiner should also review the ORE portfolio, notes and accounts receivable, and other investments on the company's balance sheet for potential classifications. ORE may usually warrant a substandard classification due to an investment's nonearning status and an increased probability of loss on disposal of the underlying assets.

Assets that represent illegal or impermissible holdings or those that are subject to some regulatory concern should not be classified, per se, for these factors. Such holdings should be treated separately within the report. In those instances where a credit-quality issue is also present, the classification and the separate treatment should be cross-referenced.

The examiner should also review any off-balance-sheet exposure for which credit risk is retained. Loans sold to investors on a recourse basis have the potential of being put back to the servicer. The portion of the recourse portfolio that is severely delinquent should be classified according to the guidelines provided previously, since the exercise of this "put option" is highly likely.

At the end of the classification process, the examiner should evaluate the level and trend of classified assets to determine whether asset quality poses undue financial risk to the mortgage

7. For mortgage-backed securities available-for-sale, similar account classification procedures apply, but those are accounted for in accordance with SFAS 115.

8. See Regulation Y, subpart G (12 C.F.R. 225.61–67), and its incorporation by reference into Regulation H (12 C.F.R. 208.18).

banking company or its parent bank holding company. A list of total classifications should be compiled and left with management.

As part of the analysis of asset quality, the aggregate of loss classifications plus an amount expected to ultimately be loss should be compared with the existing allowance for loan and lease losses. If the aggregate exceeds the existing contra asset balance(s) then additional loan-loss provisions are needed. In such situations, the parent company should be advised of the deficiency and reminded of its responsibility to ensure that an adequate allowance for loan and lease losses, as well as other contra asset valuation balances, is maintained by the subsidiary for its asset portfolio.

Any discrepancies between the classifications list and information contained on the company's MIS should also be discussed with management. If asset quality presents undue or excessive risk, appropriate comments should be documented and brought forward on Examiner's Comments and Matters Requiring Special Board Attention, page one of the report.

3070.0.5.4.2 Presentation of Classifications

As a minimum standard, brief write-ups stating the reason for classifications should be provided for any nonbank subsidiary's asset whose doubtful and/or loss classification exceeds the lesser of $100,000 or 5 percent of the subsidiary's total assets. In general, substandard assets should be listed without a write-up, regardless of size. However, a brief write-up is required for any asset whose classification is challenged by management. The examiner has the option to provide a write-up for any classified assets, regardless of size.

While the following presentation guidelines may be useful in structuring the write-ups, the examiner may include any other format appropriate to the situation:

- recapitulation of the status and purpose of the loan, the lien position, type and appraised value of the collateral, its delinquency and accrual status, guarantors and other debit or credit balances related to the loan
- the problems with the loan, borrower, or collateral, presented in a concise, descriptive narrative
- the examiner's evaluation of the situation, indicating estimated values, major assumptions, and mitigating or negative factors
- the classification, which should represent a logical combination of the relevant factors presented in the first three elements

Within the elements presented, the examiner should stress accuracy, brevity, and clarity in the presentation, as well as a logical pattern leading to the classification. Historical information and financial data that are not pertinent or that are too stale to have a direct bearing on the present situation should not be included.

Presentations for OREO properties need not include the original loan date, history, and financial information, unless there is some relevance to the current condition (for example, the property has been foreclosed on for the second time or some circumstance before foreclosure continues to have an impact). For those companies in which numerous loans and OREO properties are classified, a summary of classifications, segmented by loans and real estate owned and indexed to the pages containing the classifications, presents clear benefits to the users of the report. This becomes more pertinent when numerous assets below the write-up line are included in total classifications. In addition, both management and the subsequent examiners will have an official listing of the classifications.

3070.0.5.4.3 Reserves

Management should establish and maintain adequate contra asset allowances and other contingency reserves to cover identified loss exposure. Policies and procedures, and financial statement disclosures, should clearly state the purpose of and intended accounting treatment for each reserve. Management should evaluate the level of each reserve account at least quarterly, document this analysis, and replenish each reserve as necessary.

The financial presentation for reserves varies. Reserves maintained for on-balance-sheet exposure are generally reported as a contra asset. Reserves maintained for contingent liabilities relating to the sale of loans and servicing of loans for investors may be shown as a liability in practice.

Disclosures relating to valuation reserves should be consistent with GAAP. Examiners may wish to confer with the mortgage banking company's external auditors regarding the nature or appropriateness of any reserve accounts that are unusual.

3070.0.5.5 Earnings Performance

Earnings performance should be assessed in terms of the level, composition, quality, and trend of net income. The earnings analysis should consider internal factors such as the company's business orientation and management's growth plans, as well as relevant external factors such as interest rates and economic trends.

Unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, provisions for losses, salaries and overhead items, or income taxes should be discussed with management, as well as with internal or external auditors. Large write-downs or amortization adjustments relating to mortgage-servicing rights should also be investigated. (See section 3070.0.6.)

Current and historical ratio trend analysis, compared with published industry results (for example, see the Mortgage Bankers Association's annual statistics in the ''Mortgage Banking Performance Report''), should also be incorporated into the profitability analysis, where appropriate. This includes income structure, expense structure, and operating performance ratios. However, ratios that compare earnings to average assets or equity may be of limited use unless the examiner also considers the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage. Finally, 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).

3070.0.5.6 Liquidity and Funding

Management's ability to satisfy the company's liquidity needs and plan for contingencies without placing undue strain on affiliate bank or nonbank resources or reliance on the parent bank holding company is crucial. Liquidity needs depend on the size of the warehouse, the nature and extent of longer-term assets, opportunities to issue debt at a reasonable price, and management's ability to forecast and plan for contingencies. Liquidity is often dependent on cash generated through short-term liquid assets and on short-term borrowings to fund operations. Earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity plans are all significant factors in the evaluation of liquidity. Liquidity can quickly erode if investor perceptions of a company's credit standing change. Consequently, the ability to fund mortgage operations under economic duress and access to alternate liquidity sources become key considerations.

Funding needs are driven by the need to temporarily finance mortgage loans and MBSs before their sale to a permanent investor. The examiners should do a trend review of external liquidity to assess how easy it is to sell mortgage-backed securities by the firm in the secondary market. The analysis should include the normal trading volume in MBS securities, the volume of loans held for sale and their market value, and the size of the ''floating'' supply of mortgage securities or loans that are not closely held. Liquidity needs must also take into consideration longer-term assets such as fixed assets, mortgage-servicing rights, and permanent loan and MBS portfolios. (See section 2080.05.)

3070.0.5.6.1 Financial Flexibility

The liquidity analysis should include a determination as to the company's financial flexibility. Financial flexibility is the ability to obtain the cash required to make payments as needed. 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 capital markets.

3070.0.5.6.2 Cash-Flow Analysis

The liquidity analysis should also include a review of the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. The examiner's analysis of cash flows may reveal transactional trends between cash inflows and outflows. For example, within the Cash Flows from Operating Activities, cash flow from the sale and principal repayments on mortgage loans held for sale may correlate with originations and purchases of mortgage loans available for sale. With regard to investing activities, attention should be given to the differences between short-term purchases of mortgage loans held for investment versus

principal repayments on mortgage loans held for short-term investment. In addition, purchases of real estate owned from the loan-servicing portfolio may correlate with net sales of real estate owned. A review of the financing activities should indicate if there is sufficient cash flow provided from revolving warehouse lines of credit, commercial paper, proceeds from the issuance of any other short-term debt, and net changes in advances payable to affiliates.

The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity. When analyzing liquidity, the examiner needs to consider the principles and guidelines set forth in section 2080.05, "Funding (Bank Holding Company Funding and Liquidity)" of this manual.

3070.0.5.6.3 Asset/Liability Management

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. Management's asset/liability management program should be evaluated in terms of the degree of matching, risk aversion, and the accuracy of information that is provided to the holding company through daily, weekly, or monthly management reports.

3070.0.5.7 Capital Adequacy

Capital must be adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by third-party creditors and investors. At a minimum, a mortgage banking company must meet the nominal capital levels required by investors such as FannieMae ($250,000) or FHLMC ($1 million, based on financial reporting under GAAP, or $500,000, adjusted for certain assets and any deferred-tax liability). Additional capital is required based on the outstanding principal balance of loans serviced for investors. If these requirements are not met, the company may not be able to sell mortgages to and/or service mortgages for these investors.

As noted above, these are minimum capital requirements. Management should identify the level of capital that is required to support current operations and projected future growth, given the risk tolerance preferences of management and the board. Capital levels, dividend payments, and capital planning should be addressed in a written capital plan that is reviewed and approved by the board at least annually in conjunction with the budgeting and strategic planning activities.

There also may be a need to meet minimum leverage ratios established by the parent bank holding company or to meet debt covenants set forth in either warehouse credit facilities or long-term debt instruments. Companies that have excessive off-balance-sheet risk or high growth expectations may require additional capital. In addition, risk-based capital guidelines impose certain reporting requirements and limitations regarding the amount of MSA mortgage banking companies may include in their regulatory 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. Management and the board are further encouraged to adopt a capital policy that specifically addresses the particular needs of the company.

The examiner should evaluate capital adequacy, the amount of dividends that are upstreamed to the parent bank holding company, and the extent to which the parent company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. In some instances, the parent company may operate on the premise that the mortgage banking company requires little capital of its own as long as the parent company remains adequately capitalized.[9] Under the Federal Reserve's source-of-strength doctrine, the parent company must be prepared to support its subsidiaries should the financial need arise. If the parent is not prepared to inject capital and capital levels have declined, the examiner should comment on the mortgage banking company's extended leveraged position on page one of the inspection report. Under extreme circumstances, the examiner should also recommend that its leverage be reduced and its capital structure augmented to ensure that mortgage operations are conducted in a safe, sound, and prudent manner.

9. When MSAs are valued for inclusion in capital, the risk-based capital guidelines for banks and BHCs require the discount rate to be not less than the original discount rate inherent in the intangible asset at the time of its acquisition, based on the estimated future net cash flows and price paid at the time of purchase.

3070.0.5.8 Overall Assessment

The overall financial condition of the mortgage banking company should reflect its financial statement presentation, asset quality, earnings, liquidity and funding practices, and capital adequacy. Report comments should be prepared to the extent necessary.

3070.0.5.9 Inspection Objectives

1. To evaluate the financial condition of the mortgage banking company based on a review of the following:

- primary balance-sheet and income-statement levels and trends
- off-balance-sheet exposure such as the servicing portfolio
- asset quality
- earnings performance
- funding sources and liquidity needs
- capital adequacy

2. To determine the accuracy of regulatory reporting (regulatory accounting practices (RAP) and GAAP) and compliance with applicable state and federal laws and regulations.

3. To evaluate the quality of the mortgage banking company's assets for collateral sufficiency, performance, credit quality, and collectibility.

4. To assess earnings performance through the analysis of the level, composition, and trend of net income. If material, interest income, impairment of mortgage-servicing assets, gains and losses on asset sales, and personnel and other expenses should be factored into the analysis.

5. To assess the funding and liquidity needs of the mortgage banking company through ratio analysis and a review of the funding instruments used.

6. To assess capital adequacy by ensuring that investor minimum requirements are met and by comparing capital levels with peer and industry data. Consideration of the capital needs of the individual mortgage banking company should override any comparison with peers.

3070.0.5.10 Inspection Procedures

Financial Statement Level and Trends

1. Review the mortgage banking company's financial statements and related notes over the previous three-year period.

2. Discuss significant balance-sheet and income-statement categories with management, as well as with internal and external auditors.

3. Determine whether financial trends are consistent with the economic environment, interest-rate movements, the company's business orientation, and management's intended growth strategy.

4. Determine whether reports filed with regulatory agencies are prepared accurately and submitted in a timely manner, with particular attention paid to the reporting for mortgage-servicing assets and recourse obligations retained by the mortgage banking company.

Asset Quality

1. Spread past-due and nonaccrual loans by balance-sheet asset category (for example, mortgage loans held for sale, mortgage loans held for investment), product type, and delinquency status (for example, 31–90 days, 91–180 days, and 181 days and over). Include any loans in the process of foreclosure.

2. Obtain a trial balance and delinquency listing for loans held for sale and loans held for investment.

a. Reconcile balances of the real estate held for sale and investment to the respective general ledger accounts.

b. Classify severely delinquent loans as required based on the financial condition of the borrower, his or her inability to make monthly payments as required, and the protection afforded by current collateral values.

c. Determine accounting policies and practices with respect to these loans. Review aging reports for loans held for sale and for investment. Discuss the frequency of reviews for loans held for sale, revaluation practices, and transfers among accounts. Verify that accounting practices are consistent with GAAP and RAP.

3. Obtain a listing of loans in the process of foreclosure and bankruptcy and discuss these with management for potential classification.

4. Reconcile all other real estate owned by the mortgage banking company to the general ledger and classify based on risks and any income-producing characteristics of the properties. Compare current appraisals to carrying value for potential write-downs.

5. Obtain a list of loans sold under recourse

arrangements and assess for potential classification.

6. Discuss the methodology used to establish foreclosure reserves and related accounting procedures. Review analysis used to project future foreclosures.

- Evaluate the adequacy of foreclosure reserves based on the volume of projected foreclosure actions, average foreclosure costs, and the past history of reinstated loans.

7. Review other reserve accounts and assess for reasonableness.

Earnings Performance

1. Assess earnings performance in terms of the level, composition, and trend of net income. Consider internal factors, such as the company's business orientation and management's growth plans, and external factors, such as interest rates and the economic environment, when evaluating earnings trends.

2. Discuss any unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, reserves, write-downs or adjustments in MSA amortization, salaries and overhead items, or income taxes with management, as well as with internal or external auditors.

3. Incorporate ratio and industry comparisons into the earnings analysis, where appropriate. Bear in mind that ratios that compare earnings to total assets or equity are of limited use unless the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage are taken into consideration.

Liquidity and Funding

1. Determine the mortgage banking company's liquidity needs based on a review of the size of its warehouse and the nature and extent of other longer-term assets.

2. Determine whether sources of liquidity are adequate, both under current conditions and economic duress. Consider earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity-planning capabilities.

3. Evaluate financial instruments used to fund mortgage operations. Financial instruments may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and/or long-term debt. Review related credit agreements and systems used to monitor compliance with debt covenants.

4. Establish whether excessive borrowing activities have led to a highly leveraged financial condition that exposes the company to money market changes in the cost of funds. Evaluate the impact a change in the company's cost of funds would have on its net interest margin and earnings.

5. Determine the degree of financial flexibility the company maintains. Financial flexibility is the ability to obtain the cash required to make payments as needed. Does the company possess adequate financial strength and have access to lines of credit and/or assets that can be easily collateralized?

6. Review the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. Determine whether sufficient positive cash flow exists from the level of current transactions. The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity.

7. Review asset/liability management practices to determine whether funding maturities closely approximate the maturities of underlying assets or whether a funding mismatch exists. Is the company exposed to short-term interest-rate fluctuations that may lead to significant earnings volatility in the event that interest rates change rapidly?

Capital Adequacy

1. Determine whether capital levels are adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by investors whose loans are serviced and other external parties.

2. Review policies and procedures to determine whether management adequately monitors and reports capital levels to the board of directors. Review the capital plan to determine whether it adequately addresses the particular needs of the company.

3. Evaluate the amount of dividends that are upstreamed to the parent bank holding company, as well as the extent to which the parent

company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. Is the parent company prepared to support its subsidiaries should the financial need arise? Are cash dividends paid by the mortgage banking subsidiary to the parent company reasonable?

Accounting

1. Review accounting procedures for retail loans. Determine whether loan fees in excess of cost are deferred in accordance with SFAS 91. Verify that income is recognized over the estimated life of the asset and not in the current period and that fees and costs are allowable under SFAS 91. Are controls in place to ensure proper recognition for net fee income when loans are sold? (SFAS 91 applies to loans held in portfolio, as well as to loans swapped for securities when the securities are retained.)

2. Determine if the accounting for recognizing sales of loans and mortgage-backed securities (including participation agreements) is in accordance with the three conditions for true sales recognition specified in SFAS 77, ''Reporting for Transfers of Receivables with Recourse.''[10] Also determine if the sales price was adjusted for all probable adjustments (as defined in SFAS 5, ''Accounting for Contingencies''). If the mortgage banking company is a subsidiary of a bank, refer to the bank call report, glossary entry on ''sales of assets.''

3. If servicing is retained, determine if a ''normal servicing fee'' is set and how it conforms to FannieMae/FHLMC fees and to FASB Technical Bulletin 87-3, ''Accounting for Mortgage-Servicing Fees and Rights.''[11] If the mortgage banking subsidiary is a subsidiary of a bank, see the reporting instructions for Schedule F of the bank call report (Schedule RC-F for Other Assets, Item 3—Excess residential mortgage-servicing fees receivable).

Overall Financial Condition

1. Evaluate the overall financial condition of the mortgage banking company, considering its asset quality, earnings, liquidity, and capital adequacy. Update the financial component of the supervisory rating and prepare report comments as necessary.

3070.0.6 MORTGAGE-SERVICING ASSETS AND LIABILITIES

This subsection discusses mortgage-servicing assets (MSAs) and liabilities and provides guidance with respect to the measurement, impairment testing, and financial reporting requirements of MSAs. The subsection concludes with a discussion of MSA hedging practices and instruments.

SFAS No. 125 ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' was issued in June 1996 as an amendment to SFAS Nos. 65, 76, 77, and 115. The provisions of SFAS 125 supersede SFAS 122 and are to be applied prospectively in fiscal years beginning after December 31, 1996. The statement requires that a liability be derecognized when either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor.

Under SFAS 125, 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. 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

10. A transfer is recognized as a sale if—

a. The transferor surrenders control of the future economic benefits of the receivables;

b. The transferor's obligation, under the recourse provisions of the sale agreement, can be reasonably estimated. The transferor should have had past experience with the recourse provisions so that a reasonable estimate can be made. The current transferred receivables should possess characteristics similar to previously transferred receivables evidencing the transferor's relevant prior experience.

c. The transferor cannot require the transferee to repurchase the receivables, except as stated in the agreement's recourse provisions.

11. According to FASB Technical Bulletin No. 87-3, the servicing-fee rates set by GNMA, FHLMC, and FannieMae in servicing agreements should be considered a normal servicing-fee rate for transactions with those agencies. If the normal service fees are expected to be less than the estimated servicing costs, the expected loss should be recognized at the time the loans are sold. If a seller/servicer sells mortgage loans directly to private-sector investors and retains servicing on the loans, the seller/servicer should consider the normal servicing-fee rate that would have been specified in comparable servicing agreements if the loans had been sold to or securitized by one of the federally sponsored secondary market makers. As of May 1995, normal servicing-fee rates established by GNMA, FHLMC, and FannieMae were 44, 25, and 37.5 basis points, respectively.

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. 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.

3070.0.6.1 Measurement

A mortgage banking company initially acquires MSAs either by (1) purchasing the right to service mortgage loans separately or (2) purchasing or originating mortgage loans and selling those loans with servicing rights retained. When a mortgage banking company purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related MSAs.

With respect to SFAS 125, when an entity incurs an obligation to service financial assets, it must record servicing assets or a servicing liability for each servicing contract, unless it securitizes the assets and retains all of the resulting securities, classifying them as debt securities that are to be held to maturity. When servicing assets or liabilities are assumed, rather than being acquired by a sale or undertaken in a securitization of the financial assets that are to be serviced, they are measured initially at fair value (that is, the price paid). A servicing asset or liability is amortized in proportion to and over the period of estimated net servicing income (loss). Any impairment of a servicing asset or liability is determined based on fair value.

When the mortgage banking company sells or securitizes the loans and retains the MSAs, management shall allocate the total cost of the mortgage loans (the recorded investment in the mortgage loans including net deferred loan fees or costs and any purchase premium or discount) to the MSAs and the loans (without the MSAs) based on their relative fair values if it is practicable to estimate those fair values. If a mortgage banking organization undertakes a servicing liability in a sale or securitization, the servicing liability should initially be measured at fair value.

The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for measurement, if available. If quoted market prices are not 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 the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved; option-pricing models; matrix pricing; option-adjusted spread models; and fundamental analysis. Valuation techniques for measuring MSAs should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates. If it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs), the entire cost of acquiring the mortgage loans shall be allocated to the mortgage loans (without the MSAs) and no cost shall be allocated to the MSAs.

The amount capitalized as MSAs shall be amortized in proportion to and over the period of estimated net servicing income. Estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental-cost basis.

MSAs are highly subject to interest-rate and prepayment-rate risk since the amount of future cash flows that are provided to the holder is derived from, and is thus dependent on, the outstanding balances of the underlying mortgage loans.[12] Prepayments of underlying mort-

12. Several conventions exist for quantifying prepayment speed. The most common convention is a measure developed by the Public Securities Association (PSA). The PSA measure was based on actual historical experience of FHA mortgages, but it is not predictive. The PSA measure assumes that mortgages prepay at a rate of .2 percent per year in the first month, increase by .2 percent each subsequent month up to 30 months, and remain at 6 percent per year thereafter until maturity. This 6 percent level is referred to as 100 percent PSA. Mortgages that prepay at 200 percent PSA pay off twice as fast as a mortgage that is performing at 100 percent PSA. Another convention is known as the conditional prepayment rate (CPR) measure. CPR assumes that a constant fraction of the

gage loans accelerate during periods of declining interest rates as borrowers take advantage of the option they hold to refinance their loans. As interest rates decline, holders of MSAs are exposed to a risk of prepayment of the underlying loans, and thus a diminished amount of cash flow from their investment. Holders of interest-only stripped securities (I/O strips) are exposed to similar interest-rate and prepayment risks when interest rates decline. I/O strips possess very similar prepayment risk characteristics.

A particular mortgage company's exposure to prepayment risk can also be influenced by portfolio composition factors such as geographical mix, loan-to-value ratios, and the proportion of government (FHA/VA) and conventional loans in the portfolio. Government loans that may be assumable by the purchaser of a home are generally for smaller amounts and may be extended to borrowers with limited financial resources. As a result, government loans tend to prepay more slowly than conventional loans.

Unanticipated changes in interest rates, 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.

3070.0.6.2 Impairment Testing

SFAS 125 states that a mortgage banking company shall measure impairment of capitalized MSAs[13] based on their fair value. For the purpose of evaluating and measuring impairment of capitalized MSAs, management should stratify those assets based on one or more of the predominant risk characteristics of the underlying loans.[14] Those characteristics may include loan type, loan size, note rate, date of origination, term, and geographic location.

Impairment shall be recognized through a valuation allowance for an individual stratum. The amount of impairment that is recognized shall be the amount by which the capitalized MSAs for a given stratum exceed their fair value. The fair value of MSAs that have not been capitalized shall not be used in the evaluation of impairment.

Subsequent to the initial measurement of impairment, management shall adjust the valuation allowance to reflect changes in the measurement of impairment. Fair value in excess of the capitalized MSAs shall not be recognized. If the fair value of a mortgage-servicing liability increases above the book value, the increased obligation shall be recognized as a loss in current earnings. SFAS 125 does not address when a mortgage banking company should record a direct write-down of capitalized MSAs; therefore, examiner judgment in this area is required.

3070.0.6.3 Disclosures

SFAS 125 requires that the fair value of capitalized MSAs, and the methods and significant assumptions used to estimate that fair value, be disclosed. If no cost is allocated to certain MSAs, management shall describe those MSAs and describe the reasons why it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs). The risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment shall also be disclosed. For each period for which results of operations are presented, the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances shall be disclosed.

3070.0.6.4 Intercompany MSAs

Intercompany MSAs may arise when a mortgage banking company originates loans, sells the loans to an affiliate bank, and the affiliate bank records related MSAs. Intercompany MSAs should be evaluated closely to determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has

remaining principal is prepaid each period, "conditional" on the previous period's remaining balance. Typically, CPR is computed over a one-month time period. The PSA model simply represents a series of stable CPR assumptions.

13. The term "capitalized mortgage-servicing rights" refers to the cost originally allocated to the MSAs less the amount amortized.

14. SFAS 65, as amended, applies to impairment evaluations of all capitalized MSAs. However, a mortgage banking company may continue to apply its previous accounting policies for stratifying MSAs to MSAs that were capitalized before the adoption of the amendments to SFAS 65.

revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

3070.0.6.5 Table Funding

One method of acquiring mortgage loans, and recording related MSAs, is through so-called "table-funding arrangements." In a table-funding arrangement, the mortgage banking company provides the original funding when a mortgage broker or correspondent closes the mortgage loan with the borrower. Concurrent with the loan closing, the mortgage banking company acquires the loan and the related MSAs.

Emerging Issues Task Force Issue No. 92-10 (EITF 92-10), "Loan Acquisitions Involving Table Funding Arrangements," clarified under what conditions these arrangements could be characterized as loan purchases. According to EITF 92-10, a mortgage banking company may account for a loan acquired in a table-funding arrangement as a purchase only if *all* of the following conditions are met:

- The correspondent is registered and licensed to originate and sell loans under the applicable laws of the states or other jurisdictions in which it conducts business.
- The correspondent originated, processed, and closed the loan in its own name and is the first titled owner of the loan, with the mortgage banking company becoming a holder in due course.
- The correspondent is an independent third party and not an affiliate of the mortgage banking company as defined in SFAS 65. As a nonaffiliate, the correspondent must bear all of the costs of its place of business, including the costs of its origination operations.
- The correspondent must sell loans to more than one mortgage banking enterprise and not have an exclusive relationship with the purchaser.
- The correspondent is not directly or indirectly indemnified by the mortgage banking company for market or credit risks on loans originated by the correspondent. However, a commitment by the mortgage banking company for the purchase of loans from the correspondent is not considered to be an indemnification for purposes of this requirement.

If any one of the above criteria is not met, the mortgage banking company must account for the loan as an origination. MSAs that were recorded before the adoption of the SFAS 65 amendments should be reviewed to ensure that they were originated and funded consistent with the above requirements. MSAs that are recorded under SFAS 125 may arise in connection with either originated or purchased mortgage loan transactions.

3070.0.6.6 Regulatory Reporting

The examiner should also determine whether the method used to value MSAs is in accordance with the instructions for the Bank Report of Condition and Income (call report) and the BHC reporting instructions (FR Y-9C). If capitalized MSAs are not appropriately valued, they cannot be included in capital. Management should review the carrying amount at least quarterly, adequately document this review, and adjust the book value as necessary.

3070.0.6.7 Risk-Based Capital

Readily marketable MSAs may be included in a bank or bank holding company's tier 1 capital subject to certain limitations. Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and limited qualifying cumulative perpetual preferred stock.[14a] Tier 1 capital excludes goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, exceed 25 percent of tier 1 capital;[15] all other identifiable intangible assets; and deferred-tax assets that are dependent upon future

14a. Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.

15. Amounts of MSAs, non-MSAs, and PCCRs in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital requirements in determining tier 1 capital. Identifiable intangible assets, however, exclusive of MSAs and PCCRs, acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes. They will, however, continue to be deducted for applications purposes.

taxable income, net of their valuation allowance, in excess of certain limitations.

The amount of MSAs which may be included in capital is also limited to the *lesser* of—

- the amount recorded on the balance sheet under GAAP, or
- 90 percent of their fair market value. If both the application of the limit on MSAs and the adjustment of the balance-sheet amount for MSAs would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

3070.0.6.8 Previously Recognized Excess Servicing-Fee Receivables

SFAS No. 125, "Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (paragraph 20), addresses the accounting treatment for excess servicing-fee receivables based on contracts that were in existence before January 1, 1997. Previously recognized servicing rights and excess servicing-fee receivables are to be combined, net of any previous servicing obligations under the contract, as a servicing asset or a servicing liability. Any previously recognized excess servicing-fee receivables that exceed contractually specified servicing fees are to be reclassified as interest-only strips receivables.

3070.0.6.9 MSA Hedging Practices and Instruments

During the refinancing waves of 1992 and 1993, several mortgage banking companies experienced large losses due to the impact of rising prepayments on the value of servicing rights. As a result, many companies have begun to hedge MSAs. An effective hedge program should reflect a solid understanding of the underlying MSA risk characteristics.

3070.0.6.9.1 Hedging Practices

Interest-rate and prepayment-rate risk are often reduced through the natural offset between the production and servicing functions; however, the degree of protection afforded by this relationship depends on the company's business orientation (originations versus purchases) and can be very difficult to measure.[16] Other financial instruments are also used to mitigate interest-rate and prepayment-rate risks. The remainder of this subsection discusses existing hedge accounting guidance and rudimentary descriptions of certain customized MSA hedge products. Examiners should also refer to the Federal Reserve System's *Trading Activities Manual* for additional guidance on derivatives.

3070.0.6.9.2 Hedge Accounting

Existing accounting literature is vague with respect to the accounting treatment for MSA hedge products, particularly in the area of derivatives. However, analogies exist that facilitate the application of existing accounting standards. SFAS No. 80, "Accounting for Futures Transactions," provides financial reporting standards for exchange-traded futures contracts on both interest-rate products and raw materials (commodities). Several EITF issues releases provide financial reporting guidance for interest-rate swap transactions. Finally, an issues paper prepared by the American Institute of Certified Public Accountants (AICPA), "Accounting for Options," provides informal but nonauthoritative guidance relating to options contracts. The AICPA issues paper addresses options on all tangible goods, including both exchange-traded options and nonexchange traded options on interest-rate caps and floors.

To qualify for hedge-accounting treatment under SFAS 80, a financial instrument must meet two criteria:

- The hedged item exposes the entity to price or interest-rate risk.
- The financial instrument used as a hedge reduces that exposure and is designated as a hedge.

SFAS 80 states that at the inception of the hedge and throughout the hedge period, changes in the market value of the financial instrument used as a hedge should correlate highly with changes in

16. When interest rates fall, increases in production volumes and related revenues tend to offset runoff in the servicing portfolio and reductions in servicing-fee income. Alternatively, to the extent that the marketing department hedges less than 100 percent of its estimated long position (closed loans plus rate-locked loans that are expected to close) and interest rates fall, the resulting marketing gains on the uncovered position tend to offset a portion of any required write-downs in the servicing portfolio.

the fair value of, or interest income or expense associated with, the hedged item(s) so that the results of the financial instrument(s) used as a hedge will substantially offset the effects of price or interest-rate changes on the exposed item(s). Although required correlation levels are not specifically defined, the accounting industry has determined that 80 percent is a reasonable benchmark.

Before claiming hedge-accounting treatment, management must obtain an opinion from its CPA or internal accountant confirming that the instrument that is proposed would qualify for such treatment. If these criteria are not met, the financial instrument should be carried at its market value (i.e., marked to market). Hedge performance should be monitored daily and reported to the responsible management or board committee at least quarterly.

3070.0.6.9.3 Relevant MSA Characteristics

To evaluate a mortgage banking company's hedge program for MSAs, one must first understand how MSAs perform. Duration, convexity, and amortization are useful concepts that will be reviewed as they relate to MSAs. Duration measures the change in the value of MSAs (or their cash flows) for a given change in interest rates. Duration can be either positive or negative. An asset with a positive duration, such as a fixed-income bond, tends to increase in value as interest rates fall. Conversely, an asset with a negative duration, such as an MSA, tends to decrease in value as interest rates fall.

Convexity measures the rate of change in an instrument's duration, or the nonlinearity of its price/yield curve. Like duration, convexity can be either positive or negative. An asset with a positive convexity will rise more in value for a given change in interest rates than it will fall if interest rates move equally in the opposite direction. Conversely, an asset with a negative convexity will decline more in value for a given change in interest rates than it will increase in value if interest rates move equally in the opposite direction. Because of their prepayment characteristics, MSAs and most other mortgage-related assets are negatively convex within a specified range of interest rates. Borrowers can be expected to exercise their option to prepay a loan at a time that is most disadvantageous to the MSA holder.

MSAs are also an amortizing asset. When a prepayment occurs, the loss of value is permanent and cannot be recovered. The use of a nonamortizing asset as a hedge would necessitate an active hedge-management strategy to adjust the position as the unamortized balance of the MSAs declines. If the position is not adjusted correctly, this strategy may expose earnings and capital to additional risks that are not within the scope of the company's MSA hedge program.

3070.0.6.9.4 Hedge Instruments

An effective MSA hedge instrument will possess characteristics that mitigate the interest-rate and prepayment risks associated with MSAs without assuming additional basis risk. Basis risk measures how well changes in the value of the hedge instrument correlate to changes in the value of the MSA. An effective hedge should also be reasonable in terms of transaction costs and management's time.

Several types of specialized derivative products have evolved to meet the needs of mortgage banking companies. Early MSA hedge products were interest-rate-driven, utilizing zero-coupon Treasury bonds or interest-rate swaps. However, the basis risk of such hedges proved to be excessive. Next came principal-only (PO) and super-principal only (SPO) bonds, which were prepayment-driven.[17] However, these products also proved ineffective due to geographic basis risk, potential average-life mismatches, additional capital requirements, and dissimilar accounting treatment which led to accounting losses.

MSA hedge products generally fall into three categories: bond hedges, short-term option hedges, and long-term option hedges. Bond hedges use Treasury bonds, ''plain vanilla'' interest-rate swaps, interest amortizing rate swaps, positive convexity swaps, POs, and SPOs. Bond hedges may be either interest-rate-driven or prepayment-rate-driven. Prepayment-rate-driven products reduce more basis risk and are therefore more expensive. Although most bond hedges are positively convex, they fail to provide enough positive convexity to offset the negative convexity in MSAs. In other words, when interest rates decline, the value of the bond hedge will not increase in an amount sufficient to offset the simultaneous decline in the MSAs. Another disadvantage to bond hedges is that the downside

17. A special class of REMIC securities backed by POs. SPOs are a more leveraged type of PO.

risk is generally unlimited.

Short-term option hedges consist of over-the-counter (OTC) Treasury options, options on futures contracts, and options on OTC mortgage securities. Short-term option hedges generally contain enough positive convexity to offset the negative convexity of MSAs, and the downside risk is limited to the option premium paid at inception. However, option strategies using these products require frequent rebalancing, are therefore expensive, and do not work well in a rapidly changing interest-rate environment because they are not amortizing assets.

Long-term option hedges include prepayment caps, interest amortizing rate (IAR) servicing hedges, LIBOR floors, and swaptions. These products may protect the servicer and/or seller against changes in either interest rates or prepayments. As off-balance-sheet products, they impose very few capital constraints on the MSA holder.

A prepayment cap is an off-balance-sheet, prepayment-driven option product that can be used to hedge a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a payment from the counterparty every month that the option is ''in the money.'' The option is in the money if the difference between the ''strike balance'' and the actual balance of a ''reference portfolio,'' less the sum of previous balance differences, is positive. Each month the option is in the money, the counterparty will pay the ''strike price,'' usually the book cost of the servicing portfolio, multiplied by this balance shortfall. The reference portfolio, strike price, and strike balance can be customized to match the servicer and/or seller's risk parameters and individual portfolio.

An IAR servicing hedge is an off-balance-sheet, interest rate–driven option product that can be used as either a revenue or a balance-sheet hedge of a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a series of payments from the counterparty to the extent that amortization of a ''reference balance'' exceeds scheduled amortization of a ''strike balance.'' The main difference between an IAR and a prepayment cap is that with an IAR, option payments are based on the performance of a ''reference portfolio'' rather than the seller and/or servicer's actual portfolio. For an IAR revenue hedge, the option payout is based on the current balance shortfall between the reference and strike balances. For an IAR balance-sheet hedge, option payouts are based on the cumulative excess amortization of the reference balance over the strike balance. IAR hedges are less expensive than comparable prepayment-linked hedges because they contain basis risk. If actual prepayments occur more rapidly than predicted at the onset of the hedge, the servicer and/or seller will be underhedged.

Numerous other types of customized hedge products are available. The advantages and disadvantages of each product should be well understood before it is incorporated into a mortgage banking company's interest-rate risk management strategies.

3070.0.6.10 Inspection Objectives

1. To determine whether MSAs pose a significant financial risk to earnings and capital.
2. To evaluate management's expertise and the oversight provided by the board of directors.
3. To determine whether policies and procedures used to initially record, amortize, and reevaluate MSAs are in conformance with GAAP and risk-based capital requirements, and whether actual practice is consistent with stated policies and procedures.
4. To verify that asset values are fairly stated.
5. To evaluate the methods used to hedge interest-rate and prepayment risks associated with MSAs, the degree of oversight provided by management or the board of directors, the adequacy of written policies and procedures, and the effectiveness of the company's hedge program for MSAs.
6. To identify any excessive risk-taking which is caused by the company's business mix and/or strategy.

3070.0.6.11 Inspection Procedures

1. Determine the extent of financial risk associated with MSAs through a review of the following:

a. Significant changes in the size of the servicing portfolio. Obtain a reconciliation for the servicing portfolio for the prior fiscal year and the most recent interim period. If significant growth has occurred, determine whether loans were originated, purchased individually (on a flow basis), purchased in bulk transactions, or acquired through whole company acquisitions. If the portfolio size has declined, determine the reason for such decline (sales of servicing rights,

prepayments) and the impact on the remaining servicing portfolio.

b. The proportion of capitalized MSAs relative to the outstanding principal balance of mortgage loans in the servicing portfolio.

c. Other unusual characteristics of the servicing portfolio that may present undue risk, such as the weighted average coupon rates, weighted average maturities, delinquency characteristics, or mix of government (FHA/VA) loans versus conventional loans.

If the level of financial risk is sufficient to place earnings and capital at risk, the examiner should complete the remainder of the MSA procedures.

2. Review the qualifications of the individuals who are responsible for initially recording, amortizing and evaluating MSAs. Does management possess the necessary accounting expertise and experience with respect to valuation methodologies?

3. Review the accounting systems used to track MSAs. Is the necessary information being maintained in an understandable and useable form? Does the adoption of SFAS 65, as amended, and 125 pose any system problems for the company? Are such problems being addressed in a timely manner? At a minimum, MSAs should be tracked by product type and year of origination. The following information should be maintained for each pool of loans: the original and current principal balance for each pool; original and current book values of related MSAs; prepayment speeds, normal servicing fees, and the original discount rate used; and the actual historical payment experience for each pool.

4. Review written policies and procedures for initially recording, amortizing, and periodically revaluating MSAs. Determine the management or board committees responsible for approval of such policies, the date of last approval, and the frequency of their review.

5. Determine whether MSA policies and procedures are in conformance with GAAP and risk-based capital requirements and whether actual practice conforms with established policies and procedures. At a minimum, policies and procedures should clearly address the following areas:

a. Initial valuation of MSAs and related pricing policies. With respect to MSAs, policies and procedures should describe the method for allocating the total cost of originated and purchased mortgage loans to the MSAs and the related loans (without the MSAs) based on their relative fair values at the date of origination or purchase; procedures to be followed if a definitive plan for sale of the loans does not exist and loans are sold at a later date; procedures to be followed in the event that it is not practicable to estimate the fair value of the MSAs and the related loans (without MSAs); and MSAs recorded under table funding relationships with correspondents and/or brokers.

b. The method for amortizing MSAs over the estimated lives of the assets, and instances where amortization lives may be adjusted.

c. The method for measuring impairment of capitalized MSAs based on their fair value. Policies and procedures should address the basis for stratification of MSAs based on the risk characteristics of the underlying loans; the types of valuation allowances used to reflect changes in the measurement of impairment; the method used to arrive at the fair value of assets (quoted market prices, estimated prices for similar assets, and the results of valuation techniques); the frequency of revaluation tests; the presentation of valuation test results to senior management and the board of directors; instances where write-downs would be required; disclosures; and the basis for assumptions used.

6. Verify that the valuation techniques for measuring MSAs are consistent with the objective of measuring fair value. Review model output and related manuals and/or marketing materials. Evaluate the reasonableness of all key parameters and assumptions, with an emphasis on the source for prepayment speed estimates, the number of interest-rate ''paths'' used (vectoring or binomial models being more desirable than a single interest-rate projection path), the basis for the interest rate used to discount cash flows, and the source of servicing revenue and cost data.

7. Review the most recent quarterly valuation process and the related output to determine whether necessary write-downs or amortization adjustments were made, management or board oversight was adequate, and actual practice is consistent with established policies and procedures. Ensure that any significant changes to the model's parameters and/or output are approved by the appropriate management or board committee and that such changes are adequately documented.

8. Verify that disclosures are accurate with respect to the following:

- the fair value of capitalized MSAs
- the methods and significant assumptions used to estimate that fair value
- a description of MSAs for which no cost

has been allocated and the reasons why it is not practicable to estimate the fair values of those MSAs and the mortgage loans (without the MSAs)
- the risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment
- the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period; aggregate additions charged and reductions credited to operations; and aggregate direct write-downs charged against the allowances

9. Obtain a list of intercompany MSAs as of the close of business for the most recent quarter-end. Determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

10. Review policies and practices regarding the sale of MSAs and liabilities to investors.

11. If the company sells loans with recourse, are recourse reserves established at the time of sale? Are estimated losses factored into the calculation of gain/loss on sale of loans?

12. Obtain an organizational chart to determine the individuals responsible for hedging MSAs. Review biographies to ensure that staff members responsible for this function are knowledgeable regarding accounting guidance, hedge products, and related strategies.

13. Review methods used to hedge the interest-rate and prepayment-rate risk associated with MSAs. Verify the management or board committee responsible for approving hedge instruments, the list of approved products, and the frequency and date of last review.

14. Review management reports to determine the correlation between hedge instruments and the underlying assets, the accounting treatment for hedges, related gains and losses, and the overall effectiveness of the company's hedge program. If hedge accounting treatment is being used, management and/or the company's external accountants must perform the appropriate level of due diligence and maintain adequate supporting documentation. In determining the effectiveness of the hedging program, the examiner should compare the actual results of hedge performance with the expected results.

15. Evaluate the quality of information that is communicated to senior management, the board of directors (if applicable), and the parent company's senior management and board of directors to determine whether management and directors are adequately informed regarding the financial risks associated with MSAs, amortization methods and hedging techniques, and the degree of risk inherent in the company's strategic focus and business mix with respect to the projected volume of MSAs.

3070.0.7 INTERCOMPANY TRANSACTIONS

A mortgage banking company that is organized as a nonbank subsidiary of a bank holding company often sells assets to, receives funding from, or services loans for its bank affiliates. Given the trend toward managing mortgage banking activities as a line function rather than by legal entity, such intercompany transactions have become an area of heightened supervisory concern.

In general, sections 23A and 23B of the Federal Reserve Act are designed to prevent a bank from being disadvantaged through the purchase of low-quality assets from an affiliate, the pressure to fund the majority of an affiliate's working-capital needs, and intercompany transactions that either inadequately compensate the bank or are not conducted on an arms-length basis.

3070.0.7.1 Section 23A of the Federal Reserve Act

Section 23A was enacted as part of the Banking Act of 1933 (the Glass-Steagall Act) for state member banks and later extended to all federally insured banks.[18] Section 23A defines companies that control or are under common control with the bank as affiliates of the bank. For example, the term ''affiliates'' includes bank holding companies and their subsidiaries as well as banks and nonbanking companies that are under common individual control.[19] The two

18. As originally enacted, the Banking Act of 1933 covered only member banks. In 1966, Congress amended section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. 1828(j), to extend the coverage of section 23A to include insured nonmember banks. As a result, section 23A now applies to all federally insured banks. (12 U.S.C. 371c)

19. Nonbank subsidiaries of banks, as opposed to nonbank subsidiaries of bank holding companies, are not affiliates for purposes of section 23A, unless the Board of Governors of the Federal Reserve System determines otherwise. Banks that are

primary aspects of section 23A—quantitative restrictions and collateral requirements—are discussed next.

3070.0.7.1.1 Quantitative Restrictions

The quantitative restrictions imposed by section 23A generally limit the aggregate amount of so-called "covered transactions" to 10 percent of the bank's capital and surplus for transactions with a given affiliate, and 20 percent of the bank's capital and surplus for transactions with all of its affiliates.[20] Covered transactions include—

- a loan or extension of credit by a bank to an affiliate, such as a warehouse line of credit provided to the affiliate;
- the purchase of or investment in securities such as a privately issued MBS issued by an affiliate;
- the purchase of assets from an affiliate, such as a loan purchased either as an accommodation to a bank customer or for the bank's asset/liability management purposes;
- the acceptance by a bank of securities issued by an affiliate as collateral for a loan or extension of credit by the bank to any person or company (Securities might include either the stock of a publicly held affiliate or the stock from one of its officer's own business enterprises.); or
- the issuance by a bank of a guaranty, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate (A letter of credit might be posted by the bank to cover an excessive number of GNMA pools that lack final pool certification.).

The examiner should determine the bank's method for identifying covered transactions and applying the quantitative limits for section 23A purposes. If a covered transaction is found that exceeds these quantitative limits, either on an individual or an aggregate basis, an apparent violation of section 23A has occurred. All such apparent violations of law should be discussed with management and cited in the report.

Particular attention should be paid to intercompany asset transfers and funding arrangements to determine whether they constitute covered transactions under section 23A. In Interpretation 250.250 (12 C.F.R. 250.250)[21] the Board determined that a member bank's purchase, without recourse, and at face value, of a mortgage note, or a participation therein, from a mortgage banking subsidiary of the parent bank holding company, which had no financial interest in the underlying asset on which it had granted credit through the note, did not involve a "loan" or "extension of credit"[22] from the member bank to the seller of the mortgage note within the meaning of section 23A if—

- the member bank's commitment to purchase the loan or participation therein was obtained by the affiliate within the context of a proposed transaction or series of proposed transactions in anticipation of the affiliate's commitment to make such loan(s),
- the commitment to purchase the loan was based on the bank's independent credit evaluation of the creditworthiness of the mortgagor(s),[23] and
- there could be no blanket advance commitment by the member bank to purchase a stipulated amount of loans that bore no reference to specific proposed transactions. Accordingly, the nonbank affiliate must have adequate and independent working capital to fund its operations.

The Board stated that if the bank followed these procedures, then the bank would be taking advantage of an individual investment opportunity and thus should be exempt from section 23A. However, the Board was concerned that the bank should not be allowed to set up a business relationship with any affiliate which could create the opportunity for the bank, at some time in the future, to engage in unsafe transactions because the bank felt impelled by an improper incentive to alleviate the working-capital needs of the affiliate. Accordingly, the bank's transactions with the affiliate should not be of such a volume as to create pressure on the bank to relax its sound credit judgment concerning the individual loans involved and thereby

part of a chain banking organization are subject to the restrictions of section 23A.

20. For section 23A purposes, the definition for capital and surplus includes the allowance for loan and lease losses.

21. See also *Federal Reserve Regulatory Service*, 3–1133.

22. Under section 23A, as amended by the Garn–St Germain Act in 1982, a member bank's purchase of a loan from its nonbank affiliate that was made to an unaffiliated party is now considered a purchase of an asset from the affiliate unless it is excepted under interpretation 250.250.

23. Dual employees may not be used to satisfy the independent credit evaluation requirement.

result in an inappropriate risk to the soundness of the bank.

3070.0.7.1.2 Collateral Requirements

In addition to the quantitative restrictions, certain covered transactions between a bank and an affiliate must also be secured at the time of the transaction by collateral having a certain market value. Unless otherwise exempted, covered transactions that must be adequately secured include loans or extensions of credit, guaranties, acceptances, and letters of credit issued on behalf of the affiliate.

Collateralization requirements range from 100 percent to 130 percent depending on the type of collateral used. Acceptable forms of collateral include U.S. government or U.S. government–guaranteed obligations, instruments that are acceptable at the Federal Reserve's discount window, bank deposits that are segregated into accounts specifically earmarked for this purpose, other debt instruments, stock, leases, or other real or personal property. According to an August 31, 1987, Board interpretation (at FRRS 3–1164.3), mortgage-servicing rights do not constitute a permissible form of collateral for purposes of section 23A because of (1) their inherent volatility, making it difficult to accurately value the rights, and (2) the need to secure permission to transfer servicing rights from the legal owner of the underlying mortgage.[24]

An example of a covered transaction that is subject to both the quantitative restrictions and the collateral requirements of section 23A would be an overdraft in the mortgage company's checking account with an affiliate bank, which is considered an extension of credit. A line of credit by a bank to a nonbank affiliate also constitutes a covered transaction. It is important to remember that the full value of the line, not just the portion drawn down, must satisfy the quantitative and the collateral requirements of section 23A at all times. The examiner should review checking accounts and funding arrangements to ensure that the appropriate level and type of collateral is maintained. Collateral values should be monitored regularly so that depreciated or matured collateral is replaced as needed.

3070.0.7.1.3 Prohibited Transactions

In addition to the quantitative and collateral requirements, section 23A also prohibits certain affiliate transactions altogether. Most importantly, a bank and its subsidiaries may not purchase a low-quality asset (generally a classified or past-due asset) from an affiliate or accept a low-quality asset as collateral for a loan. Section 23A also requires that all covered transactions be conducted on terms that are consistent with safe and sound banking practices.

3070.0.7.1.4 Exemptions from Section 23A of the FRA

As mentioned previously, several types of intercompany transactions are exempted from the requirements of section 23A. For example, transactions between banks in which 80 percent or more of each bank's stock is owned by the same bank holding company (so-called "sister banks") are exempt from most provisions of section 23A.[25] Other transactions that are exempt include the following:

- deposits received from the affiliate during the ordinary course of business (checks in the process of collection)
- immediate credit given to an affiliate for uncollected items received in the ordinary course of business
- loans, extensions of credit, guaranties, acceptances, or letters of credit issued on behalf of the affiliate that are fully secured by obligations issued or guaranteed by the U.S. government or a segregated earmarked account in the bank
- the purchase of assets having a readily and identifiable market price at the time of purchase
- transactions that are deemed to be in the public interest and consistent with the purposes of the act

Internal controls should be in place to ensure

24. Item (2) refers to the bank's ability to sell the mortgage-servicing rights if the affiliate defaults on its loan.

25. Foreign banks do not qualify as sister banks for section 23A purposes. These transactions are still subject to the prohibition against the purchase of low-quality assets and to the requirement that covered transactions be on terms and conditions that are consistent with safe and sound banking practices. It should also be noted that federal savings banks do qualify for the sister-bank exemption if all banks in the corporate chain have met their fully phased-in capital guidelines, as provided for in the Home Owner's Loan Act.

that all transactions are adequately reviewed. Documentation should be maintained for intercompany transactions that are exempted from the requirements of section 23A.

3070.0.7.2 Section 23B of the Federal Reserve Act

The Competitive Equality Banking Act of 1987 amended the Federal Reserve Act to add a new provision, known as section 23B. In general, section 23B provides that covered transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If no comparable transactions exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonaffiliated companies. A bank is also generally prohibited from purchasing as a fiduciary securities or assets from an affiliate except under specified circumstances. Finally, a bank and its affiliate may not advertise or enter into an agreement that suggests the bank is in any way responsible for the obligations of the affiliate.

Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A. However, section 23B excludes banks from the term "affiliate." Therefore, transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B.

3070.0.7.3 Management and Service Fees

The Federal Reserve System's 1979 policy statement on diversion of bank income practices is intended to prevent excessive or unjustifiable management or service fees, as well as any other unwarranted payments or practices that, by diverting bank resources to the parent company or a nonbank affiliate, may have an adverse financial impact on a subsidiary (paying) bank (see section 2020.6). Diversion of income practices with respect to a mortgage banking company might potentially include, but are not limited to—

- servicing fees, or other payments assessed by the mortgage banking company and paid by the bank that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the nonbank subsidiary in its role as servicer and/or seller;
- balances maintained by the bank primarily in support of mortgage banking company borrowings without appropriate compensation to the bank;
- prepayment of fees to the mortgage banking company for services not yet rendered;
- nonreimbursed origination fees, marketing costs, or other expenses incurred by the bank that primarily support the mortgage banking company's activities; and
- loan repurchase agreements between the bank and the mortgage banking company while the mortgage banking company is processing loans in the mortgage pipeline.

Purchase and funding agreements should adequately itemize and document the types of services provided and the basis for fees. Billing statements and other documentation should clearly evidence that fees actually charged and paid are reasonable and consistent with regulatory policy requirements as described.

3070.0.7.4 Tie-In Considerations of the BHC Act

Section 106 of the BHC Act Amendments of 1970 contains five restrictions intended to prohibit anticompetitive behavior by banks: two prohibit tying arrangements; two prohibit reciprocity arrangements; and one prohibits exclusive dealing arrangements.[26] The tying restrictions, which have the greatest effect on industry practices, prohibit a bank from restricting the availability or varying the consideration for one product or service (the *tying product*) on the condition that a customer purchase another product or service offered by the bank or by any of its affiliates (the *tied product*).

Section 106 was adopted in 1970 when Congress expanded the authority of the Board to approve proposals by bank holding companies to engage in nonbanking activities. The provisions of section 106 were based on congressional concern that banks' unique role in the economy, in particular their power to extend credit, would allow them to create a competitive advantage for their affiliates in the new, nonbanking markets that they were being allowed to enter.[27]

26. 12 U.S.C. 1972.
27. See S. Rep. No. 1084, 91st Cong., 2d Sess. (1970).

Congress therefore imposed special limitations on tying by banks—restrictions beyond those imposed by the antitrust laws. Section 106 is a broader prohibition; unlike the antitrust laws, a plaintiff in action under section 106 need not show that (1) the seller has market power in the market for the tying product, (2) the tying arrangement has had an anticompetitive effect in the market for the tied product, or (3) the tying arrangement has had a substantial effect on interstate commerce.

Section 106 applies only when a *bank* offers the tying product.[28] The Board has authority to grant exceptions to section 106, which it has used to allow banking organizations to package their products when doing so would benefit the organization and its customers without anticompetitive effects.

3070.0.7.4.1 Section 225.7(d) of Regulation Y

The Board originally extended section 106, which covers tying arrangements by *banks* only, to cover nonbank affiliates and bank holding companies. The Board rescinded this extension of the statute effective April 21, 1997. Thus, unless subject to another exemption, section 106 *prohibits*—

- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from the bank; and
- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from an affiliate of the bank.

Section 106 and the Board's regulation allow—

- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from an affiliated bank; and
- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from a nonbank affiliate.

These distinctions make sense if one keeps in mind the concern of the statute: banks (*not* nonbanks) have special power over credit and, thus, are able to induce or coerce their customers into purchasing products that they would otherwise prefer not to purchase or to purchase from someone else.[29]

3070.0.7.4.2 Interaffiliate Tying Arrangements Treated the Same as Intrabank Arrangements

Section 106 contains an explicit exception (the *statutory traditional bank product exception*) that permits a bank to tie any product or service to a loan, discount, deposit, or trust service offered by that bank.[30] For example, a bank could condition the use of its messenger service on a customer's maintaining a deposit account at the bank. Although the statutory traditional bank product exception appears to have been effective in preserving traditional relationships between a customer and bank, the exception is limited in an important way—it does not extend to transactions involving products offered by affiliates.

The Board has adopted a *regulatory traditional bank product exception* that extends the statutory exception to transactions involving affiliates.[31] Although the Board has previously limited the scope of this extension, interaffiliate arrangements are now exempt to the same extent as intrabank arrangements.[32]

3070.0.7.4.3 Foreign Transactions Under Section 106

The Board has adopted a "safe harbor" from the anti-tying rules for transactions with corporate customers that are incorporated or otherwise organized and that have their principal place of business outside the United States, or with individuals who are citizens of a foreign country and are not resident in the United States. However, the safe harbor would not protect tying arrangements in which the customer is a U.S.-incorporated division of a foreign company. Furthermore, the safe harbor would not

28. See 1997 FRB 275.

29. The Board's rule also includes a limited prohibition on tying arrangements involving electronic benefit transfer services (12 C.F.R. 225.7(d)).

30. 12 U.S.C. 1972(1)(A).

31. See 12 C.F.R. 225.7(b)(1).

32. A similar action was taken for interaffiliate reciprocity arrangements, in which section 106 permits a bank to condition the availability of a product or service on the customer's providing to the bank some product or service "related to and usually provided in connection with" a loan, discount, deposit, or trust service (12 U.S.C. 1972(1)(C)).

shelter a transaction from other antitrust laws if they were otherwise applicable.[33]

3070.0.7.4.4 Technical Change

The Board also has adopted a definition of ''bank'' for purposes of the anti-tying rules. The definition clarifies that any exemptions afforded to banks generally also would be applicable to credit card and other limited-purpose institutions and to U.S. branches and agencies of foreign banks.[34]

3070.0.7.5 Inspection Objective

1. To evaluate transactions between a mortgage banking company organized as a direct subsidiary of a bank holding company and affiliated banks for compliance with federal laws and regulations, and related policy guidance.

3070.0.7.6 Inspection Procedures

1. Review management's method for monitoring and identifying section 23A and 23B covered transactions and applying the quantitative limitations. Determine whether—

a. all covered transactions have been identified;

b. quantitative limits are calculated correctly;

c. covered transactions, including any overdrafts and lines of credit, meet both the quantitative limits and collateral requirements of section 23A; and

d. adequate collateral values have been maintained over the life of the covered transactions (For example, collateral is maintained for the full amount of any credit lines with the bank, and any depreciated or matured collateral has been replaced as required.).

2. Review purchase and funding contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine that—

a. asset purchases by the bank are either within the quantitative limits of section 23A or meet the exemption requirements of C.F.R. section 250.250,

b. all purchases are at fair market value and consistent with market terms as required by section 23B,

c. no low-quality assets were transferred to the bank since the previous inspection,

d. the method of compensating the bank for balances maintained and net interest income earned on warehouse loans or lines is reasonable and based on market terms.

3. Review servicing contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine—

a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?);

b. the nature of all services provided; and

c. billing arrangements, the frequency of billing, the method of computation, and the basis for such fees.

4. Review the bank holding company's policy statement on the prohibition of tie-in arrangements, the adequacy of training provided to employees, and whether its respective subsidiaries are in full compliance with internal policy.

3070.0.8 REGULATION Y COMPLIANCE

During the course of the on-site inspection, the examiner is expected to conduct sufficient tests and inquiries to determine whether the company is in compliance with Regulation Y and the act. Such tests and inquiries would include a listing of company offices which can be compared with the approved offices, comparisons of credit-related insurance policies and rate schedules against stipulated public benefits cited in Board orders, and reviews of various activities for technical compliance.

While not specifically detailed in this guidance, the examiner may find it necessary to conduct a review of the company's ledgers and accounts that is sufficient to disclose possible impermissible activities and potential violations of law. The audit function, both internal and external, should not be solely relied on for this disclosure because the auditor's program may emphasize other areas of concern. As a nonbank subsidiary of a bank holding company, reference should be made to part 225 of the Code of Federal Regulations (such as section 225.28(b) of Regulation Y) and other relevant sections thereof.

Concurrent with the review of assets for credit quality, the examiner should undertake a review

33. See 12 C.F.R. 225.7(b)(3).
34. See 12 C.F.R. 225.7(e).

of asset-related activities for compliance with the subsidiary's approval orders. In mortgage banking firms, it is possible that the company is engaging unknowingly in certain impermissible activities, such as those described by 12 C.F.R. 225.126 (i.e., real estate brokerage, land development, real estate syndication, and property management) and those deemed impermissible by Board order (see sections 3000.0.4 and 3700.0 to 3700.12). The Board of Governors has ruled (1972 FRB 429) that the purchase and development of land for sale to third parties constitutes land development by a nonbank subsidiary. However, the completion of a foreclosed property to facilitate the recovery of funds advanced under the loan appears to be permissible, provided that the additional work brings the project underway at foreclosure up to a saleable condition. The Board has also ruled that property management for third parties is impermissible (1972 FRB 652). However, property management as a fiduciary, for operating premises of affiliates, or for properties acquired for debts previously contracted (DPC) is permissible. In addition to the other impermissible activities, engaging in real estate joint ventures has also been ruled impermissible. If such impermissible activities are found, they represent violations and should be appropriately treated. The servicing agreements should be reviewed to determine that no additional liabilities, real or contingent, are imposed on the company beyond its responsibilities as a servicing agent.

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 purchases of serviced mortgages from other companies. Under certain circumstances, usually relating to the relative percentage of the seller's portfolio, these transactions may not comply with 12 C.F.R. 225.132. Since these transactions may represent the effective acquisition of a going concern subject to prior approval by the Federal Reserve System, "servicing portfolio" acquisitions should be reviewed for compliance.

Section 225.22(d)(1) of Regulation Y provides an exemption from required Board approval for DPC property acquired in good faith and divested within two years of acquisition. The Board may permit additional extensions that can result in the property being held by a bank holding company for a total of 10 years, if the property has value and marketability characteristics similar to real estate. In conjunction with the review of real estate owned, the examiner should determine if any subsidiary holds title to any property that should have been disposed of within the time limits of Regulation Y, the book value of which has been reduced to zero and the property is not disclosed on the balance sheet. See section 3030.0 "Acquisition of DPC Shares or Assets," for additional information on DPC property acquired.

Legal counsel representing a BHC requested an opinion as to whether certain proposed flood zone–determination activities, to be conducted through a majority-owed (50 percent) joint venture company, would be within the scope of activities related to extending credit as defined in section 225.28(b)(2) of Regulation Y. The BHC proposes to engage in a variety of lending-related activities, including providing real estate appraisals and flood zone determinations.

The Board has determined, in section 225.28(b)(2) of Regulation Y, that it is permissible for bank holding companies to engage in "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board."[35] (See 12 C.F.R. 225.28(b)(2).) The Board also determined by regulation that performing real estate appraisals is an activity that is usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit. (See 12 C.F.R. 225.28(b)(2)(i).) The Board had not specifically addressed whether providing flood zone determinations is an activity that is usual in connection with lending activities.

The proposed flood zone–determination services are considered to be a necessary aspect of mortgage lending in the United States. As noted, federal law prohibits a federally regulated lender from making, increasing, extending, or renewing a loan that is secured by improved real estate or a mobile home located in an area

35. The Gramm-Leach-Bliley Act (the GLB Act) amended the Bank Holding Company Act to limit bank holding companies that are not financial holding companies to engaging only in "activities which had been determined by the Board by regulation or order under this paragraph as of the day before the date of the enactment of the Gramm-Leach-Bliley Act on November 12, 1999, to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board)" (12 U.S.C. 1843(c)(8)). Before November 12, 1999, the Board had determined that "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board" was closely related to banking. Accordingly, the Board retains authority after the GLB Act to define the scope of this section 4(c)(8) activity and to modify the terms and conditions that apply to the activity.

designated by the Federal Emergency Management Agency (FEMA) as a special flood hazard area unless the borrower obtains flood insurance.[36] (See 12 C.F.R. 208.25(c).) Further, federal law also provides that if a federally regulated lender determines, at any time during the life of a loan, that the improved real estate or mobile home securing the loan is located in a special flood hazard area and is not covered by flood insurance, the lender must instruct the borrower to obtain flood insurance and must purchase flood insurance on the borrower's behalf if the borrower fails to promptly purchase the required insurance. (See 12 C.F.R. 208.25(g).)

In addition, federal law requires the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association (the government-sponsored enterprises or GSEs) to have procedures reasonably designed to ensure that flood insurance is in place where required at the initiation of, and during the lives of, the mortgage loans they purchase. (See 12 U.S.C. 4012a(b).) The GSEs meet this requirement by requiring lenders that sell loans to them, and companies that service loans for them, to monitor on an ongoing basis the flood zone status of any loans sold to, or serviced for, the GSEs. To comply with the requirements of federal law and the GSEs, mortgage lenders must obtain an initial flood zone determination before the origination of each mortgage loan and must take steps to monitor, throughout the life of the loan, the flood zone status of any improved real estate or mobile home collateral securing the loan.[37]

The joint venture company proposes to provide initial flood zone determinations to mortgage lenders and to provide mortgage lenders with ongoing flood zone–tracking services with respect to their mortgage loans. The company's activities would be limited to making determinations as to whether particular parcels of real estate are in designated flood zones, preparing the FEMA standard flood zone–determination form, and communicating flood zone determinations to customers. The company committed to not be involved in placing, underwriting, or issuing flood insurance or in the collection of flood insurance premiums. The proposed flood zone determinations would be provided in connection with providing real estate appraisals and as a separate service. In addition, the joint venture company may assist customers who wish to request that FEMA amend its flood maps to remove a property from a designated special flood hazard area.

The proposed flood zone–determination services were found to be an essential part of mortgage lending, designed to assist mortgage lenders in complying with the requirements of federal law and the GSEs. The services generally would be provided to mortgage lenders,[38] thus usual in connection with making mortgage loans. Board staff therefore issued the opinion on July 9, 2002, concluding that the proposed flood zone–determination services are within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y (12 C.F.R. 225.28(b)(2)).

3070.0.9 ON-SITE INSPECTION OF MORTGAGE BANKING SUBSIDIARIES

Scheduling of on-site inspections of mortgage banking nonbank subsidiaries of bank holding companies should be done in accordance with the Board policy for frequency and scope of inspections. (See section 5000.0.2.) After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by nonaccrual and delinquency reports, the level of risk exposure to the organization (see section 4030.2), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted.

36. Statutory authority to issue flood insurance policies under the National Flood Insurance Program (NFIP) expired on December 31, 2002, after Congress adjourned without extending the FEMA authority. On January 13, 2003, the National Flood Insurance Program Reauthorization Act was approved, extending the authorization of the NFIP to December 31, 2003; this authorization was also made retroactive to December 31, 2002.

37. Lenders are specifically permitted to charge a reasonable fee to borrowers for flood zone determinations and life-of-the-loan tracking. For example, see 12 C.F.R. 208.25(h).

38. It was represented that the joint venture company would only market its services to mortgage lenders and that it would rarely provide services to nonlenders.

Conversely, a deteriorating condition might be detected that would require a visit, even though a satisfactory condition had been determined during the previous inspection. Mortgage subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected. All significant mortgage banking subsidiaries should be fully inspected at least once every three years.

3070.0.10 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Loans to affiliates section 23A of the FRA	371c			
Restrictions on 371c transactions with affiliates	371c			
Purchase of affiliate's notes from a third party			3–1131	
Activities not closely related to banking		225.126	4–184	
Acquisition of assets		225.132	4–175.1	
Purchase by member bank of loans originated by a mortgage banking firm		250.250	3–1133	
Mortgage companies acquired under sections 4(c)(1) or 4(c)(8) of the act		225.122	4–196	
Activities closely related to banking		225.131	4–176	
Investments in community welfare projects		225.127	4–178	
Staff opinion on engaging in certain proposed flood zone–determination activities		225.28(b)(2)	4–318.4	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3070.0.11 APPENDIX A—FIRST DAY LETTER

FEDERAL RESERVE BANK
OF BOSTON

P. O. BOX 2076
BOSTON, MASSACHUSETTS 02106-2076

June 15, 19x9

Mr. John Doe
President
XYZ Mortgage Bank Corporation
Boston, Massachusetts 02107

Dear Mr. Doe:

In conjunction with the inspection of the XYZ Bank Holding Company, we plan to begin an inspection of XYZ Mortgage Bank Corporation on July 15, 19x9. To facilitate this inspection, please provide a copy of or make available the following information relative to your organization's mortgage banking activities. Information should be as of xx/xx/xx and should be delivered to the examiner-in-charge as soon as it is available. Whenever possible, standardized management reports should be provided. Please include the name and telephone extension of the appropriate persons to contact, by department, if additional information is necessary.

Board Oversight and Management

1. Provide a listing of the mortgage banking company's board of directors that includes each individual's name, place of employment, title and position, age, management responsibilities (if any), and the length of time he or she has served on the board.
2. List significant management and board committees and have minutes from these meetings available for examiner review. Provide a copy of standardized reports that are provided before each meeting.
3. Provide an organizational chart that highlights individuals who are responsible for the following functional areas: production, warehousing and funding, marketing, servicing, finance, mortgage-servicing asset (MSA) valuations, internal audit, quality control, loan review, compliance, and legal. Include biographies and salary information.
4. Describe any organizational changes that have taken place at the mortgage banking company since xx/xx/xx, including any mergers, acquisitions, or consolidation of mortgage banking activities. Describe any management changes at or above the senior vice president level and provide details on management's new responsibilities.
5. Provide a copy of standardized management reports that are used to monitor compliance with established policies, operating procedures, and controls within each functional area.
6. Provide a copy of the mortgage banking company's most recent operating budget and its long-term strategic plan. Evaluate how interest-rate movements, competition, and other external factors have affected product mix, staffing levels, and the allocation of capital.
7. Describe the internal control environment and the internal control programs that are in place within the mortgage banking company. Have available for examiner review the following reports that were conducted since xx/xx/xx:

   a. internal and external audits

   b. loan reviews

c. internal control and compliance audits completed by or on behalf of agencies such as HUD, FHA, GNMA, FannieMae, FHLMC, state agencies, and private investors

Also have available management's response to each report and the most recent copy of any management reports that monitor the status of outstanding issues or problems.

8. Provide an organization chart for the *internal audit* department. Indicate the scope and frequency of internal audits for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make internal audit workpapers available for examiner review.

9. Provide an organization chart for the *loan review* department. Indicate the scope and frequency of loan reviews for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make loan review workpapers available for examiner review.

10. Provide details on the nature and scope of the quality control program for loans originated and/or serviced for investors. Include an organization chart for the unit(s) involved in such activities, details on any outsourcing programs used since the previous inspection, copies of quality control reports submitted to senior management, and management responses.

11. Describe the method for ensuring compliance with state and federal laws and regulations. Make available for examiner review the procedures manual, work programs, and workpapers compiled by the person/department responsible for compliance.

12. Describe the insurance coverage in effect for the mortgage banking company and its officers and the date it was last reviewed by the board of directors.

13. Recap all mortgage banking–related legal claims/lawsuits in excess of $1 million. Indicate the nature of any legal reserve that is maintained and the method used to assess reserve adequacy.

14. Describe the system for logging, tracking, and responding to customer complaints. The customer complaint file should be made available for examiner review while on-site.

15. Provide a copy of the disaster recovery plan and describe safeguards in place to protect loan documents and data processing input records.

Production and Correspondent Lending Data

16. Provide detailed organization charts for departments within the company which relate to the production function (i.e., retail originations, wholesale purchases, processing, underwriting, closing, shipping).

17. Provide information on the total number and dollar amount of loans generated by the following sources during the two most recent fiscal years and the interim year-to-date period. For purchased loans, please specify the method of purchase (i.e., bulk versus flow), program name, and amount subject to recourse back to either the seller or the investor):

    a. originated by the mortgage banking company

    b. purchased from affiliates

    c. purchased from nonaffiliated third parties

18. Provide written policies and procedures manuals that describe traditional and nontraditional mortgage products, underwriting standards, closing and funding procedures, exception reporting practices, management and employee compensation methods, and training programs for loan production personnel. State methods used to establish ongoing compliance with written policies and procedures and provide copies of relevant management exception reports.

19. Describe the credit approval process used for in-house originations. Include information on rate commitment options extended to the borrower, the average length of the commitment period,

controls that are in place to monitor fallout caused by processing backlogs, and procedures for expired commitments.

20. Provide details on the correspondent lending program, including a list of approved institutions and copies of the most recent loan-quality reports. Describe the credit review process before purchase and any controls that are in place to protect the mortgage banking company against future losses on loans purchased from affiliates and from correspondents.

21. Determine whether rate-locks are provided to correspondents on best effort production programs. What methods are used to verify reported loan fallout?

22. Provide information on the average income and cost per origination and compare with industry standards. Describe the method of accounting used for origination fees and other related noninterest income and expenses.

23. If the mortgage banking company is a subsidiary of a state member bank or sells loans to a bank affiliate that is subject to Regulation O, furnish a list of extensions of credit to ''an executive officer, director, or principal shareholder'' (as defined in section 215.2 of Regulation O) of—

    a. the state member bank;

    b. a bank holding company of which the state member bank is a subsidiary;

    c. any other subsidiary of that bank holding company;

    d. a company controlled by an insider, as defined by Regulation O; and

    e. a political or campaign committee that benefits or is controlled by an insider as defined by Regulation O.

    For all such extensions of credit, include the amount, date the loan(s) was originated or renewed, interest rate, collateral requirements, total amount of loans outstanding to that individual or company, and date of approval by the board of directors. Also include the aggregate amount of loans outstanding to all such insiders as of the inspection date in relation to the bank's unimpaired capital and unimpaired surplus as defined in Regulation O. (See subsection 2050.0.3.2.)

Marketing and Hedging Data

24. Provide detailed organization charts for departments within the company that relate to the marketing and hedging functions. Describe management's roles and responsibilities with respect to the sale of loans in the secondary market, asset securitization, funding, liquidity risk management, interest-rate risk management, and interaction with the asset/liability management function at the parent company.

25. Provide a copy of written policies and procedures used to hedge interest-rate risk associated with the pipeline and closed-loan warehouse. Describe any parameters and limits that are in place and provide a list of securities dealers with whom management is authorized to conduct business.

26. Provide management reports on pipeline and closed-loan (warehouse) inventory volume, mix, yield, age, and turnover as of the inspection date. Describe the method used to project fallout and any models that are used to determine the sensitivity of the pipeline to interest-rate fluctuations.

27. Indicate the methods used to securitize loans for sale in the secondary market, including the use of third-party guaranties and other forms of credit enhancement. Are securities generally sold or retained on the balance sheet?

28. Provide information on the number and volume of securities that lacked final pool certification as of the inspection date. State whether this volume is in compliance with investor guidelines. If

applicable, indicate whether the requirements for obtaining a letter of credit or other guaranty have been satisfied.

Servicing Data

29. Provide a detailed organization chart for the servicing department.
30. List subservicers and vendors who are employed to perform servicing functions. Briefly describe the nature of the services provided.
31. Indicate whether any contracts with subservicers and/or vendors have been terminated for cause since the prior inspection.
32. Provide the monthly servicing management reports since the prior inspection, including the number of loans serviced, dollar volume, and composition of the servicing portfolio in terms of product mix, average loan size, weighted average coupon rates, weighted average maturities, geographic location, and delinquencies and foreclosures.
33. Provide a list of investors for whom servicing was performed as of the most recent quarter-end. Identify any recourse or repurchase provisions and/or forbearance requirements.
34. State whether any investors have terminated servicing contracts with the mortgage company and/or its affiliates for cause since the prior inspection, or if any are likely to be terminated in the near future.
35. Provide a list of all major bulk purchases and sales of servicing since the prior inspection. Identify the terms of each sale and any resulting gains or losses.
36. Provide a list and aging of all outstanding advances to investors as of the date of inspection.
37. Provide access to the servicing policies and procedures manual. Indicate the frequency with which manuals are updated. How does management ensure that subservicers and vendors comply with these same policies and procedures?
38. Provide a servicing-fee schedule (in basis points) for conventional, government, and nontraditional loans serviced for third parties.
39. Provide copies of management reports used to track portfolio runoff.
40. Provide a loan delinquency report segmented into 30, 60, 90, 120, and 180 foreclosure categories. Indicate the volume and number of loans in each segment by loan type. Also include information on the number and dollar volume of delinquent loans that were purchased out of investor pools.
41. Detail the number and dollar volume of other real estate (ORE) parcels segregated by company-owned and investor-owned. Provide a list of loans in foreclosure for which action has been delayed, if applicable.
42. Provide access to the customers' complaint file so that examiners can review it while on-site.

Financial Data

43. Provide copies of the Report of Condition and Income and/or Y-series report that was filed by the mortgage banking company for the two previous fiscal years and the most recent interim period.
44. Provide an internally prepared balance sheet and income statement that reconcile with the most recent Report of Condition and Income and/or Federal Reserve Board Y-series report.

45. Provide the latest published financial statements, if applicable, including the annual report, SEC 10K, 10Qs, and any press releases.

46. Provide copies of the accounting policies pertaining to mortgage loans, securities, and other assets held for sale and held for investment. Also provide copies of management reports that monitor compliance with SFAS No. 115 (securities), the current SFAS No. 65 (loans), SFAS No. 125 (mortgage-servicing assets), and internal policies as of the close of business of the most recent quarter.

47. Provide details on all formal and informal funding mechanisms, including but not limited to repurchase agreements, commercial paper programs, and debt issuance facilities. Indicate the counterparties, where applicable; the amount uncommitted; and the amount outstanding under each facility as of the close of the most recent quarter. Provide copies of all formal and informal written agreements.

48. Provide copies of credit agreements for all funding lines from affiliated and nonaffiliated institutions. Describe methods used to monitor the credit quality of all funding sources. The following information should be included:

    a. lending bank (include copies of confirmation letters)

    b. total credit line

    c. amount in use as of the inspection date

    d. amount available for use and by whom

    e. expiration date

    f. compensating balance and/or fee arrangements

    g. purpose

    h. whether the credit lines are contractual obligations of the lenders

    i. reciprocity arrangements, if any

    j. collateral requirements

    k. legal opinions evidencing compliance with sections 23A and 23B of the Federal Reserve Act, as amended

49. Provide copies of any contingency planning documents that outline alternative courses of action should the condition of traditional funding sources deteriorate.

50. Provide a copy of any standardized financial presentations made to the executive management team and to the board of directors.

51. Provide a copy of standardized management reports used to measure and track the quality of originated, purchased, and serviced assets. Include an aging report that identifies loans that are past due 30, 60, 90, 120, and 180 or more days and indicate whether such loans are *held for sale, held for investment,* or *serviced for investors*.

52. Provide a copy of internal policies that apply to loans held for investment. Indicate the date each loan that was on the books as of the most recent quarter-end was transferred to this account, its amortized cost, market value, and any write-downs or adjustments to yield at the date of transfer. Indicate the person responsible for reviewing these loans for collectibility, the frequency of such reviews, and any adjustments or write-downs taken over the past year.

53. Provide detail pertaining to the transfer or sale of assets between the nonbank mortgage banking company and affiliated entities since the last inspection and that supports the FR Y-8 Reports. Also provide related documentation evidencing methods for asset valuation and credit-quality determination.

54. Provide detail on the allowance for loan and lease losses, contra asset valuation allowances, and

other reserve accounts as of xx/xx/xx (fiscal) and xx/xx/xx (interim). For each account in use, provide a copy of the most recent analysis and a description of the applicable loan and other losses provisions reserving methodology.

55. Provide a copy of the company's policy with respect to real estate appraisals.

56. Provide a copy of management reports that are used for liquidity, funding, and asset/liability management. If these activities are coordinated with affiliate bank or parent bank holding company personnel, provide copies of the information that is routinely provided.

57. Indicate the method for assessing capital adequacy at the mortgage company level. Provide a copy of the company's capital and dividend policies, as well as a list of dividends paid to shareholders during the two previous fiscal years and the most recent interim period. Are any changes in the level of dividends planned or anticipated?

Mortgage-Servicing Assets

58. Provide an organization chart highlighting those areas and individuals responsible for the recording, measurement, and impairment testing for originated and purchased mortgage-servicing rights (MSAs).

59. Provide an inventory listing of all MSAs as of the close of business of the most recent quarter.

60. Discuss the various loan-origination and -purchase programs that give rise to MSAs; the method for calculating and communicating the price paid to correspondents and brokers for service release premiums; whether MSAs are recorded on table-funded loans; and the details on any bulk purchases since the previous inspection, including the price paid and yield realized.

61. Discuss the various loan-sale programs that give rise to MSAs, the method for calculating and recording the initial value of MSAs.

62. Provide a copy of detailed written policies and procedures regarding the initial recording, amortization, and periodic revaluation and impairment testing for MSAs. Indicate the management and/or board committee responsible for approving such policies and the date of last approval.

63. Provide detailed information on any valuation models used for MSA revaluations and a copy of the output as of the most recent quarter-end. Indicate whether such revaluations are performed in-house or by an outside vendor and the frequency of such revaluations.

64. Reconcile fair market values of MSAs to their respective book values as of the most recent quarter-end. Provide a copy of management reports and related journal entries used to record amortization adjustments and/or write-downs.

65. Provide copies of worksheets used to calculate the amount of MSAs included in Tier 1 capital for regulatory reporting purposes as of the most recent quarter-end.

66. Furnish copies of any management reports or presentations to the board of directors or a committee thereof regarding the risk characteristics of MSAs, business risk analysis, and methods used to hedge the interest-rate and prepayment-rate risks associated with capitalized MSAs.

67. Provide an organization chart highlighting those areas and individuals responsible for hedging the interest-rate and prepayment-rate risk associated with MSAs.

68. Provide information on any financial instruments used to hedge interest-rate and prepayment-risk associated with MSAs. Include a detailed prospectus on any customized hedge products that are purchased from investment bankers and a statement from either internal or external accountants on whether such instruments qualify for hedge accounting treatment under SFAS No. 80.

69. Provide a copy of management reports that identify the number of contracts or instruments used, their current market value, and the degree of correlation between the hedge instrument and the underlying MSAs being hedged. Such reports should demonstrate the effectiveness of the hedge under varying market conditions.
70. Provide information on the number and dollar volume of servicing rights sold during the most recent fiscal year and interim period.
71. If mortgage-servicing assets are sold, provide information on the number and dollar volume sold during the most recent fiscal year and interim period.

Intercompany Transactions

72. Provide an organizational chart on a legal-entity basis that includes the bank holding company and all directly held bank and nonbank affiliates.
73. If the mortgage banking company is a direct nonbank subsidiary of the bank holding company, describe the method for identifying transactions that constitute "covered transactions" under sections 23A and 23B of the Federal Reserve Act, as well as the method for applying quantitative limits for section 23A and 23B purposes.
74. Provide a current listing of collateral that is maintained for covered transactions. Indicate whether collateral is maintained for the full amount of any credit lines with the bank and whether any depreciated or matured collateral has been replaced since the previous review.
75. Provide copies of any purchase and funding contracts between the mortgage banking company and affiliated bank(s). Please address whether any or all of the following conditions are met and/or provide written support, where applicable:
    a. asset purchases by the bank have been reviewed by management and are either within the quantitative limits of section 23A or meet the exemption requirements of section 250.250
    b. all purchases are at fair market value and consistent with market terms as required by section 23B
    c. no low-quality assets were transferred to a bank affiliate since the previous inspection
    d. the method of compensating bank affiliates for balances maintained by the parent company or its nonbank subsidiaries and the net interest income earned on warehouse loans or lines is reasonable and based on market terms
76. Provide copies of any servicing contracts between the mortgage banking company and affiliate bank(s). If not so stated, indicate the following information:
    a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?)
    b. the nature of all services provided
    c. billing arrangements, the frequency of billing, the method of computation and the basis for such fees
    d. the date of last review and approval by the mortgage banking company's board of directors
77. Provide a copy of the bank holding company's policy statement on the prohibition of tie-in arrangements, a description of training that is provided to employees in this area, and an attestation as to whether the nonbank subsidiary is in full compliance with internal policy.
78. If the mortgage banking company charges management or other fees, describe the nature of the

fees, the method of computation for such fees, and the settlement procedures. Include a listing of fees charged for the prior two fiscal years and the most recent interim period.

79. Provide a copy of the bank holding company's intercompany tax allocation policy. Indicate the amount and timing of intercompany tax payments and credits received during the two previous fiscal years and the most recent interim period. If credits are due, please indicate the amount owed to the subsidiary and the date the intercompany receivable originated.

Sincerely yours,

Vice President,
Federal Reserve Bank of Boston

3070.0.12 APPENDIX B—ACCOUNTING LITERATURE

The following is a list of generally accepted accounting principles (GAAP) governing the mortgage banking industry that are in the form of accounting standards and interpretations. Accounting standards may change over time. Current accounting literature should be reviewed with management during each inspection.

Statements of Financial Accounting Standards (SFAS)

SFAS No. 5, "Accounting for Contingencies"

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

SFAS No. 77, "Reporting by Transferors for Transfers of Receivables with Recourse"

SFAS No. 80, "Accounting for Futures Transactions"

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

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

SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"

FASB Technical Bulletin

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

Emerging Issues Task Force (EITF)

Issue No. 85-13, "Sale of Mortgage Service Rights on Mortgages Owned by Others"

Issue No. 85-26, "Measurement of Servicing Fee under FASB Statement No. 65—When a Loan Is Sold with Servicing Retained"

Issue No. 85-28, "Consolidation Issues Relating to Collateralized Mortgage Obligations"

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

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

Issue No. 87-25, "Sale of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement"

Issue No. 87-34, "Sale of Mortgage Servicing Rights with a Subservicing Agreement"

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

Issue No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate"

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

Issue No. 90-21, "Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement"

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

3070.0.13 APPENDIX C—REGULATORY GUIDANCE

The following is a list of sections in this manual that examiners may find particularly useful in the review of mortgage banking activities. Regulatory guidance also evolves over time. This list is not all inclusive.

2010.0.1	Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks
2020.0–.7	Intercompany Transactions
2050.0	Extensions of Credit to BHC Officials
2060.0–.6	Management Information Systems
2065.2	Determining an Adequate Level for the Allowance for Loan and Lease Losses
2080.05	Bank Holding Company Funding and Liquidity
2080.0–.3	BHC Funding Practices
2125.0	Trading Activities of Banking Organizations
2126.0	Nontrading Activities of Banking Organizations
2126.1	Investment Securities and End-User Derivatives Activities
2128.02	Asset Securitization
2130.0	Futures, Forward, and Option Contracts
2150.0	Repurchase Transactions
3070.0	Section 4(c)(8)—Mortgage Banking
3080.0	Section 4(c)(8)—Servicing Loans
4000 sections	Financial Analysis
4030.0.2	Nonbanks (Analysis of Financial Condition and Risk Assessment)
4070.0	BHC Rating System

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2015, this section is revised to delete a footnote reference to SR letter 02-16, "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" and its attachment, superseded by SR letter 15-6 "Interagency Frequently Asked Questions on the Regulatory Capital Rule." Refer to subsection 3070.3.2.5., "Secondary Market Activity."

The Federal Reserve and the other federal banking and thrift regulatory agencies (the agencies)[1] issued the Interagency Guidance on Nontraditional Mortgage Product Risks on September 29, 2006. The guidance addresses both risk-management and consumer disclosure practices that institutions[2] should employ to effectively manage the risks associated with closed-end residential mortgage products that allow borrowers to defer repayment of principal and, sometimes, interest (referred to as nontraditional mortgage loans). (See SR-06-15.)

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. However, during the past few years consumer demand has been growing, particularly in high-priced real estate markets, for nontraditional mortgage loans. These mortgage products include such products as "interest-only" mortgages, where a borrower pays no loan principal for the first few years of the loan, and "payment-option" adjustable-rate mortgages (ARMs), where a borrower has flexible payment options with the potential for negative amortization.[3]

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers; these borrowers may not otherwise qualify for more traditional mortgage loans and may not fully understand the risks associated with nontraditional mortgage loans.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (reduced documentation) and are increasingly combined with simultaneous second-lien loans.[4] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should—

- ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- ensure that consumers have sufficient information to clearly understand loan terms and associated; and
- recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio.

The Federal Reserve expects institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.[5]

Institutions should use the guidance to ensure that risk-management practices adequately

1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

2. The term *institution(s)*, as used in this interagency guidance, applies to Federal Reserve-supervised state member banks and their subsidiaries, bank holding companies, and the nonbank subsidiaries of bank holding companies. It also refers to all other *federally supervised* banks and their subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

3. Interest-only and payment-option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed-rate products. Refer to the appendix at 3060.3.4 for additional information on interest-only and payment-option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (HELOCs), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

4. Refer to the appendix for additional information on reduced documentation and simultaneous second-lien loans.

5. Refer to the Interagency Guidelines Establishing Standards for Safety and Soundness in 12 C.F.R. 208, appendix D-1.

address these risks. Risk-management processes, policies, and procedures in this area will be carefully scrutinized. Institutions that do not adequately manage these risks will be asked to take remedial action.

This guidance focuses on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

3070.3.1 NONTRADITIONAL LOAN TERMS AND UNDERWRITING STANDARDS

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.[6]

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure that risk levels remain manageable.

3070.3.1.1 Qualifying Borrowers for Nontraditional Loans

Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as *payment shock*, this increase is of particular concern for payment-option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and potentially develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate,[7] assuming a fully amortizing repayment schedule.[8] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[9]

6. Refer to 12 C.F.R. 208.51 subpart E and appendix C and 12 C.F.R. 225 subpart G.

7. The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest-rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (for example, the MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

8. The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest-only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

9. The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether a loan balance has the potential to reach the negative amortization cap before the end of the initial payment-option period (usually five years). For example, a loan with a 115 percent negative amortization cap but only a small spread between the introductory rate and the accrual rate may reach a moderate 109 percent maximum loan balance before the end of the initial payment-option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

Furthermore, the analysis of repayment capacity should avoid overreliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

3070.3.1.2 Collateral-Dependent Loans

Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.[10] Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

3070.3.1.3 Risk Layering

Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest-only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance, and other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

3070.3.1.4 Reduced Documentation

Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Federal Reserve expects an institution to more diligently verify and document a borrower's income and debt-reduction capacity.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

3070.3.1.5 Simultaneous Second-Lien Loans

Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien HELOCs typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk-mitigating factors.

3070.3.1.6 Introductory Interest Rates

As a marketing tool for payment-option ARM products, many institutions offer introductory interest rates set well below the fully indexed rate. When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

3070.3.1.7 Lending to Subprime Borrowers

Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the

10. A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

applicable interagency guidance on subprime lending.[11] Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for the institution and the borrower.

3070.3.1.8 Non-Owner-Occupied Investor Loans

Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.

3070.3.2 PORTFOLIO AND RISK-MANAGEMENT PRACTICES

Institutions should ensure that risk-management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk-management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should—

- develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk-management expectations;
- design enhanced performance measures and management reporting that provide early warning for increasing risk;
- establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

3070.3.2.1 Policies

An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk-management tools for risk-mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

3070.3.2.2 Concentrations

Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk-management practices. Monitoring systems should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

11. See SR-99-6, Subprime Lending and its attachment, Interagency Guidance on Subprime Lending, March 1, 1999, and SR-01-4, Subprime Lending and its attachment, interagency Expanded Guidance for Subprime Lending Programs, January 31, 2001.

3070.3.2.3 Controls

An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service, and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

3070.3.2.4 Third-Party Originations

Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If problems involving appraisals, loan documentation, credit problems, or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, and even termination of the third-party relationship.

3070.3.2.5 Secondary-Market Activity

The sophistication of an institution's secondary-market risk-management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary-market activities should have comprehensive, formal strategies for managing risks. Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets.

3070.3.2.6 Management Information and Reporting

Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by (1) loan type (for example, interest-only mortgage loans and payment-option ARMs); (2) risk-layering features (for example, payment-option ARMs with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); (3) underwriting characteristics (for example, LTV, DTI, and credit score); and (4) borrower performance (for example, payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards, and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from estab-

12. Reserved footnote.
13. Reserved footnote.

lished policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk-tolerance levels.

3070.3.2.7 Stress Testing

Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring, and managing risk, as well as developing appropriate and cost-effective loss-mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

3070.3.2.8 Capital and Allowance for Loan and Lease Losses

Institutions should establish an appropriate ALLL for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit-risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. The valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.[14]

3070.3.3 CONSUMER PROTECTION ISSUES

While nontraditional mortgage loans provide flexibility for consumers, the Federal Reserve is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

3070.3.3.1 Concerns and Objectives

More than traditional ARMs, mortgage products such as payment-option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization, neither of which may be fully understood by consumers. For example, consumer payment obliga-

14. See SR-03-4, dated February 25, 2003, Interagency Advisory on Mortgage Banking and its attachment, which has the same title.

tions may increase substantially at the end of an interest-only period or upon the "recast" of a payment-option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest-rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared with a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in the property—even when the property has appreciated. The concern that consumers may not fully understand these products is exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risks of payment shock and of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

3070.3.3.2 Legal Risks

Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z
- Section 5 of the Federal Trade Commission Act (FTC Act)

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages (1) in advertisements, (2) with an application,[15] (3) before loan consummation, and (4) when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[16]

Other federal laws, including the fair-lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Federal Reserve notes that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

3070.3.3.3 Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[17]

3070.3.3.4 Communications with Consumers

When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when (1) a consumer is shopping for a mortgage (such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products) or (2) market-

15. These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

16. The Board of Governors enforces this provision under the FTC Act and section 8 of the Federal Deposit Insurance Act. See the joint Board and FDIC guidance titled Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004.

17. Institutions should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

ing relating to nontraditional mortgage products is provided by the institution to the consumer. Clear and balanced information should not be offered by the institution only upon the submission of an application or at consummation.[18] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z, as well as other laws.[19]

3070.3.3.4.1 Promotional Materials and Product Descriptions

To assist consumers in their product selection decisions, promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages (including information about the matters discussed below).

Payment Shock. Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[20] Such information also could describe when structural payment changes will occur (for example, when introductory rates expire or when amortizing payments are required) and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest-rate index.

Negative Amortization. When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

Prepayment Penalties. If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.

Cost of Reduced Documentation Loans. If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

3070.3.3.4.2 Monthly Statements on Payment-Option ARMs

Monthly statements that are provided to consumers on payment-option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment-option ARM borrowers to select a non-amortizing or negatively amortizing payment (for example, through the format or content of monthly statements).

18. Institutions also should strive to (1) focus on information important to consumer decision making; (2) highlight key information to make it more prominent; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers who are considering the nontraditional mortgage products and other loan features described in this guidance.

19. Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

20. Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

3070.3.3.4.3 Practices to Avoid

Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.[21] Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as (1) giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); (2) making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; (3) suggesting that initial minimum payments in a payment-option ARM will cover accrued interest (or principal and interest) charges; and (4) making misleading claims that interest rates or payment obligations for these products are "fixed."

3070.3.3.5 Control Systems

Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

3070.3.4 APPENDIX (TERMS USED IN THIS DOCUMENT)

Interest-Only Mortgage Loan. An interest-only mortgage loan refers to a nontraditional mortgage in which, for a specified number of years (for example, three or five years), the borrower is required to pay only the interest due on the loan, during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or it may fluctuate based on the prescribed index and payments, including both principal and interest.

Payment-Option ARM. A payment-option ARM is a nontraditional adjustable-rate mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option

21. For example, marketing materials for payment-option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15- or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation. Reduced documentation is a loan feature that is commonly referred to as "low doc/no doc," "no income/no asset," "stated income," or "stated assets." For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan. A simultaneous second-lien loan is a lending arrangement where either a closed-end second lien or a home equity line of credit (HELOC) is originated simultaneously with the first-lien mortgage loan, typically in lieu of a higher down payment. 3070.3.5

3070.3.5 INSPECTION OBJECTIVES

1. To ascertain if the banking organization[22] has adequate risk-management processes, policies, and procedures to address the risk associated with its nontraditional mortgage loans.
2. To evaluate whether the banking organization's nontraditional mortgage loan terms are supported by a disciplined analysis of its potential exposures versus the mitigating factors that ensure that risk levels are adequately managed.
3. To determine if the underwriting standards for nontraditional mortgage loans comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.
4. To evaluate whether the banking organization's management carefully considers and appropriately assesses and mitigates the risk exposures created by the nontraditional mortgage loans by ensuring that—
   a. its loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
   b. its nontraditional mortgage loan products have strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
   c. its consumers have sufficient information to clearly understand the loan terms and associated risks prior to making a nontraditional mortgage loan product choice.
5. To determine if the banking organization has borrower qualification criteria that include an evaluation of a borrower's repayment capacity and ability to repay the debt—the full amount of the credit extended, including any balance increase that may accrue from negative amortization—by the final maturity date at the fully indexed rate.

3070.3.6 INSPECTION PROCEDURES

Risk Mitigation

1. Assess the banking organization's management procedures to mitigate the risk created by nontraditional mortgage products. Determine that—
   a. underwriting standards and terms are consistent with prudent lending practices, including consideration of each borrower's repayment capacity;
   b. products are supported by strong risk-management standards, capital levels that are commensurate with their risk, and an allowance for loan and lease losses that reflects the collectiblity of the portfolio; and
   c. borrowers have sufficient information to clearly understand the terms of their loans and their associated risks.

Underwriting Standards

1. Determine if the banking organization's underwriting standards—
   a. address the effect of a substantial pay-

22. Going forward in this section (for bank holding company inspection purposes) "banking organization" refers to the bank holding company and its nonbank subsidiaries that are supervised by the Federal Reserve System.

ment increase in the borrower's capacity to repay when loan amortization begins,
   b. comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines, and
   c. require that loan terms are based on a disciplined analysis of potential exposures and mitigating factors, which will ensure that risk levels remain manageable.
2. Verify that the banking organization's nontraditional mortgage loan qualification standards recognize the potential impact of payment shock (particularly for borrowers with high loan-to-value ratios, high debt-to-income ratios, and low credit scores).
3. Ascertain that the analysis of a borrower's repayment capacity include—
   a. an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule;
   b. a repayment schedule that is based on the initial loan amount plus any balance increase that may accrue from a negative amortization provision; and
   c. avoiding an overreliance on credit scores as a substitute for income verification or reliance on the sale or refinancing of the property (pledged as collateral) when amortization begins.
4. Determine whether originated or purchased mortgage loans that combine nontraditional features (such as interest-only loans with reduced documentation and second-lien loans) have mitigating factors (that is, higher credit scores, lower LTVs and DTI repayment ratios, significant liquid assets, mortgage insurance, or other credit enhancements) that support the underwriting decisions and the borrower's repayment capacities.
5. Verify that the banking organization has clear loan underwriting policies governing the use of—
   a. reduced documentation of the borrower's financial capacity (for example, nonverification of reported income when the borrower's income can be documented based on recent W-2 statements, pay stubs, or tax returns),
   b. minimal or no owner's equity for second-lien home equity lines of credit (such loans generally should not have a payment structure allowing for delayed or negative amortization without other significant risk-mitigating factors),
   c. introductory interest rates (banking organizations should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates),
   d. subprime lending (adherence to the interagency guidance on subprime lending),[23] and
   e. non-owner-occupied investor loans (qualifications should be based on the borrower's ability to service the debt over the life of the loan, which would include a combined LTV ratio that considers negative amortization and sufficient borrower equity, and continuing cash reserves).

Portfolio and Risk-Management Practices

1. If the banking organization originates or invests in nontraditional mortgage loans, determine if more robust risk-management practices have been adopted to manage the exposures.
   a. Verify that there are appropriate written lending policies that have been adopted and are being used and monitored, specifying acceptable product attributes, production and portfolio limits (growth and volume limits by loan type), sales and securitization practices, and risk-management expectations (acceptable levels of risk).
   b. Determine if enhanced performance measures have been designed and if there is management reporting that provides an early warning for increasing risk.
   c. Find out if the appropriate ALLL levels have been established that consider the credit quality of the portfolio and the conditions that affect collectibility.
   d. Evaluate whether adequate capital is maintained at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility.
   e. Determine if capital is held commensurate with the risk characteristics of the banking organization's nontraditional mortgage loan portfolios.
2. If the banking organization has concentrations in nontraditional mortgage products, determine if there are—
   a. well-developed monitoring systems and risk-management practices, which monitor and keep track of concentrations in

23. See SR-01-4 and SR-99-6.

key portfolio segments, such as by loan type, third-party originations, geographic area, and property occupancy status, and
   b. systems that also monitor key portfolio characteristics: non-owner-occupied investor loan and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features.
3. Determine if the banking organization has adequate quality controls and compliance and audit procedures that focus on mortgage lending activities posing high risk.
   a. Determine if the banking organization has strong internal controls over accruals, customer service, and collections.
   b. Verify that policy exceptions made by servicing and collections personnel are carefully monitored and that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk.
   c. Find out if the quality control function regularly reviews (1) a sample of nontraditional mortgage loans from all origination channels and (2) a representative sample of underwriters confirming that underwriting policies are followed.
4. Bank oversight of third-party originators—
   a. determine if the banking organization has strong systems and controls in place for establishing and maintaining relationships with third-party nontraditional mortgage loan originators, including procedures for due diligence, and
   b. find out if the oversight of third-party mortgage loan origination lending practices includes monitoring the quality of originations (that is, the quality of origination sources, key borrower characteristics, appraisals, loan documentations, and credit repayment histories) so that they are reflective of the banking organization's lending standards and in compliance with applicable laws and regulations.
5. Determine if the banking organization's risk-management practices are commensurate with the nature, volume, and risk of its secondary-market activities.
   a. Find out if there are comprehensive formal strategies for managing the risks arising from significant secondary-market activities.
   b. Ascertain if contingency planning includes how the banking organization will respond to a decline in loan demand in the secondary market.
   c. Determine if there were any repurchases of defaulted mortgages and if the banking organization complies with its risk-based capital guidelines.
6. Evaluate the appropriateness of management information and reporting systems for the level and nature of the banking organization's mortgage lending activity.
   a. Verify that the reporting allows management to detect changes in the risk profile, or deteriorating performance, of its nontraditional mortgage loan portfolio.
   b. Determine if management information is reported and available by loan type, risk-layering features, underwriting characteristics, and borrower performance.
   c. Find out if—
      1) portfolio volume and performance are tracked against expectations, internal lending standards, and policy limits;
      2) volume and performance expectations are established at the subportfolio and aggregate portfolio levels;
      3) variance analyses are regularly performed to identify exceptions to policies and prescribed thresholds; and
      4) qualitative analyses are performed when actual performance deviates from established policies and thresholds.
7. Determine if the banking organization, based on the size and complexity of its lending operations, performs sensitivity analysis on its key portfolio segments to identify and quantify events that may increase its risks in a segment or the entire portfolio.
8. Verify that the scope of the sensitivity analysis includes stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the banking organization's immediate control.
9. Find out if the stress testing results provide direct feedback for determining underwriting standards, product terms, portfolio concentration limits, and capital levels.
10. Determine if the banking organization has established an appropriate ALLL for the estimated credit losses and commensurate capital levels for the risk inherent in its nontraditional mortgage loan portfolios (considering the higher risk of loss posed by the layered risks).
11. If the banking organization has material

mortgage banking activities and mortgage servicing assets—

a. evaluate whether sound practices were applied in valuing the mortgage servicing rights for its nontraditional mortgages and

b. ascertain if the valuation process followed the nontraditional mortgage and other interagency guidance and generally accepted accounting principles, and whether reasonable and supportable assumptions were used.