MORTGAGE FINANCE AUTHORITY MANUAL FOR SUPERVISION

EGYPT FINANCIAL SERVICES PROJECT
TECHNICAL REPORT #36

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ACRONYMS

a. General:

ABS	Asset-Backed Securities
AI	Appraisal Institute
AMCHAM	American Chamber of Commerce in Egypt
ALC	Arab Legal Consultants
AOJS II	Administration of Justice Support II
BDA	Bond Dealers Association
BOD	Board of Directors
CBE	Central Bank of Egypt
CIDA	Canadian International Development Agency
CAPMAS	Central Agency for Public Mobilization and Statistics
CASE	Cairo and Alexandria Stock Exchanges
CBE	Central Bank of Egypt
CMA	Capital Market Authority
COTS	Commercial Off-the-Shelf
COP	Chief of Party
CRA	Commercial Registry Authority
CORS	Continually Operating Reference Stations
DCA	Development Credit Authority
DO	Egyptian Survey Authority District Office
DVP	Delivery versus Payment
DTGS	Direct Transfer Gross Settlement System
EAA	Egyptian Appraisers Association
EALB	Egyptian Arab Land Bank
EAR	Egyptian Association of Realtors
EAREA	Egyptian Association of Real Estate Appraisers
EBA	Egyptian Bankers Association
EBI	Egyptian Banking Institute
EISA	Egyptian Insurance Supervisory Authority
ECIM	Egyptian Cadastral Information Management (Finnish-funded project)
ECMA	Egyptian Capital Market Association
EDO	Egyptian Survey Authority District Office
EFS	Egypt Financial Services
ELF	Egyptian Finance Liquidity Facility
EHFC	Egyptian Housing Finance Company
EIMA	Egyptian Investment Management Association
EISA	Egyptian Insurance Supervisory Authority
EJA	Egyptian Judges Association
ELA	Egyptian Lawyers Association
EMA	Egyptian Mortgage Association
EMBA	Egyptian Mortgage Brokers Association
EPO	Egyptian Survey Authority Provincial Office
ESA	Egyptian Survey Authority
EREA	Egyptian Real Estate Association
ERESA	Egyptian Real Estate Surveyors Association
ESA	Egyptian Survey Authority
ESOP	Employment Stock Ownership Plan
ESRI	Environment Systems Research Institute
EU	European Union
FinBi	Finance and Banking Consultants International

FTC	Federal Trade Commission
FSVC	Financial Services Volunteer Corps
GAFI	General Authority for Free Zones and Investment
GIS	Geographic Information System
GOE	Government of Egypt
GSF	Guarantee and Subsidy for Real Estate Activities Fund
H&A	Hassouna and Abou Ali Law Firm
IFC	International Finance Coorporation
IFS	International Federation of Surveyors (Egypt Chapter)
IHF	International Housing Finance
ILS	International Land Systems, Inc.
IPF	Investor Protection Fund
KRA	Key Results Area
LADIS	Legislation and Development Information Systems
MBA	Mortgage Bankers Association
MCDR	Misr for Clearing, Depository, and Registry
MFA	Mortgage Finance Authority
MFC	Mortgage Finance Company
MLS	Multiple-listing Service
MSAD	Ministry of State for Administrative Development
MOF	Ministry of Finance
MOH	Ministry of Housing
MOJ	Ministry of Justice
MOI	Ministry of Investment
MOU	Memorandum of Understanding
NAR	National Association of Realtors
NASD	National Association of Securities Dealers
NCCIC	New Cairo Community Information Center
NCJS	National Center for Judicial Studies
NIB	National Investment Bank
NFI	New Financial Instrument
NUCA	New Urban Community Authority for Sixth of October
OST	Overseas Study Tour
PEA	Project Execution Agreement
PO	Provincial Office (of the Egyptian Survey Authority)
PIN	Parcel Identification Number
PMU	Project Management Unit
QPR	Quarterly Progress Report
QSIT	Quality Standards Information Technology
REPD	Real Estate Publicity Department
RETD	Real Estate Tax Department
RFP	Request for Proposal
RFQ	Request for Quotation
RO	Registry Office
SEC	Securities and Exchange Commission
SII	Securities and Investment Institute
ST	Short-term
TDL	Training Development Laboratory
UCD	Universal Cadastral Database
UNCITRAL	United Nations Commission on International Trade Law
USAID	United States Agency for International Development
WB	World Bank
YEBA	Young Egyptian Bankers Association
Z&K	Zarrouk, Khaled & Co.

b. Specialized:

ACH	Automated Clearing House
ADC	Acquisition, Development and Construction arrangements
AFS	available-for-sale
ALLL	Allowance for Loan and Lease Losses
ARM	Adjustable Rate Mortgage
AVM	Automated Valuation Model
C&D	Cease and Desist
CAMEL	Capital, Assets, Management, Earnings, Liquidity
CEF	Continuing Examination File
CEO	Chief Executive Officer
CMO	Collateralized Mortgage Obligation
CMP	Civil Money Penalties
D&O	Directors and Officers
DTI	Debt to Income ratio
EIC	Examiner-In-Charge
ESFR	excess servicing fee receivables
GAAP	Generally Accepted Accounting Principles
GVA	General Valuation Allowances
IAP	Institution Affiliated Parties
IAR	Internal Asset Review
IMCR	Individual Minimum Capital Requirement
IO	Interest Only
IRR	Interest-Rate Risk
IT	Information Technology
LAN	Local Area Network
LIP	Loans-In-Process
LOCOM	lower of cost or market
LTOB	Loan-To-One-Borrower
LTV	Loan-To-Value ratio
MAN	Metropolitan Area Network
MBS	Mortgage-Backed Securities
MIS	Management Information System
NRV	Net Realized Value
P&I	Principal and Interest
PCA	Prompt Corrective Action
PMI	Private Mortgage Insurance
PMSR	purchased mortgage servicing rights
R&P	Removal and Prohibition
REO	Report on Earnings
ROE	Report Of Examination
S&S	Safe and Sound
SAR	Suspicious Activity Report
SMAART	Systems, Monitoring, Assessment, Accountability, Response, and Training
SVA	Specific Valuation Allowance
SWIFT	Society for Worldwide Interbank Financial Telecommunication

TDR	Troubled Debt Restructuring
TWA	Transactions With Affiliates
VPN	Virtual Private Network
WAN	Wide Area Network
YTC	yield to call
YTM	yield to maturity

Introduction

Purpose and scope
Regulatory supervision of real estate lenders should include a continuous process, usually described as having two parts: off-site monitoring and on-site examination. Off-site monitoring includes the review and analysis of various periodic prudential reports submitted by lenders to the regulator. On-site examination includes the entry of the examination team/personnel onto the premises of the lender to review records and controls and to interview lender personnel.

This Manual for Supervision addresses policies and procedures for on-site examinations, including investigation, report, follow-up and prompt corrective action. Major examination areas are addressed. This manual is intended to be a tool taken into the field and used by on-site examination teams.

Work in process
This manual should be essentially usable in its present form. It will need to be adapted to laws, regulations, and other characteristics of the Egyptian residential lending market, some of which are to be developed or significantly revised. Revision of this document will be best accomplished through its use in actual examinations, with on-site personnel making recommendations at the end of each on-site examination for the manual's revision—whether by deletion, addition or revision of specific items. Another useful approach might be to form a working group of certain MFA legal counsel, managers, and professional staff to review and adapt the document. This approach will provide training to those doing the examinations and will allow MFA professionals fine-tune the document. These two approaches are not mutually exclusive, and both can be used if managed properly.

How this manual was compiled
Basic materials were taken from the Examination Handbook (Manual for Supervision) of the Office of Thrift Supervision (OTS). OTS is the primary U.S. regulatory of savings associations (also known as thrifts), which are a type of depository real estate lender specializing in loans on real estate, residential and other types. Thus, the principles and examination areas are considered to be an authoritative source for "best practices" pertaining to regulating real estate lenders. References to U.S. laws and regulations and other regulator-issued documents have been removed, as well as references to other U.S. regulators and institutions. Though MFA-regulated lenders are not depository institutions, most procedures herein are directed toward safety and soundness of the institution. Areas covered by this manual include capital adequacy, asset quality, management, earnings, and liquidity. An attempt has been made to retain the clear, somewhat informal style of the original source manual.

Possible errors
Despite the writer's efforts, certain references and concepts herein may not be applicable to the Egyptian mortgage industry. These should be noted to the Director of Industry Affairs, so that the errors might be corrected.

Inclusion of information not yet applicable
One form of error may be the inclusion of material on subjects not yet relevant in the Egypt real estate industry. These may be removed, though it is recommended some caution be used, since the industry is developing and new products, services, and activities are expected to appear.

Addition of material later
Likewise, some subjects may be encountered by examiners in the field which are not adequately addressed in the manual. Some subjects which will probably need to be addressed in the near future include:

Sensitivity (to market and market interest rates)
Consumer protection
Subsidiaries
Holding companies and other parent companies
Securities Law and its effects
Employee Stock Ownership Programs (ESOPs)

Sensitivity is a highly quantitative and technical area usually relying on computer models. Though Egyptian mortgage lenders will not have deposit liabilities, their management of interest rate risk will be crucial for stable profitability. Consumer protection is an area highly dependent on regulatory requirements and will be based on these once adopted. Procedures for Subsidiaries and Holding companies will depend on whether and to what extent these begin to appear in the Egyptian mortgage finance industry. Parent companies which are banks are regulated by the Central Bank of Egypt. Securities Law issues pertaining to real estate lenders should be addressed in the Capital Adequacy section.

All such revisions, corrections, and additions should be published separately, along with the date of publication. Though most or all will be incorporated into later versions of text, this separate publication will ensure that such changes are properly disbursed to regulatory and industry personnel.

Laws and regulations pending
At this time, a number of new regulations have been recommended separately. This manual assumes that most of the proposed regulatory regime will be adopted sooner or later. For the time being, however, few regulatory references are made in the manual. The basis for the manual is “best practices” for examining a lending institution according to safety and soundness. Regulatory compliance is always an important part of any supervisory regime, even though the specifics may not yet have been set out in the manual.

Organization of manual
The main sections of this manual as first issued are:

Examination administration
Capital adequacy
Asset quality
Management
Earnings
Liquidity

The manual itself is in two parts:

Manual for Supervision (with appendices)
Examination Programs and Questionnaires

The manual discusses principles and techniques for regulatory supervision of a lending institution based on safety, soundness and risk management. As the legal and regulatory systems develop, specific references to these will be added for clarity.

Examination programs set out some specific activities to perform during an on-site examination. Questionnaires address specific issues the examiner must review and judge on important regulatory subjects, and include questions to be answered by mortgage lender personnel. Questionnaires may be distributed to applicable lender personnel to be completed and/or by means of face-to-face interviews. These program checklists and questionnaires, and their notations and answers, will become a part of examination work-papers, providing evidence in support of the examination report.

Examiner-in-Charge (EIC)

The Examiner-in-Charge is the MFA professional assigned responsibility, by the Head of the Monitoring and Enforcement Department, for complete execution of the on-site examination. This key position is not a permanent MFA position, but rather an assignment for the duration of a specific on-site examination. Persons are chosen to be EIC according to their experience, knowledge, and management skills. Such assignments will, however, be rotated through qualified staff-members to give opportunities for training through experience. More details about EIC duties are given throughout the manual, especially in the section on Administration.

Mortgage Finance Authority

Manual for Supervision

000 - Administration

SECTION: Manual and Program Use 010

The Manual for supervision is a guide for the examination of real estate lenders regulated by the Mortgage Finance Authority (MFA). Specifically, the Manual aids MFA regulatory staff and the industry in the regulatory process. The Manual provides uniform standards for planning and conducting examinations and addressing supervisory issues. It also serves as a reference tool, training aid, and guide to national policies and procedures.

The Manual illustrates and describes, for examiners and the lender industry, certain standards of conduct and prudent operation that MFA views as important to the safe and sound operation of real estate lenders. These standards should be consistent with the respective fiduciary duties of those individuals associated with them.

This Manual Section explains how to use the Manual and the programs in the examination process. It describes the organization of the Manual chapters and sections, and sets forth objectives and procedures common to all phases of the examination.

REGULATORY PROCESS
The regulatory process allows you to meet the following objectives:

- Assess a mortgage lender's degree of safety and soundness.
- Assess the adequacy of the mortgage lender's compliance management program.
- Assess how well a mortgage lender manages compliance with consumer protection and public interest-related laws and regulations (compliance).
- Evaluate a mortgage lender's condition.
- Identify the mortgage lender's strengths.
- Identify existing regulatory violations.
- Identify potential problems.
- Prevent the development or continuation of unsafe operating practices.
- Report findings.
- Inform directors of mortgage lender strengths and weaknesses.
- Facilitate corrective action where needed.

Proactive regulatory supervision should evaluate future needs and potential risks to ensure the success of the lender system in the long term. This Manual provides a framework for the successful completion of that process.

The Manual encourages independent reasoning, objectivity, efficiency, and professionalism in the examination process. To promote consistency within the MFA organization, the Manual sets forth minimum standards for examination objectives and procedures. While this process promotes standardization of the examination process, we encourage you to modify programs to fit the mortgage lender's specific needs.

We are designing the Manual for supervision to cover safety and soundness, compliance, and risk-based supervision for both new and experienced examiners. Background information, applicable references, and expanded procedures within the text serve to help in the learning process.

You should supplement your use of the Manual and associated programs with your education, experience, and judgment. We will periodically update the Manual and issue individual sections as necessary.

Manual ORGANIZATION
The Manual for Supervision will contain a table of contents, and one chapter for each CAMEL element. A brief discussion of the Manual's organization appears below. Other sections may be added as they become necessary as the Egypt mortgage industry develops.

The Manual encourages independent reasoning, objectivity, efficiency, and professionalism in the examination process.

Table of Contents

000 Administration
This chapter gives a general overview of the administration and coordination of the regulatory process.

It includes instructions on determining the scope of an examination, monitoring the regulatory profile process, assigning component and composite CAMELS ratings, and devising an examination strategy.

100 Capital Adequacy
This chapter provides useful information for assessing whether a mortgage lender's capital position is sufficient, given the risk level, to ensure ongoing viability. Discussions of minimum regulatory capital requirements, prompt corrective action categories, and stock ownership and control help you determine the adequacy and composition of a mortgage lender's capital.

200 Asset Quality
This chapter addresses the following two issues:

- The determination of risks related to the mortgage lender's assets.
- The mortgage lender's management, administration, and evaluation of the quality of these assets. It also provides guidance in assessing credit risk and reviewing asset portfolios (including loans, investments, and other assets). This chapter focuses on three areas:
- The quality of loan underwriting and portfolio management.
- Affirmation of classified asset levels.
- Adequacy of valuation allowances. There are also sections discussing real estate appraisals, loan sampling, and margin securities.

300 Management
This chapter provides guidance in evaluating the capability of executive management and the board of directors. It covers objectives, procedures, and references for examining compliance management, internal controls, internal and independent

audits, fraud and insider abuse, enforcement actions, and transactions with affiliates and insiders.

400 Earnings
This chapter will assist in analyzing a mortgage lender's financial condition. It covers objectives, procedures, and references for examining the mortgage lender's financial record keeping and reporting methods and operations analysis. The chapter also discusses present value analysis.

500 Liquidity
This chapter provides assistance in assessing liquidity and the funding risk confronting a mortgage lender. It includes material on funds management, liquidity management, and investment activities.

600 Sensitivity to Market Risk
This chapter provides assistance in assessing the market risk confronting a mortgage lender. It includes guidance on managing interest rate risk and hedging.

Each manual section has a unique three- or four-digit number that allows for easy identification and referencing of materials.

SECTION ORGANIZATION
Each manual chapter contains several sections of examination material subdivided into different areas of review. For example, Chapter 300 contains a section for each area of review under Management.

Each manual section has a unique three- or four-digit number that allows for easy identification and referencing of materials. For example, under Management Chapter 300, the number 310 references the section on Oversight by the Board.
The program, questionnaire, and any work papers have the same 310 reference number. Manual page numbers follow the same sequence; hence, the introduction for Oversight by the Board of Directors, Section 310, is manual page number 310.1.

Each manual section contains a discussion of the subject area, (will eventually contain) regulatory references, a program that includes examination objectives and procedures, related questionnaires, and appendices, if applicable.

The discussion below covers each of these areas. We also provide a list of common objectives and procedures that may prove valuable during the examination, even though they may not appear in every program.

Subject Narrative
The narrative of each manual section provides the specific guidance for a particular topic. It provides basic information such as MFA policy, a historical perspective, and subject overview. The narrative highlights significant regulatory concerns such as the nature and intent of enforcement actions that may be applicable to the review area. Subheadings appear where appropriate.

References
Pertinent legislative and regulatory citations will eventually appear in the reference section, following the narrative, as relevant regulations are adopted. None are included in this initial manual.

References to other relevant MFA guidance may appear where appropriate, including: various bulletins, memoranda agency instruction and class manuals, industry sources, and accounting pronouncements.

Programs and Questionnaires

The examination program serves as a guide for the orderly completion of an examination. Programs include objectives for the review of a subject and a series of procedures for completing those objectives. Examination programs also help determine the examination scope and organization, serve as documentation, and help establish conclusions and recommendations. Once completed, the program and any questionnaires become part of the foundation for an effective quality review process.

Questionnaires guide the examiner in interviewing personnel and help establish specific issues and their responses.

Programs and questionnaires are included in a separate volume for convenience. The examiner should note, with a substantiating reason, why any procedure was not performed or question answered.

General Questionnaires

General questionnaires reflect standards for safe and sound operating procedures and may be useful for evaluating a mortgage lender's operations. They include questions on internal controls that you must answer for purposes of objectivity. These questionnaires also assist in organization, act as memory prompts, and facilitate the review process.

It is not necessary to complete all questionnaires. You should complete only those pertaining to the examination scope and objectives.

Internal Control Questionnaire and Funds Transfer Questionnaire

The Internal Control Questionnaire contains questions about the mortgage lender's internal control system. The Funds Transfer Questionnaire contains questions regarding the mortgage lender's internal controls for funds transfers. The mortgage lender should complete these questionnaires before the examination and it is your responsibility to verify the answers once you are onsite.

Appendices

Some manual sections include appendices. Appendices present additional sources of information applicable to the particular manual section and may include forms, guidelines, or Q's and A's.

EXAMINATION PROGRAMS

Examination programs serve as guides for the orderly completion of an examination by means of a set of objectives and procedures.

Examination Objectives

This segment of the program helps you identify goals in reviewing a subject area. Each corresponding program, if applicable, lists objectives for easy reference.

Certain objectives are germane to the overall examination process and to virtually every examination section. You may wish to review these common objectives during an examination, as they may not appear in other manual sections.

Common Objectives

- Document the effectiveness of a mortgage lender's operations.
- Determine compliance with laws and regulations.
- Determine the adequacy of and adherence to mortgage lender policies and procedures.
- Assess management's expertise and ability to manage the mortgage lender's affairs.
- Assess the oversight and ensure that management and the board are receiving complete and accurate reports.
- Verify that an acceptable system of records and internal controls is in place.
- Assess the effect of anticipated internal and external changes on the mortgage lender.
- Assess the mortgage lender's ability to meet its future needs (for instance, funds accessibility, provide capital, absorb losses).
- Identify any actual or potential undue risk to the mortgage lender.
- Report examination findings, presenting analysis and conclusions regarding the mortgage lender's overall condition, trends, and prospects for future viability.
- Report concerns of material risk and initiate corrective action when needed.

Examination Procedures

Examination procedures appear in a top-down fashion in three categories – Levels I, II, and III. Each category represents a different level or depth of review. The top-down approach begins with a review of policies, procedures, and internal controls while focusing on the safety and soundness of the mortgage lender (Level I). With this approach, you can expeditiously assess the degree of risk in each area of a particular mortgage lender's operations early in the examination.

You can also better determine the depth of review and the procedures (Levels II and III) needed.

The programs serve as guides and reminders throughout the examination process. For those with less experience, the programs are especially useful guides for effectively completing the assigned examination phase. For those with more experience, the programs tend to be reminders of review areas during each phase of an examination.

Not all programs will apply to a mortgage lender. Further, of those that apply, you most likely will not need to complete all the procedures. The examination scope should help determine the level of review and procedures you need to conduct in each area. See Manual for supervision Section 060, Examination Scheduling, Scoping, and Management.

When selecting programs and procedures for review, you must use a risk-focused examination approach. A risk-focused approach allows you to accomplish the following tasks:

- Highlight the concerns in the scope and any other problems found during the review.
- Assess the safety and soundness of the mortgage lender.
- Update and support the CAMEL composite and component ratings.
- Assess the mortgage lender's compliance management program.
- Update and support the Compliance rating.

Use sound professional judgment to ensure that the depth of review is sufficient to accurately assess the mortgage lender's condition, but is not excessive. The following discussion focuses on general procedures, the three levels of procedures, and the national policy guidelines for their use.

General Procedures
Although examination subject areas differ greatly, certain procedures are applicable to any phase of an examination. A list of procedures that is common to the overall examination process and to virtually every examination section appears below. You may wish to review this list when completing an area of review, as the procedures may not appear in other manual sections or programs.

Gather data:

- Review previous Report of Examination (report of examination), PERK documents, exceptions, and work papers.
- Review internal and external audit reports and related management letters.
- Review current year's scope, supervisory correspondence, and interagency data.
- Consider regulatory policy associated with area of review.
- Set forth special considerations pertinent to the areas of examination.
- Obtain mortgage lender's management reports and written policies and procedures.

Set scope (see also Manual for Supervision Section 060):

- Establish a clear understanding of examination objectives.
- Determine whether management corrected any deficiencies mentioned in the previous report of examination, audit reports, and supervisory correspondence.
- Perform analytical review procedures on financial data:
    - Identify new or unusual transactions requiring modified examination procedures.
    - Indicate areas of greatest concern.
- Consider risk-focused or tailored examination procedures.
- Tailor examination program to meet individual needs.
- Consult with other examiners; take the nature of their initial findings into account in determining the procedures to perform.
- Determine if expanded procedures are necessary.
- Develop additional procedures not covered in the Manual, if necessary.
- Perform only those procedures necessary to achieve program objectives.

Perform procedures:

- Interview mortgage lender personnel.
- Evaluate policies and procedures.
- Spot check the reliability and accuracy of reports.
- Test the mortgage lender's procedures.
- Identify any material changes in operation or policy since previous examination.
- Evaluate trends.
- Research significant variations from the previous examination to determine if there is cause for concern.
- Obtain explanations for any significant matters.

Assess management:

- Review adequacy of management reports to the board.
- Determine the extent of directors' involvement in monitoring performance.
- Review management's plan for future operations.

- Interview management and staff to determine if they have adequate knowledge of policies and procedures.
- Determine sufficiency of training and expertise to implement procedures.
- Determine if management is communicating and regularly updating policies and procedures.

Formulate conclusion:

- Keep the examiner-in-charge (EIC) informed of progress.
- Discuss concerns with other examiners.
- Identify, and determine significance of, regulatory violations and deficiencies.
- Discuss findings with management.
- Determine adequacy of management's response to problem issues.
- Consider possible strategies for corrective action and develop a recommended course of action.

Conduct post review activities:

- Review work to ensure the examination team satisfied examination objectives.
- Summarize results and conclusions.
- Draft comments, including scope and recommendations.
- Assign ratings, if applicable.
- Ensure that you properly cross reference work papers and support substantive findings and conclusions.
- Update the Continuing Examination File (CEF) and Regulatory Profile, if applicable. (See Manual for Supervision Section 060.)
- File exceptions in the General File (GF).

Examination Focus
Level I – Review of exam scoping materials and mortgage lender documents
Level II – Analysis of mortgage lender documents
Level III – Transaction or file analysis

Level I
Level I procedures focus on the review of examination scoping materials and mortgage lender documents, such as policies, procedures, and the compliance management program and self-assessment.

After the Level I review, interview personnel to determine if practices conform to written
guidelines. You should also confirm any other preliminary findings.

If you uncover significant items of concern during Level I analysis, or if you identify significant problems during pre-examination monitoring and scoping, you may need to use
Level II procedures. In certain circumstances, you may need to complete Level III procedures as well.

Level II
Level II procedures focus on the analysis of mortgage lender documents such as loan files, management reports, and supporting financial records. You should select and complete Level II procedures when Level I procedures do not reveal adequate data to support a conclusion for a review area. In the Compliance area, you must determine if the mortgage lender's compliance management program adequately

fulfils the remaining SMAART criteria, that is systems, monitoring, accountability, responses, and training. You may develop an independent analysis of asset values at this level as well as independent verification of other items.

Level I and selected Level II procedures normally provide a comprehensive analysis to support conclusions. These procedures do not include any significant auditing procedures. If you cannot rely on the data contained in mortgage lender records, Level III procedures may be necessary.

Level III
Level III procedures include extensive transaction or file analysis. In the Compliance area, this includes completion of selected MFA examination procedures.

Level III also includes steps that auditors usually perform.

Although certain situations may require Level III procedures, it is not standard practice for you to duplicate the testing efforts of auditors.

Again, it may not be necessary to complete every program or every procedure within a program. You must use discretion in determining which programs and procedures are necessary to address the scope and reach a sound conclusion.

In some situations it may be appropriate to customize existing procedures. In other situations you may perform procedures outside a program to achieve the most efficient and meaningful analysis.

You should document any decisions to deviate significantly from the initial scope instructions or to modify existing procedures on the relevant programs.

Summary, Recommendations, and Comments
In this last section of the program, summarize the following:

- Examination scope, including identification of any procedures used that are not already printed on the program.
- Key and important findings and a conclusion regarding the strengths and weaknesses of the mortgage lender's operations in the particular review area.
- Recommendations for corrective action, which may include a statement about the adequacy of management's response and commitments. *Note:* You should address any recommendation for revising a formal supervisory action in a separate memorandum.

Your work papers should support all substantive findings regarding the overall condition of the mortgage lender. It may be useful to attach copies of draft comments or schedules included in the report of examination to this portion of the program.

Programs and Work Papers
Properly prepared examination programs and work papers are essential to the examination process.

MFA relies on work papers to support the conclusions and findings set forth in the report of examination.

The reader determines conclusions about the effectiveness of the MFA examination process, in part, by the adequacy of work paper documentation. Proper documentation of procedures and subsequent conclusions in the programs leaves an effective audit trail for users of the completed programs.

Moreover, legal staff often uses examination work papers to support the MFA's position in litigation matters.

You are required to support all the applicable elements reviewed under each CAMELS component and Compliance either in the work papers or in a conclusion documented on the appropriate program. In addition, the conclusion for each work paper or area of review should summarize the examination findings, support the composite rating (in addition to the component rating), and indicate if any corrective or enforcement action is necessary.

You should avoid excessive documentation and include only information that is relevant or may require follow-up. Time spent recording extraneous information would be better spent examining high-risk areas. To facilitate any follow-up review that may be necessary, you should also document the name and title of persons or a description of the records from which you obtained the information. Schedules prepared by the mortgage lender should be clearly marked as such.

You should include the following items in work papers and programs, as appropriate:

- Statement of purpose, title, or heading.
- Scope of review.
- Sampling criteria used.
- Procedures performed.
- Legend or explanatory footnotes, if necessary.
- Results of testing.

The examination programs allow space to the right of each procedure to record a work paper cross-reference. This will lead the reader to supporting documentation found either under the same topic or in another program. You must support all substantive conclusions. Additional space between each procedure allows you to include any pertinent information.

The lower right-hand corner of each program contains an index block for the following items:

- Examination Date
- Prepared By
- Reviewed By
- Docket Number.

Fill in each of these items before completing the examination. You should also include this information in your work papers.

The EIC or designee must review and initial all work papers, indicating agreement with the conclusions reached and ensuring that assistants complied with the applicable documentation requirements.

You need only initial and date the first page of prudential reports, accounting records, and other multi-page printed documents.

The EIC should ensure that exam staff carefully checks all comments, charts, and appendices. At a minimum, the EIC's supervisor will review the work papers the EIC prepared and the supporting documentation for the report comments.

File work papers according to the MFA program number. To locate examination programs easily, you may use the Manual table of contents or the program index. You may use the program index as a cover page for file folders. You should cross-reference information germane to the report of examination, or review process to supporting documentation.

Sources of Information
Following is a generic list of information sources that will help you successfully complete the programs.

MFA Documents

- Laws and regulations
- Transmittals
- Regulatory and Lender Bulletins
- CEO Memos
- Standard and supplemental accounting manuals
- Published memos
- MFA Professional Development materials
- Prudential reports filed by lender with MFA; any MFA analytical or performance reports

Examination Materials

- Previous report of examinations, General File, and work papers
- Correspondence from the regional office
- CEF and Regulatory Profile
- Lender Financial Reports
- MFA office instructional manuals

Mortgage lender's Documentation

- Completed pre-examination schedules
- Business plan
- Operating budget and forecasts
- General ledger trial balance
- Loan trial balance
- Investment trial balance

Reports and Minutes

- Independent audit report
- Internal audit report
- Internal management and board reports
- Reports filed with the Government of Egypt
- Board of directors' minutes
- Board committee minutes
- Operating committee minutes

New or Revised Policies, Procedures, and Corporate Documents

- Compliance management program
- Compliance self-assessment
- Internal control policy
- Real estate lending policies
- Real estate appraisal policy
- Environmental risk policy
- Classification of assets policy
- Investment policies
- Interest rate risk policy

- Asset/liability management policy
- Futures and options policy
- Charter, bylaws
- Security policy
- Anti-Money Laundering policy
- Contracts (information systems, service bureau, employment, etc.)
- Contingency planning policy
- Leases (office building, etc.)
- Payment systems risk policy

SECTION: Conduct of MFA Personnel 020

This Manual Section summarizes and discusses some of the more important rules and policies of professional conduct that apply to MFA personnel, including examiners, while performing on-site examinations. For purposes of this Manual Section, we define “you” as MFA personnel.

All MFA employees must comply with the MFA Employee Standards of Conduct. Other regulations pertaining to employee conduct also apply.

If you have any questions about the regulations, contact your manager or other designated ethics officer.

Major Restrictions and Responsibilities of MFA Employees

This summary of the important MFA restrictions and responsibilities comes from applicable regulations and MFA policies. It is not all-inclusive.

As an MFA employee you need to be aware of your responsibilities, restrictions, and disclosure requirements under these rules. If you need or desire further information, you may contact your manager or MFA ethics counselor.

All MFA Employees

All MFA employees must comply with the following restrictions:

- You may not have any financial interest or obligation that conflicts or appears to conflict with your official responsibilities and duties.
- You may not, in an official capacity, participate personally and substantially in any particular matter in which you have a financial interest if the matter will have a direct and predictable effect on that financial interest. (However, the Chief Counsel, Division Director, or designee may, when appropriate, waive this restriction.) You may not participate by decision, approval, disapproval, recommendation, advice, examination, or other action. This restriction also applies where any household member, general partner, or organization in which you have a substantial personal involvement has a known financial interest in the matter.
- You may not accept from a prohibited source (defined below) food, refreshments, or entertainment unless it is of a nominal value. You may only accept a nominal value item infrequently, such as during an official conference or other function that you may properly attend.
- You may not accept unsolicited advertising or promotional material if its retail value exceeds LE 20. You must return items exceeding this value to the sender or dispose of them as directed by the Chief Counsel (or designee) or your ethics counselor.
- You must receive prior supervisory approval before speaking about MFA or publishing MFA-related material for a non-agency audience.
- You may not engage in any outside employment or business activity, paid or unpaid, without prior written supervisory permission from the Deputy Director, Managing Director, Regional Director, or Chief Counsel.
- You may not directly or indirectly make recommendations or suggestions concerning the acquisition, sale, or other divestiture of securities of any MFA-regulated mortgage lender or mortgage lender holding company.

- You may not purchase property owned by the government and under the control of MFA, or sold under the direction or incident to the functions of MFA, without an appropriate waiver.
- You may not have communications with a lender, its holding company, or affiliates suggesting either of the following:
  - That the examination process is in anyway influenced by political issues or considerations.
  - That either the lender, its holding company, or affiliates should take a particular position on political or legislative issues.

  You must notify your supervisor or ethics counselor if you are aware of any communications that might conflict with or compromise either of these restrictions.

Definition of Prohibited Source

The term "prohibited source" (as used in this Manual Section) means any person, or entity, who meets any one of the following criteria:

- Seeks official action by MFA.
- Does, or seeks to do, business with MFA.
- Conducts activities regulated by MFA.
- Has interests that may be substantially affected by the performance or nonperformance of your official MFA duties.
- Is an organization with a majority of members who fall within any of the above classifications.

Covered MFA Employees

If you are a covered MFA employee, you must comply with the following restrictions and disclosure requirement(s):

- You (or your spouse or minor child) may not knowingly accept or become obligated on, directly or indirectly, any impermissible extension of credit from an MFA-regulated mortgage lender or its subsidiary.
- You (or your spouse or minor child) may not purchase any asset from a mortgage lender or its affiliate, including an institution in receivership or conservatorship.
- You (or your spouse or minor child) may not purchase, own, or control, directly or indirectly, any security of an MFA-regulated mortgage lender and most mortgage lender holding companies.
- You must file required financial disclosures as described below.

Negotiations for Employment

As an MFA employee you should not negotiate or have any arrangement concerning prospective employment with any person or organization while simultaneously representing MFA in any particular matter that affects the person or the organization. Concerning job offers, you must immediately inform your supervisor of offers of employment in either of the following circumstances:

- If you do not unconditionally and immediately reject the offer from a mortgage lender or other prohibited source.
- The MFA has assigned, or you believe it is likely the MFA will assign, you to examine, supervise, or make any regulatory decision affecting that prohibited source. Your supervisor and/or ethics counselor must decide if you should provide an employment restriction (recusal) to eliminate any potential conflict of interest. Recusal from any current assignment(s) should last until you resign or send a written rejection of the employment offer. Outright and immediate rejection of unsolicited offers requires no recusal, but a memorandum to the file or to your supervisor is advisable.

An MFA employee rejected for a job by a prohibited source should generally refrain from participating in MFA matters relating to the potential employer for at least one year. However, a written review of the matter by an MFA ethics official recommending an exception may permit earlier participation by the employee.

Rules governing the conduct of MFA personnel prohibit covered MFA employees from obtaining new credit from real estate lenders or mortgage lender subsidiaries.

PROFESSIONAL CONDUCT IN INSTITUTIONS

The following presents professional conduct guidelines that address some issues that examiners may face in their day-to-day work in institutions.

Duration of Onsite Examinations

Examiners should conduct each examination in the most efficient and least disruptive manner possible, to limit the time spent on site at each institution. To this end, you should thoroughly scope and plan each examination, targeting problem and high-risk areas.

Pre-examination activities should include contacting the institution's management and obtaining lists of employees and documents necessary to perform the examination.

Working Hours

EICs should manage time in a responsible and professional manner. The examination staff conducts examinations on a work schedule at hours and days of the week as specified by the Director of MFA.

Examiners should obtain approval from the EIC for deviations from normal working hours during an examination and should explain to the EIC the reason for all absences not pre-approved. Also, the EIC should inform the institution's management of any unusual variances, especially absences, from the normal work schedule. Absences without notice give the impression of lack of responsibility and care.

Working Space

Real estate lenders should provide adequate working space for examiners. If space is inadequate, examiners may request additional or other space as long as its use does not unreasonably disrupt mortgage lender operations.

To avoid any appearance of impropriety, when you are working in an institution you should take the following precautions:

- Ensure that a representative of the institution is on the premises whenever you are working.
- Not accept keys to the institution's offices or assume responsibility for its property.
- Not enter places where there is a possibility of access to cash or other negotiable instruments unless a representative of the institution accompanies you.

Access to Information

When you are in an institution you must take care to adhere to the following procedures:

- Carefully protect all information an institution entrusts to you and secure it from unauthorized access.

Never leave confidential documents unattended; you should lock them up when not in use.

Never divulge confidential information in any form to unauthorized persons.

Never leave computers unattended in the following circumstances:

- While logged onto an MFA system.
- While the computer is in a status that would allow unauthorized access to an MFA system or to any confidential data stored on diskettes or disk drives. You should notify the EIC or other supervisors if the institution refuses to provide you with any information needed to conduct an examination.

Breaks

The EIC will determine the propriety, times, and lengths of breaks.

Lunches

You may use an institution's dining facilities if the institution invites you to do so and you pay for your own meals. Examiners on assignments with large crews should stagger their lunch breaks so that the entire crew is not absent from the work place simultaneously.

Professional Decorum

The following guidelines are general prescriptions for interacting with other regulators and institution employees during an examination.

You should limit unnecessary conversations with other regulators and the institution's employees.

You should treat institution employees in a courteous, friendly, yet businesslike manner.

You should not discuss work with unauthorized employees. You should generally confer with the EIC before discussing anything other than routine matters with employees or management.

Smoking

MFA employees who smoke should always be courteous and considerate of others, and should follow any institution rules regarding smoking.

Telephone Calls

You should limit telephone usage, even for official matters. You should avoid personal telephone calls unless they are absolutely necessary.

Parking

You may use an institution's private parking facilities if invited to do so by the institution. The EIC must, however, approve such use, which should not unduly inconvenience employees or customers. If the institution uses an independent parking facility, you may not park there at the institution's expense.

Travel Expenses

All travel, lodging, and subsistence expenses incurred while on official duty shall be paid for or reimbursed only by MFA. For further information regarding reimbursement for travel and lodging refer to MFA's travel policy manual.

Business Attire

You should wear appropriate business attire at an institution. Standards of appropriateness may vary depending on the institution, and the customs of the community.

SECTION: Examination Strategy And Objectives 060

Timely, efficient, and **risk-focused** examinations are essential to an effective regulatory oversight function.

Timely examinations ensure that the agency stays abreast of changes in the condition or management of a mortgage lender. A risk focused examination ensures that MFA examines those mortgage lenders that pose most risk more frequently, and those with less risk, less frequently.

An efficient examination eliminates multiple reviews of the same area for different purposes by combining safety and soundness and compliance reviews of the same areas such as lending, management, or liquidity.

MFA bases the timing of an on-site examination partly on the risk profile of the mortgage lender and partly on the scope of examination for any given mortgage lender.

All examinations should be **risk-focused**, meaning that you spend more time looking at higher risk areas within an organization and less time looking at low risk areas. Risk can be based on the nature of a mortgage lenders operation, the quality of management and staff, and the adequacy of management and the board's ability to identify, manage and monitor risk, and take timely action to remedy identified problems.

Risk-focused examinations assist the agency in ensuring **efficient** use of its resources and ensures that examiners spend the most time looking at areas or activities that pose the most risk. We also achieve efficiency in the examination process through a well-managed examination. Staffing should be appropriate to the size of the mortgage lender and the scope of the review. In addition, the EIC achieves economies of scale whenever possible to eliminate any redundancies in the review process. In those mortgage lenders with adequate compliance management functions and a lower risk loan portfolio, transactional level review may be minimal and thus limit the opportunities for combining transaction review processes. However, the EIC should be mindful of situations where examiners can combine safety and soundness and compliance reviews (particularly at a transactional level).

The goal of the comprehensive examination process is to conduct a single examination where the exam team reviews the compliance and the CAMELS component areas. Based upon the findings in each of these areas, the examination team should be able to make an overall assessment of the mortgage lender in terms of risk, adequacy of management and the system of risk and compliance management, and future prospects.

SCHEDULING EXAMINATIONS

MFA must schedule full-scope, on-site examinations of regulated mortgage lenders once
during a 12-month cycle or once during an 18-month cycle. You may conduct a limited examination under certain conditions. (See the discussion of Limited Examinations at the end of this Manual Section.)

Timely, efficient, and *risk-focused* examinations are essential to an effective regulatory oversight function.

A full-scope examination means that you conduct an on-site examination and rate all CAMELS components. For comprehensive examination purposes, MFA also conducts a compliance review as part of a full-scope examination.

MFA measures the 12-month and 18-month cycles from the “close date” of the last examination to the “start date” of the next examination. The “close date” is the date MFA transmits the Report of Examination to the mortgage lender.

12-month Cycle
You must conduct a full-scope, on-site examination of the mortgage lender once during each 12-month period unless the mortgage lender meets the 18-month cycle requirements below.
By conducting examinations annually, you increase the chances of discovering problems and resolving them early. MFA may conduct full-scope, on-site examinations more often than prescribed if warranted by significant and unresolved problems.

All de novo real estate lenders are subject to the 12-month examination cycle. The 12-month examination cycle should continue until management has demonstrated its ability to operate a mortgage lender in a safe and sound manner and satisfied all conditions imposed at the time of approval.

18-month Cycle
An 18-month examination interval applies to insured real estate lenders that meet the following criteria:

- The most recent examination received a composite CAMELS rating of 1 or 2 and a Compliance rating of 1 or 2.
- The most recent examination received a Management component rating of 1 or 2.
- The mortgage lender is well-capitalized as defined under capital laws and regulations.
- The mortgage lender is not currently subject to a formal enforcement proceeding or order by the MFA.
- The mortgage lender has not undergone a change in control during the 12-month period since completion of the last full-scope, on-site examination. Revert to the 12-month examination schedule if any of the following occurs:
- An enforcement action.
- An acquisition or change in control.
- A downgrade to a 3 or worse in the CAMELS composite rating, the Compliance rating, or Management component rating. If a triggering event occurs in any of the following time frames at a mortgage lender that otherwise meets all of the criteria for an 18-month examination interval, you must conduct a full-scope examination within the appropriate interval:
- Within 9 months of the “close” date of the prior full-scope examination, start the next examination no later than 12 months from the close of the last full-scope examination.
- Between 9 and 12 months since the close of the last full-scope examination, start the next examination within 90 days.
- Twelve or more months since the close of the last full-scope examination, start the next examination within 90 days, but no later than 18 months from the close of the last full-scope examination. Conversely, if a mortgage lender under a 12-month examination interval becomes eligible for an expanded interval, MFA may immediately expand the interval to 18 months.

EXAMINATION SCOPING AND PLANNING

Scoping an Examination
Scoping is an integral part of a risk-focused examination process, assisting examiners in targeting higher risk areas for review and in determining the appropriate examination procedures for that review.

Scoping is the examination planning process that matches the risk profile of a mortgage lender with the examination programs to enable a focused evaluation of mortgage lender performance and appropriate rating assignments and conclusions.

Scoping is the starting point of any examination and usually begins off-site.

In brief, scoping enables you to understand the present risk profile of a mortgage lender based on the following:

- A review and analysis of prior examination reports and prior track record of management.
- A review of agency monitoring records and pre-examination data.
- Interviews with management.
- An assessment about changes in business operations, staffing, or external circumstances.

Based on this risk profile, the EIC can then determine the appropriate areas for examiner review, the depth of review required, the examination procedures to use, and the examination personnel requirements. The EIC may modify an examination scope based on findings during the course of an examination.

Scoping consists of three stages:

- Reviewing pre-examination information.

Scoping is an integral part of a risk-focused examination process, assisting examiners in targeting higher risk areas for review and in determining the appropriate examination procedures for that review.

- Conducting management interviews.
- Developing a risk assessment. It is critical to the risk-focused examination process that you conduct these stages using the most effective off-site and on-site methods that resources permit.

Review Pre-examination Information
Generally, the EIC begins the scoping process off-site, before the start of the examination, leveraging off work performed by regional staff responsible for monitoring and updating the ECEF and Regulatory Profiles, prior exams and work papers, and relevant pre-examination materials.

A sample of items that you may review off-site includes the following:

Agency Information

- The Continuing Examination File (CEF).
- Results, including reports and analyses, of off-site monitoring.
- MFA prudential reports submitted by the lender
- Prior examination work papers and recommendations
- Unresolved issues from preceding examinations
- Correspondence with MFA covering significant matters involving the mortgage lender that transpired between exams
- Other correspondence and internal memoranda involving the mortgage lender

- Application information – conditions of approval and major applications filed
- Documentation on supervisory and enforcement actions
- Consumer complaints filed with MFA since the last examination
- Suspicious Activity Reports and Currency Transaction Reports

Pre-examination Information
Preliminary Examination documents completed by mortgage lender management before the start of the examination for information related to the following:
- Changes in operations
- Changes in technology risk, systems and controls
- Board meetings
- Internal and external audits
- Compliance self-assessments
- Responses and corrective actions to exams and audits
- Letter from lender's general counsel discussing significant litigation in process or resolved since last examination

General Data
- Economic information about the mortgage lender's market area(s).
- News articles, including Internet sources.

When you arrive on-site for the examination, review additional information that may affect the scope as soon as possible. Examples of scoping materials commonly reviewed on-site include the following:
- Relevant pre-examination documents not available before the examination begins
- Board reports, board minutes, and management reports
- Compliance reviews and/or compliance self-assessments
- Internal audit reports
- Internal Asset Review reports
- Business plan
- Operating budget
- Any new contracts (for example: employment, information systems, leases, etc.)
- Any new or revised policies and procedures
- Any new product or delivery channel specifications and associated marketing plans

Conduct Management Interviews
In this stage of the scoping process, the EIC should conduct detailed interviews with the
President/CEO, senior management, compliance officer, internal auditor, information security officer, general counsel, or other responsible staff, as applicable. You may conduct some of the initial discussions off-site.

Further discussions will take place on-site at the start of the examination and continue (as needed) throughout the duration of the examination. Use the interview process to confirm, modify, or supplement your preliminary judgment about the mortgage lender's risk profile, changes in risk profile, management's response to those changes, and management's track record.

As the EIC, you should communicate the results of the interviews to the examination team. Discussions should cover the operational impact of the following:
- Business strategic development and implementation.

- Modifications of organizational structure and lines of responsibility.
- Scope and effectiveness of employee training programs.
- Variations in financial condition or risk profile, and operating performance in comparison with the budget.
- Changes in operations that could affect ongoing safety and soundness and compliance performance.
- Actions taken to correct deficiencies identified in previous examinations, audits or compliance self-assessments.
- Management's perspective on economic conditions directly or indirectly affecting the mortgage lender's financial performance and risk profile.
- Management's status in implementing a formal written compliance policy and self-assessment.
- Alteration of existing or development of new products.
- Significant internal or external audit findings, and management's response to those findings.
- Management's adherence to, or departure from, formally established procedures or standard practices.
- Addition or removal of third-party service providers.
- Adoption, deployment or modification of information technology platforms or tools. You should adapt the interview process to address the particular circumstances at each mortgage lender in response to findings from the pre-examination analysis. (Consult the Basic Matrix in Appendix A as an aid in identifying the regulatory obligations associated with particular products.) This process will assist you in refining the examination scope and in determining to what extent you examine certain operations, and particular laws and regulations.

Risk Assessment
Proper scoping (through document reviews, data analysis and management interviews) allows the EIC to formulate initial conclusions about the mortgage lender's condition and risk profile, including credit risk, operational risk, interest rate risk, compliance risk, strategic risk, and reputation risk.

Using pre-examination information and management interviews allows the EIC to formulate an initial assessment of:

- Current financial condition.
- Management and the board's prior track record.
- Material changes in risk profile or operating strategy, and management's response to those changes.
- The mortgage lender's internal controls, including technology risk controls, risk management, and compliance management systems.
- Responsiveness of management and the board in implementing corrective action to risk management and compliance management deficiencies since the previous examination, audits or reviews.
- Mortgage lender's efforts to stay abreast of and train the board, management, and staff on safety and soundness and regulatory compliance developments.

Your assessment of these areas is a critical step for determining examination scope and the risk profile.

Selecting Examination Programs and Procedures
Based upon the risk assessment, you will determine the appropriate examination programs and procedures to use. You should consider all programs and questionnaires within the scope of the examination, including the risk-focused and

tailored examination procedures. You may use a combination of procedures when performing an examination. You should perform a more detailed review of areas with greater risk or with deteriorating performance indicators and actively pursue any concerns or red flags that you uncover during the examination process. For example, if risk factors require you to go beyond tailored examination procedures, you may use any examination procedures included in the risk-focused examination procedures, examination procedures in the Examination Manual, or conduct any other type of review determined appropriate to assess risk. You may expand the depth of review of any given area as additional facts surface that necessitate a more comprehensive review.

Use programs and questionnaires as appropriate, but only to the extent necessary to address the scope and support the examination conclusions. Programs provide guidance necessary to support examination findings and report of examination comments. Wherever possible and indicated by the risk assessment conduct simultaneous reviews for safety and soundness and consumer compliance assessments.

In many circumstances, you will not need all or even a majority of the programs. The EIC may find it helpful to use the Examination Scope Worksheet in Appendix B to indicate the examination programs to complete on an examination. Discuss the scope of the examination with the Director of Monitoring and Enforcement and document their agreement on the worksheet. Before the start of the examination, the EIC will prepare a scoping memorandum, signed by Director of Monitoring and Enforcement that sets forth the risk assessment and exam programs. Retain a copy for the work papers.

For example, if your review of the policies, structure, administration, and results of the mortgage lender's internal asset review program reveals that the program is sufficient and the results are accurate, you may place a greater reliance on the mortgage lender's internal review. The risk that the mortgage lender is not adequately reviewing and classifying its assets would be low, so more detailed examination procedures would generally not be necessary.

When using this risk-focused examination approach, use sound professional judgment to ensure that the depth of review is sufficient to accurately assess the mortgage lender's condition, but is not excessive.

For further information regarding the examination program and the three levels of review, refer to Manual for Supervision Section 010, Manual and Program Use.

EXAMINATION MANAGEMENT

Effective management of the examination expedites and enhances the examination process by ensuring that the examination team meets the exam objectives and does so in an efficient manner. The level and sophistication of examination management methods and procedures will vary depending on the size, nature, and activities of the mortgage lender.

The EIC may elect to use an Examination Management Checklist such as that found in Appendix C. The checklist provides the time frames of tasks that need to take place before, during, and after each examination.

EIC Responsibilities

The Examiner-in-charge (EIC) carries the primary responsibility for managing the examination. The EIC's responsibilities include:

• Examination planning, organization, and implementation: The EIC is responsible for scoping the examination, setting the examination objectives, communicating the examination objectives to the examination team, and ensuring that the exam team meets the examination objectives.

• Assignments and job monitoring: The EIC must determine the expertise necessary to
perform certain aspects of the examination and make assignments accordingly. The EIC is responsible for realizing the maximum efficiency from conducting coordinated safety and soundness and compliance reviews consistent with the examination's scope. Depending on the size of the job, the EIC may delegate certain management responsibilities to assistants for efficiency and to improve upon administrative and management skills of assistants.

- Assign priorities to examination tasks and determine optimal use of comprehensive reviews across exam programs.
- Brief the examination team members on their respective assignments, including their participation in examination segments that will involve comprehensive reviews across exam programs and/or cross-training. Provide them with the necessary information and resources to conduct their assignments efficiently.
- Explain the risk assessment and scoping judgment relevant to each assistant's assignment.
- Discuss the effect of information developed during the exam on the mortgage lender risk profile, possible changes to the scope, opportunities for conducting comprehensive reviews across exam programs, and the ability to meet assignment deadlines throughout the examination. Adjust assignments as warranted by these considerations.
- Consider completing the Examination Scope Worksheet in Appendix B when assigning tasks and budgeting examination hours. The EIC specifies the areas to review on the examination considering the scope. As needed, you may add any activities not included on the worksheet.
- Monitor the progress of the examination to achieve examination objectives in a timely manner and to identify early adjustments to the scope, staffing, and completion date. The EIC should notify a supervisor as soon as adjustments to scope or other events may affect scheduling or the completion date. The supervisor might consider staff reassignment from other jobs, if necessary.

• Prepare Report of Examination: Incorporate program findings and conclusions, edit comments and finalize the report of examination. Compile, index and file work papers. Properly record necessary exam data and regulatory violations in agency systems.

• Serve as the primary communications link: The EIC is the focal point for communications on significant matters. Assistants, mortgage lender personnel, and regional office staff must all know how to communicate information and when to share information. During the examination, it is important that only one responsible individual provide answers to significant items. The EIC should coordinate this in case questions arise.

- Examiners should communicate any significant changes to the scope and the reasons for them with examiners involved in holding company, trust and asset management, and information technology (IT) examinations. Share significant findings and conclusions to avoid duplicating efforts.

- Maintain close communication other regulatory authorities as prescribed by the MFA, such as the Central Bank.
- Early in the examination, the EIC should discuss with the President/ CEO, or with a designated mortgage lender representative, some of the administrative aspects of the examination, including:
    - Time frames for receiving requested information.
    - The availability of the examiners to answer questions from the staff preparing requested information.
    - Names of key contact people.
    - Facilities and parking availability.
    - Hours for work.
    - Use of equipment.
    - The expected duration of the examination.
    - Any planned interruptions (these should be kept to a minimum).
    - Names of assisting examiners.
    - The EIC should schedule regular meetings with the CEO to discuss the progress of the examination and to address any issues of concern. Conduct the examination efficiently to minimize undue disruption for the mortgage lender. Convey any unresolved concerns management expresses about exam progress to a supervisor.
    - The EIC should schedule an examination exit meeting with the mortgage lender's senior management to discuss examination findings, the examiner's overall conclusions, and recommendations (see Manual Section 070, Ratings: Developing, Assigning, and Presenting).

• Manage staff development and evaluation of assistants: Assistants may need guidance, depending on their experience and ability. The EIC should encourage questions and ensure that someone is available to provide guidance. Depending on the size of the job, the EIC should be familiar with the work performed by the assistant(s) so that they can make fair and constructive evaluations of their work.

- Whenever possible, assign assistants to program areas that they can complete, including report pages and comments, before leaving the assignment. This allows for efficiency and accountability and provides necessary on-the-job training.
- Monitor assistants' performance throughout the examination to ensure that they are meeting objectives according to schedule and consistent with agency standards for quality work product. Early identification of work-related problems also allows the assistants the opportunity to correct mistakes and to immediately improve upon skills.

• Ensure a cooperative and positive working environment: Conduct examinations with as little disruption, conflict, and confusion as possible. A positive work environment fosters the productivity of the team members. Disagreements will occur at times, but avoid an antagonistic role. Allow for regular meetings with management to discuss findings and questions, and avoid monopolizing the time of the staff as much as possible. A professional and considerate approach usually results in cooperation from the mortgage lender staff.

Off-Site vs. On-Site Examination Procedures

MFA may conduct some examination procedures off-site as proficiently as they conduct them on-site. Performing examination procedures off-site is optional.

Regional directors or their designee should determine whether off-site work is feasible and develop appropriate policies and procedures. In simple terms, you may perform certain procedures off-site at the beginning and end of an examination. Some of the advantages of performing procedures off-site may include reduction in travel expenses and a reduction in the disruption to normal lender operations attendant with even the best-run examinations.

Mortgage lender Selection Criteria
You should determine whether to use off-site examination procedures based on certain criteria, including:

- The mortgage lender's CAMELS and Compliance ratings.
- Prior history.
- Complexity of operations.
- Reliability of data.
- Capabilities of staff assigned.

This approach is flexible because there are no firm guidelines such as asset size, rating, or location to determine when you can or cannot use off-site examination analysis.

Open lines of communication with mortgage lender personnel are essential at all examinations, but you may have to take extra steps to keep those lines open during off-site portions of the examination. Advise mortgage lender management of the start and completion of off-site work. Finally, exercise judgment so that you perform on-site work that is appropriate to on-site performance.

Pre-examination Information
You may specify in the Pre-examination letter that MFA will conduct some of the examination work off-site.

Unless it is necessary to retrieve items from the mortgage lender, request some items in advance for delivery to the field office or other appropriate location. If you select this option, send the pre-examination materials out a few days earlier than recommended in the normal customer service standards.

Do not require lenders to photocopy and ship materials to examiners if it creates rather than reduces regulatory burden. Regulatory staff will have to gauge the resources and attitudes of each lender toward using off-site examination procedures. Again, keep open the lines of communication with management.

Continuing Examination File and the General File

Continuing Examination File
Include the following items, only if applicable to the particular mortgage lender being examined, in the Continuing Examination File (CEF), or file them with the applicable examination programs and carry them forward from examination to examination until no longer applicable. Maintenance of these documents preserves examination continuity and reduces excessive requests for information during examinations:

- Management and Director Committees and Members
- Organizational Chart
- Officer Resumes
- Directors' and Officers' Home Addresses
- Enforcement Documents
- Schedule of Branch Offices
- Copy of Charter and Bylaws
- Summary of Leases

- Holding Company/Affiliates Corporate Structure
- Internal Audit Program
- Stockholders' Schedule
- Proxy Statement, if applicable.
- Approved Appraisers and Qualifications
- All Contracts
- Copies of Written Policies

If you must include a mortgage lender policy as part of work paper support, file it in the appropriate CAMELS or Compliance section of the work papers. Similarly, include the business plan and budget requirements in the Management/Administration work paper file.

General File

The general file contains the administrative information related to the examination and is organized to correspond with the administrative section of the Manual. Include the following items in the general file:

- Exceptions Sheets
- Examination Scope Worksheet (Appendix B)
- Examination Scheduling, Scoping, and Management Program
- Pre-examination materials Summary Schedule (for next exam)
- Pre-Assignment Analysis
- Overall Conclusions Program
- Recent Correspondence
- News articles

You should use exception sheets to record all specific regulatory and policy violations that you do not specifically discuss in the report of examination. Either the managing officer or the appropriate department head must provide a disposition for each problem noted and initial the exception sheet. Provide a copy of all exception sheets to the managing officer.

Examination Conclusion

The EIC is responsible for reviewing and compiling the examination findings and ensuring the Examination Conclusions and Comments page presents a concise and balanced portrayal of a mortgage lender's condition and future prospects. The ratings should reflect the overall examination findings and conclusions. Also, ensure that the mortgage lender takes prompt corrective action for any problems found during the examination and closely monitor the mortgage lender's condition for any recurrence of these or new problems.

MFA staff must send the report of examination to 1- and 2-rated real estate lenders within 30 days from completion of on-site examination activities, and to 3-, 4-, and 5-rated mortgage lenders within 45 days from completion of on-site examination activities.

Refer to Manual for Supervision Section 070, Ratings: Developing, Assigning, and Presenting, for other appropriate examination closing procedures. (Time requirements subject to MFA approval.)

Mortgage Finance Authority

Manual for Supervision

100 - Capital

SECTION: Capital Stock and Ownership 110
INTRODUCTION

This Section of the Handbook presents information concerning the following:

- Stock organization
- Types of capital stock
- Securities Commission reporting requirements for publicly traded companies
- Insider stock trading
- Change in control
- Divestiture of control
- Contributed capital
- Mortgage lender holding companies
- Capital distributions
- Loans by real estate lenders on its own stock

STOCK ORGANIZATION

Stock organization means that management decisions are subject to shareholder vote and scrutiny. Stock real estate lenders must hold annual meetings of shareholders subject to regulatory requirements.

CAPITAL STOCK

Capital stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest in the real estate lender. One or more individuals or any business entity such as a partnership, a trust, or a corporation may own the stock.

Common Stock

Common stock represents all the basic rights of ownership. Common stockholders exercise their basic rights in proportion to the shares owned.

A real estate lender may list its shares on an organized exchange, or trade them directly according to law. A real estate lender may act as its own registrar and transfer agent.

Among the records a stock real estate lender must maintain is a (registrar's) list of stockholders. The list should include the following information:

- Name of holder
- Address
- Number of shares owned
- Date acquired
- Certificate number(s) held
- Amount and type of dividend paid each stockholder

It is important to promptly record transfers of shares to new owners. Real estate lenders, periodically, should reconcile the stockholder ledger with the general ledger control account and the stock certificate book.

Preferred Stock

Preferred stock carries certain preferences, such as a prior claim on dividends, over common stock. Often preferred stock conveys no voting rights, or only limited voting rights, to the holders. The articles of incorporation (charter) govern special rights of a preferred stock issue. The chartering authority may also regulate stockholders' rights. Whether preferred stock is includable in regulatory or Egyptian accounting principles capital depends on its permanence as a funding source. The status of preferred stock as part of capital also depends on whether redemption of the stock is required to occur only upon the liquidation or termination of the real estate lender.

Like common stockholders, preferred stockholders have basic ownership rights and do not have priority over creditors in the event of liquidation. Although forms of permanent perpetual preferred stock exist, other preferred stock contains defined redemption terms and consequently it is not as permanent or long term a funding source as common stock.

Real estate lenders include non-cumulative perpetual preferred stock in core regulatory capital. Real estate lenders include cumulative perpetual preferred stock in supplemental capital. Supplemental capital also may include certain redeemable preferred stock and subordinated debt issued under MFA regulations and memoranda. Eligibility for such instruments to qualify as part of regulatory capital depends on the timing of the redemption and other contractual characteristics.

Securities Laws

Egyptian securities laws and regulations pertain to all real estate lender stock transactions. In addition certain reporting requirements are also made.

Other Types of Beneficial Ownership

Persons may own directly any stock held in their own name, or the stock may be held by a bank, broker, or nominee in "street name" for their account. Under the convention of holding shares in street name, a broker executes the trade and holds the stock in the name of the brokerage firm or a nominee. The real estate lender, through the shareholder (registrar's) ledger, is unaware of the individual initiating the transaction. There are no rules governing the disclosure of ownership held in street name except for the threshold reporting requirements described above.

Persons are the beneficial owners of any stock that they have the right to acquire through the exercise of presently exercisable options, including options granted through a stock option plan. Indirect beneficial ownership includes stock held in the name of another person if, because of an agreement or relationship, a person obtains benefits substantially equivalent to those of ownership. Such benefits include the right to receive income and the right to control transfer of the stock. For example, a person generally is the beneficial owner of stock in the following situations:

- Stock held by certain family members, such as a spouse or minor children.
- Stock owned as trustee, where the person or members of the person's immediate family have a vested interest in the income or principal of the trust.
- Stock held in trust for which the person is a beneficiary.
- Stock owned by a partnership of which the person is a member.
- Stock owned by a corporation that the person controls.

Proxy and Information Statements

Egyptian Securities Regulations require the filing of preliminary copies of all proxy statements, other soliciting materials, and Information Statements. Real estate lenders must file this material with MFA according to time periods set out in Egyptian Securities Regulations. Real estate lenders must file definitive copies of the above materials with MFA no later than the date of sending or giving such information to shareholders.

In certain circumstances, real estate lenders must provide an Information Statement that contains the information specified under the Securities Law. In those instances where a mortgage lender plans corporate action, the Securities Law requires the filing of an Information Statement. The Information Statement may relate to an annual meeting, a special meeting instead of an annual meeting, or a written consent instead of either an annual or special meeting that includes election of directors. This is a requirement even where there is no solicitation of proxies. The corporate action may occur either at a meeting of the real estate lender's security holders or by written authorization or consent of such holders.

Annual Report to Shareholders

Real estate lenders must mail to shareholders copies of the Annual Report to Shareholders.
Mortgage lenders mail the Annual Report to Shareholders with, or subsequent to the mailing of, either proxy solicitation material or an Information Statement.

INSIDER STOCK TRADING

There are substantial limitations on the ability of real estate lender directors, officers, and ten percent shareholders to trade in the mortgage lender's stock. Generally, any profit realized from any purchase and sale or sale and purchase of the real estate lender's stock within a [six-month] period (short swing trade) is subject to recapture. Either the real estate lender or the mortgage lender's stockholders by filing suit on its behalf may seek recapture. The rule provides a rigorous guard against misuse of confidential information by insiders. Furthermore, the Securities Law generally prohibits directors, officers, and ten percent stockholders from making any short sale of their real estate lender's stock. That is any sale of stock that the seller does not then own.

The Securities Law also requires that directors, officers, and 10 percent stockholders deliver to buyers promptly any stock they sell. Alternatively, the Securities Law requires the depositing in the mail any stock sold by directors, officers, and 10 percent stockholders. In addition, the Securities Law prohibits a person from trading any stock using material inside information. Inside information refers to material information not available to the public in general. The rule also prohibits a person in possession of material non-public information from selectively disclosing this information to others (tipping) and generally bars the tippees (persons who may have received such non-public information) from trading on such a tip. Information is material for this purpose if a reasonable investor would consider it important in reaching an investment decision or would attach actual significance to the information in making the decision. Thus, real estate lender officers, directors, and others in possession of material inside information must not trade in the real estate lender's stock until the information is available to the investing public. Managers must not make any disclosures of material information to selected persons without concurrently releasing the information to the public.

CHANGE IN CONTROL

Regulators have concerns about the control of a real estate lender's voting rights because a change in control may influence the direction and operating policies of the real estate lender. No person may acquire control of a real estate lender through a purchase, assignment, transfer, pledge, or other disposition of voting rights of such real estate lender without MFA approval. This includes the individual acting directly or indirectly, or through or in concert with one or more other persons.

Companies that seek to acquire direct or indirect control of a real estate lender must also seek MFA approval before the acquisition of control. Companies may act in concert with individuals or other companies to acquire control of a real estate lender. Special notification requirements apply whenever a change occurs in the outstanding voting rights that will result in control (or a change in control) of any mortgage lender. The president or other chief executive officer must report such facts to the MFA. They should file the report within 15 days of their knowledge of such change.

The real estate lender should file a report whenever there is a change in control of any real estate lender or holding company and there is also a change or replacement of the chief executive officer within 15 days. The president or other chief executive officer should file a report when a change in control of a mortgage lender or holding company occurs concurrently with, or 15 days, a change or replacement of the chief executive officer.

The president or other chief executive officer must report to MFA whether a change in ownership or other change in the outstanding voting rights under will result in control or a change in control of the real estate lender or holding company. Regulations to be developed will outline the conditions under which an acquirer possesses control. The regulation will also include conclusive control determinations.

REGULATORY CONSIDERATIONS

Divestiture of Control

Any acquirer subject to a capital maintenance obligation must give prior written notice to MFA if the acquirer proposes a divestiture of the real estate lender. After receiving the notice, MFA should promptly conduct an examination of the real estate lender. MFA determines the extent of any capital deficiency and communicates the results to the acquirer. If the examination indicates that no deficiency exists, the acquirer may divest control of the real estate lender upon receiving written notice of the examination results.

If a capital deficiency does exist, any acquirer subject to a capital maintenance agreement may only divest a real estate lender if they provide MFA with a capital infusion agreement. Such an agreement must provide that the acquirer will infuse the real estate lender with the amount necessary to remedy the deficiency. Further, the acquirer must arrange for payment, satisfactory to MFA, or otherwise satisfy the deficiency. If the acquirer provides MFA with a satisfactory agreement before the completion of an examination made to determine the extent of any capital deficiency, it may proceed to divest control. Also, the acquirer must arrange for payment, satisfactory to MFA, to ensure payment of any deficiency. Alternatively, the acquirer may immediately satisfy the deficiency.

Contributed Capital

Real estate lenders may accept without limit the following capital contributions:

- Cash
- Cash equivalents

Capital Distributions

A real estate lender is permitted to make a distribution of cash or other property. Whether a real estate lender must file a notice or application with MFA depends on whether the capital distribution falls within certain criteria established in law or regulations. Regulations prohibit an insured institution from taking certain actions if, as a result, the institution would fall within any of the three undercapitalized capital categories. The prohibited actions include the following:

- Declare any dividends
- Make any other capital distribution
- Pay a management fee to a controlling person

A real estate lender permitted to make a capital distribution under the prompt corrective action regulations may do so in accordance with the regulatory agreement only. The capital distribution regulation incorporates capital distribution requirements and imposes other limitations.

Loans by Mortgage Lender on Its Own Stock

MFA prohibits real estate lenders from making loans or discounts on the security of the shares of their own capital stock. Since repayment of the loan may require the mortgage lender to take title to the collateral and remarket it, MFA considers such action an unsafe and unsound practice, particularly for a mortgage lender that cannot easily remarket its stock.

MFA may allow a real estate lender to make a loan or discount on the security of the shares of its own capital stock if it acquires the stock to prevent loss upon a debt previously contracted for in good faith. Real estate lenders may also take their own stock as additional collateral in “work-out” situations. This provides lenders with greater security against default and enhances the safe and sound operations of a lender. Real estate lenders may own or acquire shares to reduce capital.

SECTION: Capital Adequacy 120

INTRODUCTION

Capital absorbs losses, promotes public confidence, and provides protection to borrowers and other consumers. It provides a financial cushion that can allow a lender to continue operating during periods of losses or other adverse conditions. This section of the Manual provides guidance in determining a lender's capital adequacy.

Capital Adequacy
A lender's level of capital is adequate when it meets regulatory requirements, *and* is commensurate with the lender's risk profile. The capital level should also be sufficient to support future growth. The various MFA capital requirements assume that a lender primarily engages in traditional, relatively low risk activities. Higher risk permitted activities requires more capital, especially if the activities are conducted at significant concentration levels. Lenders engaged in higher risk activities should also have higher loan loss reserves and risk management expertise appropriate to the risk.

MFA maintains, revises, and interprets its capital regulations in collaboration with Central Bank of Egypt. MFA capital rules are substantially similar to those of the other international financial regulators as a result of various statutory requirements. Many of the MFA's uniform capital rules are based on the principles set out in the Basel II Accord.

SECTION OVERVIEW

This Section of the Manual provides guidance in three main areas:

Capital Requirements
Evaluating Capital Adequacy
Rating the Capital Factor

Appendices to this Handbook Section provide additional guidance:

Capital Components & Risk-Based Capital (Appendix A)
Supplementary Information and Issues (Appendix B)
Prompt Corrective Action Restrictions (Appendix C)

CAPITAL REQUIREMENTS

Lenders must meet two capital requirements under current regulations: LE 50 million founding capital, and a capital ratio of 10% of assets.

- *Funds for capital investment must not be lent by the mortgage company to its owners.*
- *Article 35-b of the Regulations stipulates that the company's equity should not be less than 10% of assets and that total loans received by the company should not exceed 9 times the company's equity. For the purpose of calculating the company's capital adequacy ratio the elements of the company's capital, assets and contingent liabilities should be risk-based calculated as follows:*

- *Capital is to be composed of two tiers:*

- *Tier one: represents the core capital that made up of paid capital, general reserves, and un-distributed profits. It cannot include goodwill or loss of previous years.*

- *Tier two: represents the subordinating capital that is made up of general provision for loans, regular contingent liabilities, and supporting loans that have maturities of more than 5 years. 20% of the latter should be amortized in each of the last 5 years of the loans period. Supporting loan(s) should not exceed 100% of the core capital.*

- *Assets and contingent liabilities should be weighed according to the risks associated with each of them, ranging from 0% to 100%, according to the following:*

  - *Loans, financial papers and investments:*
    - *Local currency loans to the public service sector: 0%.*
    - *Local currency loans to public sector: 20%.*
    - *Loans collateralized by real-estate mortgage: 50%.**

  - *Due from banks:*
    - *Mature within one year: 20%.*
    - *Mature in more than one year: 100% (from the date of preparing the balance sheet)*

  - *Off-balance sheet items (provisions made for contingent liabilities are excluded):*
    - *Rediscounted instruments and bills of exchange (accepted and endorsed: 20%.*
    - *Contingent liabilities for loans general guarantees: 100%.*

Prompt Corrective Action Categories
Lenders fall into one of five Prompt Corrective Action categories. The minimum requirements are as follows:

Tier 1 / Total Risk-Based

Well Capitalized 5% or greater *and* 6% or greater *and* 10% or greater

Adequately Capitalized - 4% or greater (3% for 1-rated) *and* 4% or greater *and* 8% or greater

Undercapitalized - Less than 4% (except for 1-rated) *or* Less than 4% *or* Less than 8%

Significantly - Undercapitalized Less than 3% *or* Less than 3% *or* Less than 6%

Critically Undercapitalized - Has a ratio of tangible equity to total assets that is equal to or less than 2%

Minimum Standards vs. Capital Adequacy

The regulatory capital requirements are minimum standards designed for soundly managed lenders that do not present credit or other risks requiring more capital. *Compliance with the minimum capital requirements does not automatically ensure an adequate level of capital. Lenders with higher risk should hold capital well in excess of the minimum requirements.* In addition, MFA has the authority to establish a capital requirement for a lender that is higher than its normal minimum regulatory capital requirement.

MFA may target a higher capital level for specific assets or conditions, or to eliminate or limit the inclusion of a capital component, or to otherwise achieve a higher capital level. Through the reservation of authority, MFA may require the discounting or deduction of an asset or capital component, or may assign a higher risk weight or conversion factor than an asset or risk exposure normally receives.

Documentation Requirements
Lenders must have adequate systems in place to compute their capital requirements and capital levels. Supporting documentation should establish how a lender tracks and reports its capital components, how it risk weights its assets, and how it calculates each of its capital levels. Where a lender has inadequate documentation to support its assignment of a risk weight to a given item, examiners may assign an appropriate risk weight to that item. Examiners should verify that lenders are correctly reporting the information requested in

EVALUATING CAPITAL ADEQUACY

In order to determine whether a lender has sufficient capital at a specific point in time, you should first consider whether the lender complies with the following requirements:

- Regulatory capital requirements
- Capital levels established by a business plan or the Board of Directors
- Capital levels established by a capital plan, approved application, enforcement action, other applicable agreement or plan, or through use of the MFA reservation of authority. You should then determine if the lender holds capital that is sufficient relative to its risk profile. This process evolves during your examination. You should consider all of the following factors, as well as any other important factors that you note.

Asset Quality
Asset quality is a key factor in evaluating capital adequacy. You should consider the extent to which individual assets exhibit serious weaknesses or loss of value. Key indicators of overall asset quality are the EGP value of assets subject to adverse classification and the severity of those classifications relative to capital. You should consider delinquency and foreclosure trends, the level of non-accrual or nonperforming loans, and market depreciation of securities. When assessing capital adequacy, you should evaluate the risks associated with each lending and investment program. Lenders with higher risk lending programs should maintain sufficient loss reserves to offset expected losses and a higher capital base to absorb unanticipated losses.

Earnings
Consider earnings performance and dividend practices. Good earnings performance enables a lender to fund its growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. However, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. Generally, management should first apply

earnings to the elimination of losses and the establishment of necessary reserves and prudent capital levels; and then, after full consideration of those needs, management may disburse dividends in a reasonable amount.

Subsidiaries
Subsidiaries can significantly affect the operations and overall financial condition of their parent lender. Therefore, it is important to determine if subsidiaries pose risk to the capital adequacy of the parent. Where a regulator other than MFA regulates the subordinate organization, it is important to consider whether capital from the subsidiary would actually be available to the parent lender in a time of stress. Furthermore, it is important to consider whether the parent lender has obligated itself, either formally or informally, to fund obligations of its subsidiary. As with other assets, MFA examiners may classify as substandard, doubtful or loss, a lender's investment in its subsidiaries including loans to subsidiaries. In some instances, MFA requires deduction (and deconsolidation where applicable) of a parent's investment in its subsidiary. (See Appendix B for further details.)

Relationships with Affiliates
A holding company's policies and practices can significantly affect the capital levels of its lender subsidiary. It is critical that a lender's dividend policies, tax-sharing agreements, consulting arrangements, and other transactions with its holding company do not lead to an unsafe or unsound condition for the lender.

Double-leveraging occurs when a lender's parent organization borrows funds to purchase newly issued stock of the subsidiary lender. If the principal means of servicing the parent company's debt consists of the cash dividends from the lender, you should consider the potential effect on earnings. In particular, you should ascertain whether the lender has the ability to sustain an adequate level of capital given the cash dividend demands of the parent holding company.

When you evaluate capital adequacy, you should generally discount the lender's capital level by the amount of any loans or other credits or investments outstanding to the lender's holding company or to affiliates that are not subsidiaries of the lender.

Interest Rate Risk
Lenders with excessive interest rate risk exposure may experience a significant decline in capital levels as a result of unfavorable changes in interest rates. Therefore lenders with relatively high interest rate risk should have correspondingly high capital levels to offset that risk.

Liquidity and Funds Management
Lenders that are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows, and such losses must be absorbed by the capital accounts. Generally, the lower a lender's level of liquidity, the more seriously you should consider higher capital requirements.

Contingent Liabilities
Lawsuits involving the lender as defendant or other contingent liabilities may indicate a need for a greater level of capital protection. You should determine whether the lender has significant contingent liabilities that have the potential to materially impact the capital level.

Off-Balance-Sheet Activities and Exposures
A lender may engage in off-balance-sheet activities such as loan commitments or construction lending. In such cases, you must determine whether the lender is

exposed to economic risks or potential legal liabilities that are not fully captured by Egyptian accounting principles or regulatory capital rules. Note that while risk-based assets include many off-balance-sheet risk exposures, the capital requirement does not address off-balance-sheet risk.

New Products and Activities
The financial marketplace is dynamic and innovative. Many lenders constantly formulate new products and engage in new activities to meet customers' needs. You should determine whether a lender has properly analyzed the risks related to new products and activities, and whether capital levels are appropriate to match these risks.

Local Characteristics
The stability and diversification of local population, business, industry or agriculture are important considerations. In evaluating capital adequacy, you should consider potential changes in the lender's operating environment as well as the pressures of competition.

Risk Diversification
Generally, a greater degree of asset and liability concentrations increases the need for capital at most lenders. You should review on- and off-balance-sheet assets for concentrations in industries, product lines, customer types, geographic areas, funding sources, and nontraditional activities.

Quality of Management
The ability, experience, depth, integrity and record of management are important in your assessment of a lender's capital adequacy. In fact, it is difficult to conceive of a capital structure capable of withstanding the deterioration that eventually results from inept or dishonest management. Sound management includes the formulation and implementation of strong policies and procedures relative to loans, investments, interest rate risk, operations, internal controls, audits, and other functional areas. Deficiencies in these policies or their implementation can readily have an adverse effect on the lender's capital position.

Future Plans
Consider reasonable expectations of what may occur in the future. It is not sufficient to simply consider that capital is adequate as of the examination date. Conditions on which you base that judgment can change materially. You should consider the lender's business plan or capital plan and its underlying assumptions. Such a review is largely a reasonableness check of the forecasted numbers and their underlying assumptions. Specifically you should consider the following:

- Whether the plans are consistent with the trend of historical performance
- The volume of non-accrual and renegotiated debt and other non-earning or marginally earning assets
- Loan demand
- Debt growth
- Competition
- General composition and strength of the local economy
- Expansion plans
- Other pertinent factors. An analysis of the ratio of equity growth to asset growth can be helpful in your analysis of capital trends. When this ratio is less than one, it signifies that assets are expanding faster than capital growth, hence a declining equity position and increasing financial leverage.

Peer Comparison

You should also assess capital adequacy by comparing a lender with similar (peer) institutions, though you should not rely on this information exclusively. For example, while strong management practices or stringent internal controls may reduce the need for additional capital in some cases, weak management practices or controls may indicate a need for higher capital elsewhere. You should make an independent, case-specific judgment on the capital adequacy for each lender you examine.

Appendix: A Prompt Corrective Action Restrictions

Capital Category Restriction

Well and adequately capitalized
Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization.

Undercapitalized Mandatory actions:

Capital distributions and management fees restricted.
Capital plan required.
Monitoring of condition and capital plan.
Growth restricted.
Prior approval of certain expansion proposals such as acquisitions, branching and new lines of business.

Significantly Undercapitalized Mandatory actions:

Activities restricted.
Payments on subordinated debt restricted.

Discretionary actions:

Require recapitalization:
- Issue stock.
- Require acquisition (if grounds exist for appointing a conservator or receiver).

Restrict interest rates paid.
Impose more stringent asset growth restrictions (or require shrinkage).
Restrict activities.
Improve management by requiring the election of directors or employment of qualified senior executive officers.
Prohibit deposits from correspondent banks.
Require prior approval for capital distributions by a bank holding company.
Require divestiture.
Require other actions the regulator determines appropriate.

Critically Undercapitalized Mandatory actions:

Activities restricted - Associations may not:
- Enter into any material transactions other than in the usual course of business.
- Extend credit for any highly leveraged transaction.
- Amend the mortgage lender's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.
- Make any material change in accounting methods.
- Engage in any covered transaction.
- Pay excessive compensation or bonuses.

Payments on subordinated debt prohibited.

200 - Asset Quality

SECTION: Lending Operations and Portfolio Risk Management Overview 201

Lending is the principal business activity for most mortgage lenders. The loan portfolio is typically the largest asset and the most predominant source of income. As such, it is one of the greatest sources of risk to a mortgage lender. Lax credit standards, poor portfolio risk management, or poor internal controls can expose a mortgage lender to excessive loss. Effective management of the loan portfolio and the credit function is fundamental to a mortgage lender's safety and soundness.

The risks associated with any specific lending program or activity will depend in large part on:

- The extent to which the activity is in keeping with the strategic direction and risk capacity of the mortgage lender
- How it fits in with the other activities of the mortgage lender
- The adequacy of lending policies and procedures, underwriting and documentation practices, and pricing decisions
- Monitoring and reporting systems, and internal controls
- The experience and knowledge of staff
- Current and prospective market conditions
- Interest rates
- Financial condition of the mortgage lender

Credit risk should be assessed across the entire loan portfolio and within the context of other noncredit related risks. A risk management system that provides the board of directors and management the ability to identify, measure, monitor, and control risks associated with an mortgage lender's lending activities as a whole is essential and must be appropriate to the size, complexity, and risk profile of the mortgage lender.

While this and other sections of this manual focus largely on **credit risks** and risk mitigation factors for various types of lending programs, there are obviously a number of other risks associated with lending activities, such as interest rate risk, market risk, operational risk and compliance risk.

Management and the board of directors must ensure that lending activities are managed and evaluated in the context of the broad array of risks and their potential impact on the mortgage lender's earnings and capital. For example, a loan portfolio that, although performing well financially, is riddled with operational or compliance problems (e.g. inaccurate truth in lending disclosures, deceptive marketing practices, settlement disclosure problems) exposes the mortgage lender to substantial legal, restitution, and ultimately reputation consequences.

This overview section presents guidance fundamental to all lending programs and overall loan portfolio and credit risk management. The subsequent sections and appendices provide comprehensive detail on prudent lending and risk management practices for specific lending programs. The sections completed during an examination will depend on the types of lending activity conducted at the mortgage lender and the adequacy of portfolio risk management practices. This overview section might be the only one you use for the asset quality phase of the examination for some small or low-risk mortgage lenders, or for completing the lending review during a risk-focused or targeted examination. However, you should consult with the examiner-in-charge (EIC) when making this determination.

In this overview section, we will focus primarily on the responsibilities of the Board of Directors and management in overseeing and managing the lending function of a mortgage lender including:

- Strategic planning
- Portfolio diversification
- Lending policies:
    - Underwriting standards
    - Documentation standards
    - Credit administration
  - Loan pricing
  - Loan terms
  - Loan types and portfolio management

- Portfolio Risk Management:
    - Internal loan review
    - Management Information Systems
    - Internal controls

RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

Strategic Planning
The Board of Directors has the fiduciary responsibility for all of the activities of the mortgage lender. The board is responsible for establishing the strategic direction and investment objectives of the mortgage lender.

A mortgage lender's lending activities should be in keeping with its strategic direction and business plan. When developing the lending strategies, the board and management should consider:

- The mortgage lender's strategic plan and risk tolerances.
- The desired composition of the portfolio: loan product mix, portfolio diversification, loan quality goals, loan growth rates, etc.
- The mortgage lender's defined and targeted market areas and market conditions within those areas.
- The size, financial condition and financial goals of the mortgage lender.
- The expertise of its lending and credit administration as well as compliance personnel.
- Legitimate credit needs and nature of its community.

The board of directors is also responsible for establishing a lending framework and portfolio risk management program consistent with the size, complexity, and risk profile of the mortgage lender.

Elements of a sound risk-management system include:

- Adequate board and management oversight.
- Adequate policies, procedures, and strategic lending goals including lending limits.
- Adequate portfolio monitoring, risk assessment, and management information systems.
- Comprehensive internal controls.

Effective internal audit and compliance functions

The board of directors relies on management to operate the mortgage lender on a day-to-day basis. Thus, it must select a management team that is experienced and competent, and that will follow its guidance and directives.

Management is responsible for the day-to-day operation of the mortgage lender and for implementing the policies established by the board in a manner consistent with safe and sound lending practices and in accordance with laws, regulations, and supervisory policies. Management is also responsible for providing timely and accurate reports to the board of directors, to MFA, and to any other applicable regulatory agencies.

Portfolio Diversification
The board of directors should address diversification strategies as part of the strategic planning process, and its decision should be reflected in the board of directors' minutes, the mortgage lender's lending and risk management policies, the annual budget, and the strategic business plan. A diversification policy should contain quantified goals and objectives that establish the composition of the loan portfolio mix and limits in EGP amount or percentage of assets for each loan type, category, or geographic area.

Loan portfolio diversification is a means of controlling and limiting overall credit risk. By prudently diversifying loans among different loan types, industries, borrower groups, and locations, the mortgage lender can spread credit risk and limit losses that may arise from a regional economic recession, failure of a critical industry, or any factor affecting a group of loans having similar risk characteristics.

Limits and Guidelines for Concentrations of Credit
The board of directors should establish limits on and monitor the mortgage lender's concentrations of credit. A credit concentration will typically relate to a key factor (such as a common industry or employer), and when weakness develops in that key factor, every individual loan in the concentration may be affected. Certain types of concentrations may be unavoidable (or even desirable, such as single-family mortgage loans in the mortgage lender's primary lending area).

To evaluate both the need for diversification and collectability of a mortgage lender's loan portfolio, management should be alert to indicators of weakness in the markets served. Management should also be alert for indicators of actual or potential problems in the individual projects or transactions financed.

Indicators of potential or actual difficulties in local markets and projects may include:

- Increase in unemployment.
- High or increasing vacancy rates in the area.
- Numerous similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a owner-occupied project converted to a rental project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space.

- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a local market, business, or project become more pronounced, problems with related credits may also surface.

It is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.

In general, you should include in the Report of Examination concentrations that present a supervisory concern, for example, those that exceed 25 percent of core capital plus the General Reserve (allowance for loan and lease losses/ ALLL) or two percent of total assets for undercapitalized mortgage lenders. When loans have an especially high risk of loss, you should report lower levels of concentrations, such as ten percent of capital plus General Reserves or one percent of assets. Moreover, it is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.

Loans-to-One Borrower
Multiple loans, or a very large loan, to one borrower, related entities, or a common enterprise, are a form of credit concentration. MFA regulations establish a general limit on loans-to-one borrower or a related group of borrows xxx. The loans-to-one borrower (LTOB) regulatory limitations are an important safety and soundness standard intended to prevent financial institutions from concentrating too great a portion of their assets in any one borrower.

Aggregate Limits on Loans Outstanding
In addition to establishing controls for credit concentration risks, mortgage lenders should establish procedures and guidelines to monitor and limit the total volume of loans outstanding (usually expressed relative to deposits, capital, or total assets), primarily to ensure adequate liquidity. In setting such guidelines, the mortgage lender should consider various factors such as credit demand, the volatility of the debt structure, and availability of alternative funding sources.

Limits and Guidelines for Purchasing Loans
Mortgage lenders that purchase whole and/or participation loans must thoroughly review such loans prior to purchase or commitment. The mortgage lender's loan policies should address the acquisition of purchased or participation loans, establish standards for review, and require that such loans meet the standards set by MFA and also meet the underwriting, documentation, and compliance standards applied to loans originated by the mortgage lender.

When purchasing loans, the mortgage lender may rely on the stated written underwriting standards of the originating lender, provided it performs a due diligence review of the purchased portfolio that includes a review of the loan portfolio's performance as well as a review of a statistically valid and representative sample of individual loans within the portfolio.

Major loan purchases should have board of directors authorization. In addition, the mortgage lender should determine the financial health and capability of the selling institution, and if the selling party retains the servicing of the loan, the mortgage lender should ensure that all contracts require the selling party to administer the loan in accordance with prudent industry standards, and enable the mortgage lender to change servicers if performance is inadequate. Finally, the policy should consider establishing aggregate limits on the amount of loans purchased from any single outside source.

Loan Policies
A mortgage lender's loan policies, and underwriting guidelines and procedures should communicate and support the strategic objectives for the portfolio. The loan policy is the primary means by which senior management and the board guide lending activities. Although the policy primarily imposes standards, it is also is a statement of the lender's basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the lending activities in a manner consistent with the lender's strategic direction. Loan policy sets forth standards for portfolio composition, individual credit decisions, fair lending and compliance management.

The board of directors and management should formulate lending policies that are appropriate for the size and complexity of the mortgage lender's existing and planned lending operations, and ensure that the mortgage lender has sufficient staff with the expertise to originate, service, and monitor the lending programs and loan portfolio. Lending policies must be specific and detailed enough to foster prudent and compliant credit practices.

If properly formulated, communicated to all lending personnel, and monitored, a well-structured and prudent lending policy will serve to guide, direct, and control the decisions of lending officers consistent with safe and sound and compliant lending practices. Because each mortgage lender is unique, no single policy can best serve all mortgage lenders; rather, each mortgage lender should tailor its policy and procedures to its own needs and characteristics.

It is an unsafe and unsound lending practice for a mortgage lender not to have written well-defined policies and procedures in place for the type and complexity of its lending activity.

The lending policy should include a statement of the general credit philosophy of the mortgage lender (referencing the importance of compliance with consumer credit protection laws and regulations), portfolio diversification objectives, underwriting standards, loan structure and documentation standards, loan administration policies, risk mitigation strategies, and requirements for an internal monitoring and reporting system. MFA requires general lending standards for all loans. In addition, mortgage lenders should have written real estate lending standards. (Manual Section 212 covers the latter standards in detail.)

- The mortgage lender may not transfer the responsibility for risk analysis to another lender. The mortgage lender assumes the risk of noncompliance with consumer protection laws and regulations by another lender when acquiring loans.

The mortgage lender's lending standards should:

- Clearly state the board of directors' objectives for the composition and risk of the loan portfolio, including the types of investments to avoid or exclude.

- Apply to loan purchases and loan participations as well as to loans originated by the mortgage lender for portfolio and/or sale.

- Establish a system of internal controls, monitoring, and reporting.
- State the types of management and board reports for monitoring the mortgage lender's lending activities, including delinquency and asset classification reports.
- Undergo review by the board of directors at least annually to ensure that policy remains appropriate as loan performance, market conditions, and regulatory obligations change.
- Set forth the composition of the loan committee(s), the frequency of meetings, and loan approval responsibilities.
- Require the board to ratify all significant loans either prospectively or through a series of subsequent reporting events.
- Require that loan review or other monitoring personnel systematically review all credit portfolios for consistency with established lending policies, and regularly review problem credits, identify problem relationships in a timely manner, and initiate remedial action.
- Establish loan authorities and prudent officer lending limits. Moderate limits are generally established for individuals, based on the officer's position, experience, and tenure with the mortgage lender. Higher lending limits are typically allowed for groups of officers or loan committees.
- Set forth underwriting requirements including the extent of financial information necessary for the type and risk of the loan, acceptable collateral limits and the means for securing a lien against the collateral, and credit file content requirements, such as loan offering sheets, records of officer, committee, and board approvals, business and guarantor credit reports, financial statements and analysis, and memoranda supporting and/or criticizing the credit.
- Establish loan administration procedures for the servicing, collection, charge-off, and foreclosure of loans and establish guidelines to ensure that charge-offs are taken in accordance with regulatory standards. Establish effective collection policies and procedures to reduce lending risk and prevent loan losses.
- Establish policies and procedures for the use of automated underwriting and credit scoring systems.
- Address standards for loans made as exceptions to standard underwriting requirements, paying particular attention to fairness in underwriting exception practices.
- Establish effective loan product pricing strategies consistent with sound financial planning.

Underwriting Standards
A mortgage lender's first defense against excessive credit risk is the initial credit-granting process. Sound underwriting standards are key.

The mortgage lender's lending policies and procedures should include prudent underwriting standards to mitigate and manage credit risk. The application of sound underwriting principles to the lending process is essential to a high-quality loan portfolio. Underwriting standards should be in keeping with the types of loans being originated. The extent of the credit evaluation needed to support the lending decision should be commensurate with the size and complexity of the loans.

For single-family mortgages, credit evaluation is often based on the borrower's credit valuation, debt to income ratios and the loan to value ratio. More complex lending (e.g., commercial and income property, agricultural and large consumer loans) is often not standardized and requires careful evaluation and consideration of the borrower's ability and willingness to repay the loan.

Prudently underwritten loans should reflect consideration of all credit evaluation factors relevant to the type of loan, including:

• The borrower's *capacity*, or income from the underlying property or business, to adequately service the debt. (in certain lending programs, including small balance consumer loans, or well-secured, low-documentation residential loans, the lender may assess the ability and willingness to repay from the borrower's credit history, collateral, and other factors.) The capacity to successfully repay debt is a critical consideration. It is important that the lender have a clear understanding of the purpose of the loan and the source of repayment so that it can be structured in a way that is consistent with realistic prospects of repayment. For consumer loans, the lender may assess capacity from debt-to-income ratios, where the borrower's total monthly obligations are compared with gross income. The lender may use other methods. For example, if a borrower has difficulty documenting income, but has performed well on other loans of similar size with the mortgage lender or with other lenders, the lender may determine that the borrower has demonstrated capacity. However, the lender has to consider the Money laundering regulations.

• *Capital* or the money a borrower has personally invested in the property or business. How much does the borrower have at risk? Mortgage lenders should consider the amount of equity in the property by the borrower, guarantors or other interested parties. The mortgage lender should ensure that borrowers have sufficient capital and cash flow to repay the loan even during economic downturns.

• *Collateral* or guarantees as an additional form of security against the loan. Collateral is a secondary source of repayment for a loan should the borrower become unable to repay. In general, the longer the term or the greater the size of the loan, the more likely and appropriate it is for the lender to require collateral. Often lenders will also require collateral for smaller, short-term loans when the borrower has not established nor has only marginal credit. The mortgage lender should appropriately consider any secondary sources of repayment, including any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or take-out commitments. The mortgage lender's lending policy should include an explanation of loan-to-value or margin requirements, what constitutes acceptable collateral, and the means for perfecting liens against various collateral types. The mortgage lender should generally not rely on collateral liquidation as the primary source of repayment. The mortgage lender should base loan term and amortization on the economic life of the asset being financed, and take into account market price variances, depreciation, condition, usefulness, and any technological and functional obsolescence. The mortgage lender should obtain an accurate valuation of the security property. An appraisal or evaluation of the primary collateral for real estate loans should be in accordance with MFA regulations and memoranda and accepted standards of practice. The mortgage lender should also document its perfected security interest and the insurance policies protecting the collateral (such as hazard insurance and earthquake insurance).

• *Character* or the overall creditworthiness of the borrower. A positive assessment of the borrower's character or willingness to repay is essential in the underwriting process. The borrower's payment record on existing and previous loans with the mortgage lender, his or her credit history in general and reputation in his or her business or industry or community all provide evidence of the borrower's character and willingness to repay the loan and should be documented in the loan file.

• The *conditions* surrounding the loan. What is the purpose of the loan? How will the proceeds be used? What are the key economic factors that could contribute to the success or failure of a loan's repayment? The credit analysis should reflect consideration of such external factors as: area income-level; employment trends; vacancy rates; and other factors that affect the borrower's ability to repay the loan.

• Conformance with consumer protection and fair lending laws.

You should closely scrutinize from both a safety and soundness and compliance perspective any underwriting standard that gives consideration to credit factors that are not directly relevant to the borrower's ability or willingness to repay the debt. The lending policies should provide clear and measurable standards that enable the lending staff to determine whether the loans comply with the mortgage lender's underwriting standards. Underwriting standards should address the following items:

Loan Types
Specific departmental lending policies should outline borrower qualifications and documentation standards for each type of loan offered and should take into consideration the economic composition of its entire market area.

Maximum Maturities
The mortgage lender should establish realistic repayment plans for loans, including maturities that relate to the anticipated source of repayment, the purpose of the loan, and the useful life of any collateral. For each type of loan, the lending policy should state the maximum number of months for amortization or the maximum length of time to maturity. The mortgage lender may also develop specific procedures for unique situations. For example, when making a home improvement loan to a borrower on fixed income, the mortgage lender could offer extended terms or a loan with a balloon payment and option to renew.

Loan Pricing
The mortgage lender's loan pricing should reflect the mortgage lender's cost of funds, overhead, credit risk premium, and a reasonable profit, yet must be at a level that is competitive in the market. It is not uncommon to see some lenders adequately estimate their cost of funds and losses, yet fail to estimate the true servicing costs of the loans. Pricing models should also take into account the high degree of variance in loan losses and servicing costs associated with higher-risk lending programs. In making such an assessment, management must ensure that risk-based pricing is applied equitably and does not result in pricing based on a prohibitive basis under the fair lending laws and regulations.

Guarantees
The lending policy should include guidance for guarantees and endorsements. Support from financially responsible endorser/guarantors can be an important factor in assessing the credit risk of a loan.

Loan-to-Value Ratios
A mortgage lender should establish internal loan-to-value (LTV) ratio limits for all types of secured loans, and apply those standards consistently. Loan performance data has shown that borrowers are more likely to repay their loans when they have equity in the property securing them.

For real estate lending activities, LTV limits should reflect consideration of the MFA Guidelines.

Exceptions to Lending Standards
Some approved loans do not comply with a mortgage lender's written loan standards. Policy exceptions may be appropriate in certain instances; however, the reasons for the exceptions should be well documented in the loan file and approved by the board of directors, its delegates, or a committee thereof. Also, the board of directors may be responsible for establishing standards for handling requests that do not meet articulated policy statements but are deemed worthy of consideration.

Frequent exceptions to a policy may mean that the policy needs revision or may indicate the more serious problem of management's unwillingness or inability to follow established policy. You should scrutinize policy exceptions to ensure management is not exercising them in a manner inconsistent with sound lending practices, including fair lending laws and regulations. Policy exceptions that thwart or diminish legislative or regulatory mandated consumer protections are never appropriate.

Lenders should establish procedures to ensure that adequate documentation, consistent with the size and complexity of each loan transaction is obtained and maintained.

Loan Documentation Standards
An effective loan approval process establishes minimum requirements for the information and analysis upon which a credit decision is based. It provides standards for the documents needed to approve new credit existing borrowers. It is important that a mortgage lender's loan policies include loan documentation standards to help ensure that underwriters and approving officials have the necessary information to make prudent credit decisions. Furthermore, a properly documented loan file is needed to enable internal loan review staff, external auditors, and examiners to readily ascertain the quality of the loan and whether it was underwritten in compliance with board-approved policies.

The inability of an independent third party to ascertain the loan officer's reasoning for approving a loan often indicates poor credit management and may be an unsafe and unsound lending practice.

The mortgage lender should establish and maintain loan documentation practices that:

- Ensure that the mortgage lender can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.
- Lenders should establish procedures to ensure that it obtains and maintains adequate documentation, consistent with the size and complexity of each loan transaction. The mortgage lender should tailor the documentation for the various types of loans they originate.

Below is a partial list of documents that mortgage lenders should include in the credit files for various loans. Although the documents listed are generally appropriate for prudent lending, a rigid requirement that all these documents be present for each loan is too restrictive and does not take into account other mitigating factors.

• Loan application – should include the purpose of the loan and the identity of any security property. The borrower should sign the loan application.

• Promissory note – evidence of the borrower's obligation to repay the loan, executed by the borrower or agent.
• Deed of trust or mortgage for real estate loans – evidence of the creation of a security interest in the real property for the benefit of the lender, signed by the borrower (or agent). (Currently both prom note and Mortgage are included in one document)

• Valuation Report (Appraisal) – a report prepared by a qualified individual or firm independent of the borrower (which may include a lender employee or agent) that discloses an estimate of the market value of the security offered by the borrower as collateral for the loan as of a specific date. For valuations on real estate loans, refer to Manual Section 208, Appraisals.

• Financial Statement and Credit Report – should include CBE' ACP or a written credit report prepared by one of the credit reporting agencies and the borrower should sign the financial statement. The documents should be current at the time of application. Up-to-date and accurate financial information on each borrower is essential:

- For individual borrowers, a credit report and a statement of gross income may be all that is necessary. Financial statements are often requested for self employed applicants. In such cases, the financial information should reflect the borrower's financial condition as of the day of application.
- Tax return statements must be for the most recent tax year.

The board of directors should establish the amount or type of loan that requires audited financial statements. For large loans, the mortgage lender should require audited financial statements or ensure that staff verifies pertinent information in unaudited financial statements. For example, if a business reports real estate as one of its primary assets, the lender should verify ownership, determine that the value stated on the financial report is reasonable and that there are no undisclosed liens on the property.

Likewise, if inventory is a significant business asset reported on the borrower's unaudited financial statement, the lender should perform an inspection of the business premises and ask to see the most recent inventory and monthly inventory reports. The lender should also perform a document search to determine whether those assets have already been pledged. Of course, such steps are only necessary where the presence of such assets is an important consideration in the loan decision.

Mortgage lenders should review several years of financial statements and compare income and assets between periods. Loan personnel should carefully scrutinize borrowers whose income fluctuates considerably and insist on up-to-date financial information.

• Approval – approval sheet or committee minutes showing the officer(s) or committee responsible for reviewing and approving the loan request, and establishing the terms and conditions of the approval.

• Disbursement – use of a proceeds schedule, disclosing date, amount, purpose, and recipient of the loan proceeds.

• Application for recording real estate guarantee, and any other document evidencing perfection of the security interest – affirming the description, validity, and priority of the lender's lien on the collateral taken as security for the loan, and any continuing filings required to maintain the mortgage lender's lien position.

• Settlement Statement/Disclosure Statement – evidence proving that the lender provided the borrower, upon closing, an application, a loan settlement statement and disclosure statement(s) setting forth in detail the charges or fees payable by the borrower to the lender and any legal rights the borrower may have with respect to those charges or fees and the transaction in general.

• Record of Payment – showing the status and current payment of taxes, assessments, insurance premiums, other charges on the security of the loan, and documentation for any loss (and subsequent recoveries) on the loan security by an insurance settlement.

• Evidence of hazard and life insurance policies – maintenance of appropriate insurance policies that will protect the mortgage lender from loss in the event of damage to or destruction of the collateral securing the loan. All applicable policies should list the mortgage lender as a loss payee.

• Modifications – evidence of any changes to the loan or original security interest with the appropriate approval of each party.

• Collateral Release – evidence of any portion of the collateral pledged to secure the loan, showing the portion released, consideration (if any), and documentation that the required pay down has been collected and cleared, and appropriate officer approvals. With any type of lending, experienced and competent legal assistance is particularly important in developing a lending operation. Likewise, engaging the services of a professional compliance officer at the outset of development of a lending operation will significantly reduce any risk of noncompliance and will enhance the mortgage lender's ability to adjust loan programs in the future without running afoul of consumer protection laws and regulations.

Properly executed legal documentation is critical in establishing and maintaining collateral liens, endorser/guarantor liability, and in working out problem credits through restructuring, liquidation, or rehabilitation of the credit.

Loan administration is perhaps one of the more complex areas of the mortgage lender that requires strong management, experienced staff, and diligent oversight.

Credit Administration

It is important that a mortgage lender have a strong loan administration function, particularly when it is engaged in construction, nonresidential, or commercial lending. Loan administration includes loan closing and disbursement, payment processing, collateral administration and control, servicing and participation reports, and the timely receipt, review (both initially and ongoing, as needed), and follow-up of all borrower financial information.

Loan administration duties are much more involved for construction, and multifamily lending, so mortgage lenders may have a separate loan administration department for these loans. Loan administration includes monitoring the borrower's periodic financial statements, determining ongoing collateral adequacy, and maintaining contact with the borrower to evaluate his condition and determine additional funding needs.

It is important that the mortgage lender establish operating procedures and internal controls for the loan administration function in the following areas:

- Loan closing and disbursement; payment processing; escrow administration; and loan payoffs.
- Collateral administration and control, including type and frequency of collateral evaluations.
- Claims processing.
- Servicing agreements.
- Type and frequency of financials statements reviews, including verification of information where appropriate.
- Segregation of duties (where appropriate).
- Collateral release; site inspections.
- Loan refinancing and modification procedures; collections and foreclosure procedures; and charge off and recovery policies.

Portfolio Risk Management: Internal Loan Review, Management Information Systems, and Internal Controls

Effective portfolio risk management requires managing credit risk across the loan portfolios, not just on a loan-by-loan basis. Effective risk identification starts with the evaluation of individual credits.

Rating the risk of individual loans in timely credit evaluations is fundamental to loan portfolio management. The mortgage lender should implement an internal loan review system to monitor the credit quality of the portfolio and compliance with or conformity to loan policies. The internal asset review process should be separate and independent of the lending function.

To manage their portfolios, mortgage lenders must understand not only the risks posed by individual credits but how the risks of individual loans, loan portfolio segments and the entire portfolio interrelate—and manage those risks accordingly. Effective loan portfolio risk management depends in large part on the quality of management information systems (MIS). Credit related MIS helps management and the board to fulfill their respective oversight roles. Considerations in effective management information systems are whether the right people are receiving the right information at the right time, and whether that information is up-to-date and accurate.

Such information might include:

- Total loans and commitments by type, including new extensions, credit renewals and restructured credits.
- Loans in excess of existing credit limits.
- Aggregate exception tracking and reporting.
- Concentration or credit exposure monitoring reports (by type, geographic area, collateral, large employers, etc.).
- Delinquent and non-accrual loans and credits adversely graded.
- Risk pricing models.
- Internal audit and loan review reports.

You should consider:

- Whether the mortgage lender’s risk monitoring practices and reports address all of its material risks.
- The appropriateness of key assumptions, data sources and procedures used.

- Accuracy and timeliness of reports to management and the board.

Another element of an effective portfolio risk management system is internal controls appropriate to the size and complexity of the mortgage lender and the level of risk it accepts. The mortgage lender should ensure that its lending operations are subject to strong internal controls.

Finally, an effective self-assessment compliance review program should verify that the mortgage lender is complying with all applicable consumer protection laws and regulations.

SUPERVISORY REVIEW

You should assess to the extent to which the board of directors and management have in place the policies, processes and systems necessary to identify, measure, monitor, and control risk exposures within the loan portfolio. You should assess the extent to which management and the board of directors are able to evaluate and manage risk of individual credits, individual portfolios by loan type, and across the portfolio as a whole. The analysis of a mortgage lender's lending operations and portfolio risk management should include a review of portfolio objectives and risk tolerance levels, portfolio diversification and concentrations, loan policies, loan administration practices, underwriting and documentation requirements, and internal credit portfolio risk systems, including internal asset review function, MIS and internal controls to evaluate the mortgage lender's asset quality. Under a risk focused examination approach the degree of transactions testing should be reduced when internal risk management processes are determined to be adequate or when risks are minimal. The maintenance of prudent written lending policies and effective internal systems and controls are essential to quality loan production. If a mortgage lender has concentrations of credit, management should show a heightened degree of diligence in the review of controls and policies. If the sampling review indicates significant asset quality concerns, it may be necessary to expand the review for one or more of the loan portfolios.

If further review is deemed necessary for any of the areas of lending, the sections in the Asset Quality chapter of this Manual will guide you to perform an assessment of each of the mortgage lender's lending activities, overall loan portfolio performance, and the adequacy of the General Reserves. You should also consider whether management has implemented an internal compliance review program that focuses on systems, monitoring, assessment, accountability, response, and training or a compliance review program.

SECTION: Real Estate Appraisal 208

INTRODUCTION

The soundness of real estate loans and investments made by financial institutions depends upon the adequacy of the underwriting standards and credit analysis used to support these transactions. Real estate appraisal or evaluation is one of several essential components of the lending process. For the purpose of collateral administration in a loan portfolio, an institution's estimate of value of real property may be supported by an existing or new appraisal or evaluation. This Manual Section provides: (1) examiner guidance on what to look for in a mortgage lender's administration of its appraisal and evaluation programs, (2) guidance as to what should be contained in an appraisal report, (3) guidance on the appropriate evaluation of real estate in those circumstances where an appraisal is not required, and (4) a reference to MFA's Credit Procedures for Mortgage Finance.

Responsibilities of Management and the Board of Directors
The mortgage lender's lending policies are a critical component of a sound underwriting policy. An appraisal or evaluation is an integral part of the decision-making process in credit analysis and investment underwriting. The value of real estate taken as loan collateral provides additional support to the borrower's credit capacity because it can provide a secondary repayment source in the event that the primary repayment source - the borrower's cash flow - fails to permit servicing of the indebtedness in a satisfactory manner. Also, appraisals and evaluations play an important role in administering foreclosed properties, both in the determination of a carrying value and in the establishment of a sale price. The soundness of mortgage loans depends to a great extent upon the adequacy of the loan underwriting. An appraisal standard is one of the most important elements of the underwriting policy because appraisal reports contain estimates of value of collateral held or assets owned. The responsibilities of management include the development, implementation, and maintenance of appraisal standards to determine compliance with the appraisal requirements in the MFA regulations.

The board of directors is responsible for adopting and reviewing policies and procedures that establish effective real estate appraisal and evaluation programs. At a minimum, the programs should:

- incorporate prudent standards and procedures for obtaining initial and subsequent appraisals and evaluations;
- be tailored to the institution's size and location and to the nature of its real estate-related activities;
- establish a method(s) to monitor the value of real estate collateral securing an institution's real estate loans; and
- establish the manner in which an institution selects, evaluates, and monitors individuals who perform or review real estate appraisals and evaluations.

Competency, expertise, independence, and ability to render a high-quality written report are the appropriate selection criteria for appraisers and evaluators.

To avoid potential conflicts of interest, sufficient safeguards must be in place to permit appraisers to exercise independent judgment.

Mortgage lenders are also required to comply with regulations which set forth the responsibilities of management to develop written appraisal policies to ensure that adequate appraisals are obtained consistent with the requirements of the MFA appraisal rule, to institute procedures pertaining to using the services of qualified appraisers, and to annually review the performance of appraisers.

Appraisal and Evaluation Compliance Procedures (for all real estate-related transactions)
Institutions should establish procedures to ensure appraisals and evaluations satisfy the technical requirements of regulations and professional standards, as well as internal policies and procedures. Checklists may be used to assist an institution's personnel in determining the completeness of appraisals and evaluations. Loan files should contain documentation that the appraisal or evaluation received an appropriate technical compliance check. The technical compliance procedures should provide an assessment to detect deficiencies in appraisals and evaluations. If there are deficiencies that render an appraisal's or evaluation's estimate of value unreliable, the institution should obtain a replacement prior to making its final credit decision. Deficiencies that do not affect the estimate of value should be corrected by the appraiser who conducted the appraisal or evaluation before the transaction is completed.

Audit/Critique Procedures (for a sample of real estate-related transactions)
Management should also test the substance of appraisals and evaluations through audit procedures. An institution's audit procedures should provide for a critique of selected appraisals and evaluations. The criteria to identify transactions subject to this substance critique should be consistent with prudent audit sampling or testing practices and have a bias toward large credit exposures and loans secured by out-of-area properties and specialized types of properties.

The critique should assess the adequacy, reasonableness, and appropriateness of the methods, assumptions and techniques that were used to perform the appraisal or evaluation. An individual who performs critiques, whether an institution employee or an outside auditor or consultant, should have real estate-related training or experience and be independent of the transaction. The estimate of value in an appraisal or evaluation may not be changed as a result of a critique. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted in compliance with professional appraisal practices.

Appraisal and Evaluation Review Procedures (for certain real estate-related transactions)
An institution should have appraisal and evaluation review procedures that are separate from the appraisal and evaluation compliance and audit procedures. If an institution needs to perform a review of an appraisal or evaluation, it may incorporate the above-discussed compliance procedures into the review. An individual conducting an appraisal or evaluation review must have appraisal-related training or experience, and should be licensed by MFA. An appraisal review will determine the adequacy and relevance of the data in the appraisal or evaluation. The reviewer will assess the reasonableness of analysis, opinions, and conclusions in the appraisal. The reviewer will also form an opinion as to the appropriateness of the methods and techniques used in the appraisal. The reviewer should determine the propriety of any minor adjustments to the data that do not affect the estimate of value of the real property. The reviewer, however, may not change the value of an appraisal through the review process. Appraisal reviews should be appropriately documented in the file. If the original appraisal is deemed unreliable, a new appraisal should be conducted.

Appraisal Management
The mortgage lender's appraisal policies must ensure that appraisals are performed by MFA-licensed appraisers. Appraisals should reflect professional competence and facilitate the reporting of estimates of market value. Appraisal policies should contain the minimum standards specified under Appraisal Content, comport with safety and soundness, and should be related to the mortgage lender's lending policies. Management must develop and adopt guidelines and implement procedures relative to the using the services of appraisers to perform appraisals for the mortgage lender. The guidelines must address, at a minimum, appraiser experience and education requirements that are consistent with the requirements of professional standards and MFA regulations.

It is vital that management furnish the appraiser with all information it has available to contribute to the valuation process. Management should furnish the appraiser with an engagement letter and any necessary attachments that may include, but are not limited to, the following information:

- a copy of the mortgage lender's written appraisal policies
- a copy of the appraisal rule (if not fully included within the mortgage lender's appraisal policies
- a legal description of the subject property
- the interest to be appraised
- the types of value estimates requested
- financing information
- income statements of the subject property leases and purchase agreements

Management should review annually the performance of all approved appraisers used within the preceding year to determine compliance with the mortgage lender's appraisal policies and procedures and the reasonableness of the value estimates reported.

Staff Review Appraisers
An institution may choose to have its appraisals reviewed by a staff appraiser. Such appraisers, however, must be independent of the lending, investment, and collection functions of the institution and have no direct or indirect interest, financial or otherwise, in the properties they appraise.

Fee Appraisers
The mortgage lender, or its agent, must directly engage the appraiser. The appraiser must have no direct or indirect interest, financial or otherwise, in the property or transaction. The lender may accept an appraisal that was prepared by an appraiser engaged directly by another institution if:

1. the institution that accepts the appraisal has established procedures for review of real estate appraisals and
2. the institution reviewed the appraisal under its established review procedures, found it acceptable, and documented the review in writing

Appraisals Required
The appraisal rule requires written appraisal reports be prepared by MFA-licensed appraisers for all real estate-related financial transactions.

Appraisal Content

Appraisals should contain sufficient supporting documentation to enable the reader to understand appraiser's logic, reasoning, judgment, and analysis in reaching a final estimate of value. The following are the minimum standards for appraisals for real estate lenders.

- Appraisals must conform to MFA regulations and to recognized professional appraisal standards.
- Appraisals must explain and support any exception to standards.
- Appraisals shall be written and presented in a narrative format or on forms that satisfy the requirements of regulations and standards.
- Appraisals must be based on the definition of market value found in regulations and standards.
    - Appraisals should be sufficiently descriptive to enable both the mortgage lender's personnel and regulatory staff to ascertain the estimated market value and the rationale for the estimate by providing detail and depth of analysis that reflects the complexity of the real estate appraised. Appraisals must contain sufficient supporting documentation so that the appraiser's logic, reasoning, judgment, and analysis in arriving at a conclusion indicate to the reader the reasonableness of the market value reported. For example, any current agreement of sales, option, or listing of the property should be analyzed and reported, if this information is available to the appraiser.

    - All appraisal reports must include the market value of the property on the appraisal date. For appraisals of properties where a portion of the overall real property rights or physical assets would typically be sold to the ultimate user(s) over time, reports should include: (1) market value of the property and interest "as is" on appraisal date, (2) market value "as if complete" on appraisal date, and (3) prospective future value of the property and interest upon completion of construction. For appraisals of properties where market conditions indicate that stabilized occupancy is not likely upon completion, reports should include: (1) market value "as is" on appraisal date, (2) prospective future value upon completion of construction, and (3) prospective future value upon reaching stabilized occupancy on the projected date of stabilization.

    - Appraisals should analyze and report data on current revenues, expenses, and vacancies for the property if it is and will continue to be income-producing. For these existing income-producing properties, appraisals should include actual profit and loss statements, or a statement indicating that such statements are unavailable, and a projection of future operating performance. Current rents and occupancy levels should also be reported.

    - Appraisal reports should also contain an estimate of the subject property's highest and best use, regardless of whether the actual or proposed use is the highest and best use.

    - Appraisal reports for proposed projects should be identified, dated and based upon the most recent plans and specifications. For proposed construction, development, or changes in use of a property, the appraisal report should address the project's economic feasibility. (If a feasibility study is used that was prepared by another party, the appraiser should explain the reasoning for accepting or rejecting the study). Appraisals should analyze and report on current market conditions and trends that will affect projected income or the absorption period, to the extent they affect the value of the subject property. Appraisals must analyze and report deductions and discounts (such as holding costs, marketing costs, entrepreneurial profit, leasing commissions, rent losses and tenant improvements) for any proposed construction, any completed properties that are partially leased or leased at other than market rents as of the date of the appraisal, and any tract developments or projects with unsold units.

- Appraisals must follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value, reconciles those approaches, and explains the elimination of any approach not used.
  - For the direct sales comparison approach, appraisal reports should contain sufficient information to demonstrate that the comparison transactions were conducted under terms and conditions similar to the proposed transaction. The selected properties should be physically and economically comparable with the subject property, and any adjustments made should be sufficiently explained, including how the adjustment amounts were determined.

- Appraisals must analyze and report in sufficient detail any prior sales of the property being appraised that occurred within the past twelve months for family residential properties and the past three years for all other properties. A longer history of comparable sales should be analyzed and reported when such properties have been sold several times over a brief period or when sales prices of such properties have increased or decreased at a significant rate.

- Appraisals should analyze and report a reasonable marketing period for the property.

- Appraisals must identify and separately value any personal property, fixtures, or intangible items that are not real property but that are included in the appraisal and discuss the effect of their inclusion or exclusion on the estimate of market value.

- Appraisals must include in the certification required by professional standards an additional statement that the appraisal assignment was not based on a requested minimum valuation, a specific valuation, or the approval of a loan.

- Appraisals must include a legal description of the real estate being appraised, in addition to the description required otherwise by standards.

- The appraisal should disclose and explain any unavailable pertinent or required information, as well as the date of the value estimates and the date of the report.

- Appraisal reports should contain a certification that states: (1) that the appraiser has no present or prospective interest in the subject property or the parties involved, (2) whether the appraiser made a personal inspection of the subject property, and (3) that to the best of the appraiser's ability, the analyses, opinions, and conclusions were developed and the report was prepared in accordance with the mortgage lender's appraisal standards.

Appraisal Forms

MFA regulations permit appraisals to be completed on forms that satisfy the requirements of the regulation. Primary mortgage lenders and/or Egyptian Association for Real Estate Appraisers (EAREA) may develop uniform residential appraisal report forms (URAR). In its on-site examination process MFA will evaluate whether such appraisals meet minimum standards.

Useful Life of Appraisals or Evaluations
An institution should establish criteria to determine whether an existing appraisal continues to be valid to support a subsequent transaction. The useful life of an appraisal will vary depending upon the circumstances of the property and the market place. In problem institution's management should determine if there have been material changes to the underlying assumptions in the appraisal that affect the original estimate of value.

Examples of factors that could cause material changes to reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject property or competing surrounding properties; a change in zoning; or environmental contamination. If the useful life of an appraisal or evaluation has lapsed, an institution should determine whether there is a need to reappraise the real estate.

Reappraisals
An institution's real estate appraisal programs should also include safety and soundness considerations that identify when it is in the institution's interests to reappraise real estate collateral. Some of these considerations are the condition, performance, situations, such as loan workouts, renewals, or restructurings, or troubled real estate loans, when the institution is more dependent upon the real estate collateral, management should consider the prudence of a reappraisal of the collateral. Institutions should document information sources and analyses used to determine the validity of an existing appraisal. Reappraisals of collateral must comply with regulations and standards.

Updated Appraisals
An updated appraisal that does not fulfill the appraisal requirements is currently not an acceptable appraisal.

Supervisory Considerations
Regulators will review an institution's real estate appraisal and evaluation policies, programs, and procedures as part of the examination process. Regulators will consider the institution's size and the nature of its real estate-related activities in their assessment of the appropriateness of its programs. In the analysis of individual transactions, regulators will review appraisals or evaluations to determine that the methods, assumptions, and findings are reasonable and in compliance with regulations.

In addition, regulators will review the steps taken by an institution to ensure that the individuals who perform its appraisals or evaluations are qualified and are not subject to any conflicts of interest. Failure to establish and maintain acceptable programs or to comply with applicable regulations and policies is considered an unsafe and unsound practice. Institutions will be required to correct violations and deficiencies detected in their appraisal and evaluation practices. Appraisers should be independent of the borrower and seller, and of the loan underwriting and collection functions.

Use of Appraisals

Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property. Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic. This review and any resulting adjustments to value are solely for management's use and do not involve actual adjustments to an appraisal. A regulator should analyze the collateral's value as determined by the institution's most recent appraisal or evaluation. A regulator should review the major facts, assumptions and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser).

Under certain circumstances, the regulator may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of a regulator's analysis and classification of a credit and do not involve actual adjustments to an appraisal. If a regulator concludes that an appraisal or evaluation is deficient for any reason that fact should be taken into account in reaching a judgment on the quality of the loan or investment. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the regulator can establish that any underlying facts or assumptions are inappropriate and the regulator can support alternative assumptions. It is important to emphasize that a regulator's overall analysis and classification of a loan or investment may be based upon other credit or underwriting standards, even if the loan or investment is secured by real property whose value is supported by an appraisal or evaluation.

Corrective Actions

When regulators find substantial indications of unacceptable appraisal practices, they should discuss their findings with the examiner-in-charge, Head of Monitoring and Enforcement, and the lender to initiate corrective action. Examples of unacceptable practices include fraudulent omission of critical information, misleading assumptions, manipulation of data to create an unjustified conclusion, ignoring environmental risk, acceptance of compensation contingent upon reporting a predetermined value, and conflicts of interest.

In some instances, review of appraisal reports by the staff review appraiser may be appropriate. When examination findings disclose substantial indications of poor appraisal practice, the Examiner-in-Charge, with the approval of the Head of Monitoring and Enforcement is authorized to refer appraisers to either:
(1) the MFA Licensing Division and/or (2) the professional societies of which the appraiser is a member.

The referral memorandum should describe the basis for referral, identify the security property, identify all appraisers involved, state the professional societies of which each appraiser is a member, and indicate the date of each appraisal report. In connection with the examination of mortgage lenders, the Head of Monitoring and Enforcement is authorized to obtain appraisal reports for real estate securing a mortgage lender's loans. The Head of Monitoring and enforcement may require appraisals of real estate owned (REO) when considered necessary.

Supervisory Review Process

Department of Industry Liaisons shall establish a process for reviewing adverse supervisory and examination decisions. Among the decisions subject to review is the appraised value of any property serving as collateral to secure the repayment of any loan held by the claimant. Institutions are encouraged to raise examination-related disagreements that cannot be resolved during the examination with the regional office. A supervisory decision in dispute may be raised either orally or in writing to the Head of Monitoring and Enforcement. MFA will act promptly according to its procedures to resolve such an appeal.

Appendix A: Appraisal Practices

Estimating Value: Three Approaches

There are three approaches to estimating value: the cost approach, the income approach, and the market (or sales comparison) approach. Each approach to value has merits for specific property types. All three approaches should be included in an appraisal report unless the appraiser explains and supports the omission of one or more of the approaches.

The Cost Approach

The cost approach to value is based on the value of land as if unimproved and available for improvement to its highest and best use, plus the reproduction or replacement cost of any improvements, less depreciation. The cost approach is seldom synonymous with market value. The justification for the cost approach is the premise that an investor will pay no more for a property than the cost to construct a similar property with equal utility. This approach to value is best used for single-use properties with no similar properties being marketed.

The accuracy of this method is dependent upon proper adjustment for depreciation, as well as the estimate of the market value of the land. There are three types of depreciation: physical deterioration, functional obsolescence, and economic or external obsolescence.

Physical depreciation represents an impairment of the physical condition of a property's improvements. Causes include wear through normal use, the action of the elements, and structural damage due to fire, vandalism, or other causes. Physical depreciation has both curable and incurable components.

Functional obsolescence represents impairment of an improvement's value resulting from poor design, inadequacies, super adequacies, or outmoded fixtures and equipment. Functional obsolescence can be curable or incurable.

Economic or external obsolescence represents impairment in a property's value due to factors external to the property, such as decreased demand or zoning changes. Whereas physical deterioration and functional obsolescence are evident in the property improvements, economic obsolescence is not. This type of depreciation is nearly always incurable.

The Income Approach

The income approach to value discounts the future benefits of ownership of a property to present value. This approach is best used for income-producing properties and has little relevance for a single-family residence that is to be owner-occupied. To arrive at a value estimate, projected net operating income is capitalized, or projected cash flow is discounted at an appropriate interest rate. This rate is driven by a number of factors, including risk, inflationary expectations, opportunity costs, historical returns, and the supply and demand of loanable funds. This rate should be derived from market sales data of comparable properties, and can be developed with any of several capitalization techniques. The accuracy of this method depends upon the reasonableness of estimates for potential gross income, vacancy, credit loss, and operating expenses, as well as the appropriateness of the overall rate used.

Sales Comparison Approach

The market, or sales comparison, approach to value uses market data to draw units of comparison. Information is gathered from recent sales and current listings of properties that are physically and economically similar to the subject property. Comparable properties are then adjusted for any differences between the comparable and the subject property. Aside from adjusting for physical differences or changes in market conditions, adjustment may be necessary for financing terms. When data are drawn from comparable properties where favorable financing is evidenced, appropriate adjustments should be made to reflect cash equivalency. The accuracy of this method is dependent upon the suitability of the comparable properties used.

Final Estimate of Value

Once all appropriate value estimates have been made, the values should be reconciled and a final estimate of value should be derived. Reconciliation should not simply be an averaging of individual value estimates, but should be a well-supported process where the quality and quantity of data are analyzed and properly weighted in reaching one value estimate. Note that it is inappropriate for appraisal reports to arrive at the value of fractional interests in real estate by subdividing the whole, or to arrive at the value of the whole by summing the fractional interests.

SECTION: Sampling 209

INTRODUCTION

A key component in the evaluation of the quality of an institution's assets is the review of a portion or sample of those assets. Sampling is the process of selecting a limited number of assets from a large group of assets so that conclusions about the quality of the entire portfolio may be drawn from the characteristics of the sample. The objective is to limit the number of assets reviewed while still providing enough information to enable the examiner to draw and support a reliable conclusion about the portfolio without requiring a review of all of the assets. The underlying assumption is that the quality of assets in the sample is representative of the quality of assets in the portfolio. Inherent in the use of a limited sample of assets for review is the risk of sampling error (i.e., the risk that the quality of assets selected for review will not be representative of the portfolio). Generally, sampling risk is reduced by increasing the size of the sample. Large samples are costly and time consuming, so examiners must balance the risk of sampling error against the costs of using large samples. The application of the guidance in this Section will reduce the likelihood of significant sampling error and will also enable examiners to:

- Select a representative sample of assets for review;
- Determine if the institution is in compliance with both safety and soundness standards and its underwriting policies;
- Analyze the level of reliance that can be placed on the institution's Internal Asset Review (IAR) program for the purpose of including the results of the program in meeting minimum examination review coverage standards; and
- Determine if an expansion of the asset classification review is needed.

Examiners, in addition to performing a review of individual assets and loan files, should base their final assessment of the quality of the portfolio on factors that include the following:

- the adequacy of the institution's underwriting policies and procedures;
- an evaluation of portfolio performance and credit quality;
- the experience and training of personnel; and
- the adequacy of the institution's pre- and post-funding quality control reviews and other internal controls related to the portfolio.

Examiners should use different methodologies for the sampling and testing of two different asset types: homogeneous and non-homogeneous assets.

For the purpose of this Manual Section, "homogeneous assets" are those that amortize monthly and are typically underwritten based on common, uniform standards. They include family residential real estate loans, home improvement loans, amortizing residential property loans, consumer installment loans and leases, and similar loans. Because homogeneous assets are generally classified based on delinquency status, the examiner's sampling should be directed to the determination of whether the institution uses prudent underwriting standards, rather than the IAR program's classification of such assets.

SAMPLING METHODOLOGIES FOR HOMOGENEOUS ASSETS

To determine if loans reviewed are made in accordance with the institution's own underwriting standards, examiners must first review the institution's loan underwriting and asset acquisition policies and internal controls for adequacy. Examiners should also evaluate the structure, administration, scope, and results of the institution's IAR program for homogeneous assets. The IAR program should follow the classification requirements applicable to "slow loans" and "slow consumer loans" discussed in Section 260 of this Manual.

For homogeneous assets, examiners should sample the assets to detect any asset quality problems that result from poor underwriting standards. Because the examiner will be looking to draw a conclusion about the whole portfolio, the assets selected for review should not be limited to only those underwritten since the last examination. With respect to loans made since the previous examination, examiners should determine if the institution is using prudent underwriting standards and is exercising proper lending controls.

With respect to loans made in prior periods, examiners will generally evaluate asset quality by reviewing loan performance history. If seasoned loans are paying as agreed, examiners will forego further review of the asset. If loans are not paying as agreed, examiners will determine the cause of the delinquency, such as poor underwriting or local economic factors, and evaluate the effect that such factors have on the institution's asset quality. Asset quality problems that result from declining economic conditions will not be considered exceptions unless poor underwriting contributed to the delinquency. However, examiners should factor in the effect that well-underwritten delinquent loans may have on the institution's overall asset quality.

Risk-Focused (Judgmental) Sample Selections
In addition to the use of numerical interval sampling, it may be appropriate for the examiner to also select and review a judgmental sample if significant subcategories of assets are not covered by the systematic sample or for other purposes.

Examiners should consider including each of the following subcategories in judgmental samples of homogeneous assets:

- Loan types for which exceptions were reported in the last examination;
- Loans originated by new personnel;
- Loan types where loan volume has increased dramatically;
- Loans sold with recourse; and
- New loan products.
- Examiners should use their best judgment and ensure that their sample of homogeneous assets is sufficient to assess underwriting practices and asset quality.

Review of Sample
The selected homogeneous assets should be reviewed by the examiner to ascertain whether the loans made during the review period were underwritten in a prudent manner and in compliance with the institution's policies. For determining whether an asset is underwritten in a prudent fashion, the examiner should focus on the overall quality of the asset, not merely on documentation. An exception should only be noted if it is material. Note that the underwriting policies of institutions often allow for deviations from the general standards. For example, an institution may have generally applicable debt-to-income ratios for home mortgage loans, but may allow borrowers to exceed those ratios if the loan has other credit strengths such as a low loan-to-value ratio.

For institutions with prudent underwriting standards, examiners should first focus on whether the assets comply with the institution’s underwriting policies. Secondly, the examiner should, for any asset that differs from the institution’s general standards, review whether the asset is prudently underwritten.

ASSET REVIEW DOCUMENTATION

Documentation should be in adequate detail to help examiners sample assets for review in the next examination, and should identify records used as a basis for sampling, such as: IAR schedules, alphabetical trial balances, customer information file printouts, and loans-to-one-borrower lists. Work papers must include a description of methods and criteria used to select samples, including the cut-off amounts and initial and supplementary sampling techniques. Documentation should be sufficient to allow a reviewer to identify the assets reviewed, understand the rationale for the selection of assets, and determine the percentage of assets reviewed for each portfolio, the overall coverage of non-homogeneous assets and any exceptions that are found. Information sources, such as officers, credit reports, etc., should be identified if not obvious.

REFERENCES

SECTION: Loans to One Borrower 211

Lenders create a form of concentration risk when they extend a significant amount of credit to any one borrower or to borrowers who are related in a common enterprise. As such, mortgage lenders are subject to regulatory limitations on loans to one borrower (LTOB). Borrower lending limitations are a critical safety and soundness standard to prevent mortgage lenders from placing themselves at risk by concentrating too great a portion of their assets in any single borrower.

A mortgage lender's compliance with the regulatory limitations, however, does not diminish regulatory scrutiny over high risk loans within the legal lending limit nor does it relieve the mortgage lender's board of directors from exercising due diligence. The LTOB regulation places a limitation on the aggregate amount of a mortgage lender's loans to each "borrower and it does not limit the number of loans to any one borrower with that aggregate limitation.

Management must ensure, and examiners should verify, that lending staff is conversant with the lending limitations applicable to mortgage lenders, that the lending limitations are clearly set forth in underwriting guidance, and that management's practices, recordkeeping and internal controls regarding LTOB limits are adequate and provide a high degree of confidence that the mortgage lender is in compliance with LTOB regulatory requirements.

This Manual Section provides an overview of the LTOB regulations applicable for mortgage lenders and various exceptions that authorize mortgage lenders to exceed the LTOB limits.

OVERVIEW

General Lending Limit
Under the general lending limitation a mortgage lender's total loans and extensions of credit outstanding to one borrower at one time shall not exceed 10 percent of the mortgage lender's net equity.

The Director of Industry Affairs may impose more stringent restrictions on a mortgage lender's loans to one borrower if MFA determines that such restrictions are necessary to protect the safety and soundness of the mortgage lender.

Calculation of General Lending Limit
To calculate a mortgage lender's general lending limitation you should utilize the most recent Prudential Report filed with the MFA prior to the date of granting or purchasing the loan (unless there has been a significant change in capital).

Borrower
The term *borrower (or investor)* has the meaning set out in MFA Regulations. Loan concentrations exist when separate persons or business entities have sufficient common familial relationship, or ownership or control.

Debt guaranteed by a person is attributed to the guarantor if the guarantor becomes an obligor under the terms of the guarantee.

Loans

Loans and extensions of credit mean a mortgage lender's direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds. Loans and extensions of credit include all contractual commitments for lender to advance funds.

SECTION: Residential Real Estate Lending 212

The primary business of the mortgage lending industry is residential real estate lending. Residential real estate loans include permanent mortgage loans, construction loans, or other loans secured by single- and multifamily residential dwellings. This Manual Section focuses on permanent mortgage lending secured by one- to four-family residential properties. We discuss construction loans in Manual Section 213.

The single-family residential mortgage market is a highly competitive market and one that can offer a wide variety of loan products to meet consumer demand. Loan products are, on the one hand, likely to become highly standardized as a secondary market develops, along with innovations in automated underwriting and credit scoring.

This section will concentrate on fixed-rate, fully-amortizing permanent mortgage loans having a loan-to-value ratio of 90% or less, and those with similar terms and conditions. As new products are introduced to the Egyptian mortgage market, regulatory guidelines for these will be added as they become applicable. Since regulations cannot always address every possible instance of such products, the examiner's responsibility requires thorough review of such loans as to their safety and soundness.

From a credit risk perspective, well-underwritten loans to creditworthy individuals secured by their personal residences are among the safest loans in a mortgage lender's portfolio. Portfolios of such loans generally present much less credit risk than commercial real estate loan portfolios because:

- The risk of default is spread over many moderately sized loans rather than a few large loans.
- Mortgage lenders generally use standardized underwriting criteria, which makes overall performance more predictable.
- Default risk is low and diversified. It is generally not dependent on the success of a particular business or industry.
- The amount of loss given default is generally lower because the loans are well secured by the borrower's home.

Single-family mortgage loans do entail risks. These risks include interest-rate risk, an increased default risk if underwriting standards are weak or are not followed, and the risk that properties in a particular community or during an economic downturn may experience price declines. Price declines may lead to both higher defaults and greater losses in each default. The risks inherent in a real estate mortgage loan depend on:

The borrower's creditworthiness (or ability and willingness to pay) over the loan term.

The loan amount relative to the value of the security property (LTV) over the life of the loan.

The loan's terms and interest rate over the loan term.

Lenders can mitigate risk by establishing and adhering to sound lending standards and portfolio diversification strategies; maintaining high quality loan servicing and collections departments; regularly assessing portfolio risk and monitoring portfolio performance; and making changes or taking remedial action as necessary.

This Manual Section has the following part:

Real Estate Lending Policies and Operations: an overview of real estate lending standards, loan portfolio risk management, and other underwriting considerations.

REAL ESTATE LENDING POLICIES AND OPERATIONS
Real Estate Lending Standards

As indicated in Manual Section 201, one of the first steps in creating a sound lending program is the establishment of safe and sound lending policies and prudent underwriting criteria. Mortgage lenders should adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate or are made for the purpose of financing the construction of a building or other improvements to real estate.

Such policies must be consistent with safe and sound lending practices, appropriate to the size of the institution and the nature and scope of its operations, and reviewed and approved by the board of directors. Such lending policies must establish:

- Loan portfolio diversification standards.
- Prudent underwriting standards, including LTV limits, which are clear and measurable.
- Loan administration procedures.
- Documentation, approval, and reporting requirements to monitor compliance with the mortgage lender's lending standards.

In addition, mortgage lenders must monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions. An institution's written lending policy should contain an outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made. In particular, the institution's policies should address the following:

- Geographic lending areas.
- Loan portfolio diversification strategies.
- Prudent underwriting standards that are clear and measurable.
- Appropriate terms and conditions by type of real estate loan.
- Loan origination and approval procedures.
- Loan review and approval procedures for loan exceptions.
- Loan administration procedures.
- Monitoring and reporting procedures.
- Appraisal and evaluation program.

The institution should consider both internal and external factors in the formulation of its loan policies, including the expertise and size of its lending staff, market conditions, and compliance with real estate related laws and regulations.

Underwriting Standards
Prudently underwritten real estate loans should reflect all relevant credit factors including:

- The capacity and creditworthiness of the borrower.
- The value of the security property.
- Borrower equity.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (guarantees, private mortgage insurance, etc.).

The underwriting standards should also address:

- Maximum loan amounts.
- Maximum loan maturities.
- Amortization schedules.
- LTV limits.

- Pricing structures.
- Borrower credit evaluation.
- Debt-to-income requirements for loans originated, loans purchased and loans sold in the secondary market.

Documentation Standards
MFA expects mortgage lenders to document loans to establish a record of each transaction, demonstrate loan quality, and secure its interest in any collateral pledged for the loan. MFA designed its documentation requirements to be flexible and based on the size and complexity of the mortgage lender's lending operations. Each mortgage lender, should establish and maintain loan documentation practices that:

- Ensure the mortgage lender can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose of and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate the appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

The purpose of this rule is not to mandate a list of required loan documents, but to ensure that the mortgage lender maintains the necessary documents to protect its interest in the loan and verify management's determination that each borrower has the willingness and ability to repay their obligations in accordance with the loan's contractual terms.

Typical Documentation
For residential real estate lending, mortgage lenders typically obtain the following documentation:

- A signed loan application.
- A copy of the signed and dated sales contract
- Tri-partite agreement
- Promissory note
- Application to register a real estate guarantee (mortgage)
- A deed of title
- An appraisal or evaluation, in accordance with regulatory and professional standards, evidencing the value of the security property.
- Evidence that the borrower obtained adequate hazard (fire and life) insurance, and a certification that the borrower will retain such insurance for the life of the loan.
- A credit report or financial statement evidencing the borrower's other credit obligations and payment history.
- Verification of the source of down payment, and a verification of borrower income and employment.
- Debt-to-income ratio calculation, to document the borrower's ability to repay the loan.
- An underwriting or approval memorandum or form (signed off by the person(s) or committee authorized to approve the loan) that documents the loan's compliance with the mortgage lender's underwriting requirements, rules, and regulations.

Some mortgage lenders may require additional documentation such as bank statements, salary advice and income tax returns.

Reduced Loan Documentation
Some mortgage lenders may reduce loan documentation requirements to expedite loan approval and reduce administrative costs. Such procedures are considered to be of high risk and will provoke supervisory scrutiny and corrective action.

Well-documented loans. A well-documented loan has the documentation necessary to: record the loan and secure the lender's interest in the collateral, support the borrower's willingness and ability to repay the loan, and establish the sufficiency of the collateral to liquidate the loan, if it should become necessary.

Supervisory Loan-to-Value Limits
As set forth in MFA regulations, permanent mortgage or home equity loans on owner-occupied, 1-4 family residential property must have a LTV ratio at or below 90 percent at origination.

Loans above 80% LTV ratio should generally be more carefully underwritten, both in appraisal and borrower credit standards. Private mortgage insurance for high LTV ratio loans is offered in most developed markets and may be introduced in Egypt in the future. Such insurance covers default risk for some "upper" portion of the loan amount, meaning that the lender is paid some claim amount to offset potential losses.

Loans with higher risk, such as construction loans or permanent loans secured by commercial property, should have a lower loan-to-value ratio. Such guidelines should be set out in the mortgage lenders lending policies.

Exceptions to the General Lending Policy
Lending policies may provide for prudently underwritten loan approvals that are exceptions to its standard lending policies. The board of directors is responsible for establishing standards for review and approval of such exceptions. A written justification that clearly sets forth all the relevant credit factors that support the underwriting decision should support the loan approval. Tracking of the aggregate level of exceptions helps detect shifts in the risk characteristics of the loan portfolio. When viewed individually, underwriting exceptions may not appear to increase risk significantly; however, when aggregated, even well-mitigated exceptions can increase portfolio risk. Management should regularly analyze aggregate exception levels and report them to the board. An excessive volume or a pattern of exceptions may signal an unintended or unwarranted relaxation of the mortgage lender's underwriting standards.

Loan Administration
The loan administration function is responsible for receiving and recording payments, recording security agreements, retaining loan documentation, and maintaining escrow accounts.

Mortgage lenders should establish procedures to monitor the payment of real estate taxes and insurance and to arrange for interim or blanket hazard insurance policies to cover any lapse in coverage. This becomes more important with seriously delinquent loans because borrowers may have less incentive and ability to make such tax or insurance payments. Loan administration procedures for real estate lending should address:

- Documentation requirements.
- Collateral administration, including the type and frequency of collateral evaluations.

- Loan closing and disbursements; payment processing; and loan payoffs.
- Escrow monitoring and administration.
- Collection procedures and timing, including foreclosure procedures.
- Claims processing.
- Servicing and participation agreements.

Timely collection of delinquent loans is a critical factor in portfolio performance. A mortgage lender's written policies should provide for enhanced collection efforts as delinquency problems become more serious.

You should look for indications of delinquency problems where staff and management are:
- Unaware of delinquency problems.
- Inaccurately reporting such problems to the board.
- Not taking appropriate action to collect on the loan or foreclose, where appropriate.

Real Estate Appraisal and Evaluation
Experience has shown that the lower the LTV, the lower the likelihood of default and the lower the amount of loss in the event of default. While the sale of collateral is not an acceptable *primary* source of repayment, the borrower's equity in the home is an important factor in borrower motivation and should be integrated into the lending decision. Real property provides protection to the lender should the borrower's circumstances change and he or she is unable to service the debt.

Thus, an adequate system of collateral appraisal or evaluation and review is an essential element in sound real estate lending. A real estate appraiser should base the market value estimate contained in the real estate appraisal or evaluation on the conveyed interest in real estate on a cash or cash equivalent basis.

Portfolio Risk Management
Loan Review and Monitoring
A sound real estate lending policy should be augmented by strong and effective internal controls. These controls should emphasize proper segregation and independence of duties between:
- Loan officers who assist the customer and facilitate the application process.
- Loan administration personnel who disburse funds, collect payments, and provide for the timely receipt, review, and follow-up of all necessary mortgage loan documentation.
- Accounting staff that record loan transactions.
- Loan review and internal audit staff.

To monitor credit quality and compliance with board established policies and procedures, the mortgage lender should implement a system of internal loan review commensurate with its size, risk, and the complexity of its lending and investment activities. Management's inadequate response to problem loans or lending practices can often be traced to an inadequate loan review function, or one that is poorly structured or that is not sufficiently independent of the officers who made the loans.

A prudent internal loan review program should:
- Promptly identify loans with potential credit weaknesses so that timely corrective action can be taken to minimize losses.
- Assess relevant trends that may affect collectability.

- Provide information to assess the adequacy of the valuation allowances and general loss reserves.
- Assesses the adequacy of and adherence to internal loan policies.
- Evaluates the activities of lending personnel.
- Provides management and the board of directors with objective, accurate, and timely information on the portfolio's quality.
- Includes all loans, whether originated or purchased.
- Includes sample coverage that is statistically valid and includes periodic reviews of high-amount, high-risk loans.

The purpose of the internal loan review or IAR is to assess overall asset quality, and identify specific problem assets so that mortgage lender management may implement corrective action. An effective IAR should enable management to identify weaknesses in the loan portfolio and take appropriate corrective actions when necessary, both with respect to individual loans and any weaknesses in the mortgage lender's loan policies and procedures.

Several important elements for an effective loan review system are:

- Qualifications and independence of loan review personnel.
- Frequency, scope, and depth of reviews.
- Management review of findings and follow-up corrective action.
- Report distribution to appropriate staff, management, and the board of directors.

While each of these elements is important to an effective loan review function, one of the most critical elements is independence. Often, the initial loan review function is given to loan officers because they are the most familiar with their loans and can spot weaknesses early. This is acceptable as a first line of review. However, mortgage lenders should avoid over-reliance on loan officers and their line supervisors for identification of problem loans.

Senior management and the board of directors should ensure that loans are also reviewed by individuals who do not have control over the loans they review and are not part of, or influenced by, anyone in the approval process.

Management Information Systems

Accurate and timely management information reports are key to a successful lending operation. Management information systems (MIS) reports should enable management and the board of directors to assess the performance of each loan product type (LTV, credit evaluation, originating office, loan officer, geographic location, and profitability); and the performance of the portfolio as a whole. This will enable management to make changes to poorly performing, or unprofitable programs.

MIS reports may include:

- Summary reports showing trends in outstanding loans, new loan volume, delinquencies, and portfolio yield by different product types and LTV.
- Past due, non-accrual, trial balance, and collections reports.
- Extension reports.
- Reports on the volume and significance of underwriting exceptions.

You should ensure that MIS reports are:

- Used to monitor loan performance or improve the portfolio.

- Timely, accurate and appropriate to the size and complexity of the mortgage lender's operations.
- Provided to both management and the board.

Interest Rate Risk Considerations
In addition to credit risk, mortgage lending, particularly long-term fixed rate loans, expose the mortgage lender to interest rate risk; that is the risk that the mortgage lender's liabilities will reprice faster than its assets as interest rates rise, causing net interest margins and thus earnings to decline. In addition to establishing sound lending policies, the mortgage lender can mitigate other portfolio risks such as interest rate and market risk, and shorter term mortgages, and by selling some or all of its most interest-rate sensitive mortgages.

Moreover, many mortgage lenders sell residential mortgage loans in the secondary market to reduce the interest-rate risk associated with funding long-term, fixed-rate assets with short-term liabilities. This can also provide future fee income if the loans are sold with servicing retained. These activities represent unique risks and are addressed in the Mortgage Banking sections of the Manual.

Compliance Considerations
As part of a sound lending program, the mortgage lender must ensure that all loans are made in accordance with relevant Laws and Regulations. MFA regulations being developed should prohibit a mortgage lender from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of loans originated. Loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws.

Capital Considerations
Risk weighting for qualifying mortgage loans are to be established in capital requirements. Those most prudent and requiring least capital support will be a loan that:

- Is fully secured by a first lien on a 1-4 family residential property.
- Is underwritten in accordance with prudent underwriting standards, including standards relating to the ratio of the loan amount to the value of the property (LTV ratio).
- Maintains an appropriate LTV ratio based on the amortized principal balance of the loan.
- Is performing and is not more than 90 days past due.

If a mortgage lender holds both the first and junior liens on a residential property, and no other party holds an intervening lien, the transaction is treated as a single first lien loan for purposes of determining the LTV and appropriate risk weighting.

In essence, 1-4 family residential mortgages that are performing, are prudently underwritten, and have loan-to-value ratios at origination of less than 90 percent, may qualify for a favorable risk weighting. MFA has not specifically defined the term "prudently underwritten" for purposes of determining compliance; however, MFA holds that to be prudently underwritten, a loan must be made in a safe and sound manner to ensure that the borrower has the ability and willingness to repay the loan in a timely manner.

• **Lending Standards.** Mortgage lender lending policies relating to its home lending program should be appropriate given the size and financial condition of the mortgage lender, the expertise and size of the lending staff, the need to avoid undue concentrations of risk, market conditions, and compliance with real estate laws and regulations. The policy should also clearly state the goals of the mortgage lender's home lending program.

• **Credit Management.** Once loans are on the books, a mortgage lender should perform periodic risk assessments through loan review and portfolio monitoring. Monitoring should include the evaluation of trends in loan volume, delinquencies, nonperforming and classified loans, as well as losses and the adequacy of the general reserves (ALLL). At a minimum, mortgage lenders should segregate portfolios by LTV ratio and analyze them separately. The mortgage lender should make adjustments to underwriting standards and loan administration and collection procedures when performance does not meet expectations or economic cycles dictate added concern.

• **Servicing and Collections.** Because foreclosure is seldom a cost effective option, lenders that engage in home equity lending often need to make special efforts to develop and maintain effective servicing and collection procedures. Mortgage lenders need to ensure they can absorb the costs associated with a more intensive loan servicing and collection function.

• **Other Strategies to Minimize Risk.** To further minimize risk, mortgage lenders may want to adopt strategies more pertinent to the unique nature of the various types of home equity loans. When credit report data indicates a decline in the borrower's credit standing, lenders should consider taking action to limit their exposure.

SECTION: Construction Lending 213

INTRODUCTION

This section of the manual discusses some of the general characteristics and major risk factors associated with construction lending and outlines some of the controls necessary to manage and contain related risks. Construction lending provides funding for the development of residential and commercial properties. Construction loans often serve as a form of interim financing until permanent financing is secured by the developer or buyer. Construction loans are generally secured by a first mortgage and may be backed by a purchase or take-out agreement from a permanent lender. With proper underwriting and controls, construction lending can offer significant profits in a short time. This high rate of return, however, is commensurate with the risks of this type of lending.

Real Estate Lending Standards Rule

MFA regulation requires each lender to adopt and maintain written internal real estate lending policies that are consistent with safe and sound lending practices and appropriate to the size of the institution and the nature and scope of its operations. It applies to extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property. Examiners assigned to the construction/development lending phase of the examination should determine that the institution's written construction lending policies: (1) are in writing, (2) have been approved by the board of directors, (3) promote safe and sound lending and are in compliance with MFA regulations.

The Real Estate Lending guidelines establish the following standards that pertain to construction/ development loans.

For development and construction projects, and completed commercial properties, the institution's policy should establish, commensurate with the size and type of project or property:

- Requirements for feasibility studies and sensitivity and risk analysis (e.g., sensitivity of income projections to changes in economic variables, such as interest rates, vacancy rates, or operating expenses).
- Minimum requirements for initial investment and the maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property).
- Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- Standards for the acceptability of and limits on non-amortizing loans.
- Standards for the acceptability of and limits on the use of interest reserves
- Pre-leasing and pre-sale requirements for income- producing property.
- Presale and minimum unit release requirements for non-income-producing property.
- Limits on partial recourse or non-recourse loans and requirements for guarantor support.
- Requirements for take-out commitments.
- Minimum covenants for loan agreements.

Construction Loan Risk Factors

Construction loans are susceptible to a number of major risk factors, such as:

- Uncertainty associated with securing permanent financing for the project. Unknown future interest costs of permanent financing is a risk faced by any lender engaged in construction lending, whether or not it is also the permanent lender;
- Insufficient experience or capacity of the contractor to meet the challenges of the specific construction project;
- Risk of diversion of progress payments or fraud; and
- The contractor's inability to complete construction within cost and time limitations. Clear warning signs that indicate problems have been encountered with construction loans include:
- Delinquency in the payment of interest;
- Inspection reports citing departures from approved specifications or other adverse comments. They may reflect higher costs or, in the case of building to lesser specifications, the intent to divert loan proceeds;
- Draws requested ahead of schedule for work yet to be completed or draws not taken on schedule, indicating the possibility of slow sales where residential construction is concerned;
- Additional working capital loans to a troubled developer; and
- Restructuring take-out restrictions that could not be complied with.

Risk Containment

The best method for limiting risks and avoiding costly mistakes is to establish and implement sound policies and procedures. Although policies and procedures should be tailored to the different types of construction lending undertaken by the institution, the following major elements will typically be found in sound construction lending policies and programs:

- Construction loan application review and approval procedures that, at a minimum:
- Define acceptable types of construction loans, including limitations on aggregate construction loans and for particular types of construction projects;
- Require borrowers to contribute and maintain equity in their project. Requiring land to be bought with funds from another source, limiting loan funds to be used for land acquisition, and requiring a first lien on land are all steps that provide protection to the lender. A common practice of prudent lenders is to loan no more than 50% to 65% for land acquisition costs or provide no more than 50% to 65% of current appraised value on land. The collateral margin provided by the borrower's equity serves to protect the lender from loss in the event of cost overruns or slow sales.
- Require limitations as to percentage of cost or value for construction loans that do not carry prearranged permanent financing and that are subject to the mortgage lender's own take-out commitment; and
- Provide for the satisfactory investigation of the character, expertise, and financial standing of all related parties in assuring that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The credit file should include background information on the developer (borrower) and any relevant third parties describing their experience on similar projects.
- Minimum standards of documentation, including:
- Specific, reasonable, and supportable cost estimates. Regulators should at all times be able to determine the nature of project costs and the extent to which these costs contribute to collateral value.
- Clearly identified sources of repayment.

Such sources as contracted anchor tenants in a mall, a primary tenant in an office development, or sales of housing units would be appropriate. Although the use of interest reserves is common, it is preferable to ensure loan servicing from known funding sources, such as other investments of the borrower or cash provided by initial investors, until the project is producing a positive cash flow.

A feasibility study should project cash flow adequate to service debt and ensure orderly liquidation of principal. Projected debt service coverage of anywhere from 110% when tenants are financially stable and under contract, to 150% for speculative properties, is a reasonable underwriting requirement;

- Specific plans for permanent financing.

The plans should include requirements and standards for take-out commitments and tri-party (buy/sell) agreements. The take-out commitment supports the source of repayments and is issued by the lender that provides the permanent financing. The amount of the take-out commitment should be adequate to cover principal and interest that has not otherwise been planned from other sources. The expiration date and restrictions in the take-out commitment should be reasonable. All requirements should be met and approved by the permanent lender prior to construction and the institution should ensure that the issuer is financially capable of honoring its commitment. The building and loan agreement, which is entered into by the institution, the builder, and the property owner, outlines the performance responsibilities of each party and generally contains certifications that plans and specifications conform to all applicable laws and are approved by appropriate interested parties. It also contains certain covenants that protect the lender's interest during the term of construction. The tri-party (buy/sell) agreement is entered into by the borrower and the construction and permanent lenders. It contains provisions protecting the interest of each lender, such as preventing the permanent lender from withdrawing the take-out commitment because of unacceptable documentation or unforeseen developments such as the death of a principal before permanent loan documents are signed.

- Appropriate insurance. The lender should assure that the project is at all times protected from liability and various hazards through builder's risk and hazard insurance protection, if not otherwise provided. Title protection should ensure perfected liens, preferably through insurance from before the start of construction through completion. All liens should be paid or otherwise cleared to the satisfaction of the title insurer.

- A formal system of loan administration, inspection, and disbursements. Loan administration should have definite control procedures to prevent overpayment and ensure that liens are paid and released. Controls should involve segregation of duties, site inspections, budget comparisons, and dual approval of disbursements. Records should be kept that can show that remaining funds in Loan in process (LIP) are adequate for completion. Records of expenses should be complete and subject to audit, independent of the loan administration staff. The percentage of completion of the project and the percentage of funds expended should be easily determinable at any time. If regulators are not comfortable with the control procedures on a major project, an additional site inspection should be done to ensure that progress is as reported in the credit files.

- Inspections. For major projects, architect or engineering inspection reports, independent of the borrower, should be required with each draw to ensure work is done to specifications. A representative of the lender should at least occasionally inspect the site to ensure work is done as reported. The loan administration staff should compare site inspection reports to construction plans and specifications preferably prior to disbursement. Inspection reports should state compliance with plans and specifications, support disbursements, and state whether or not the project is progressing as anticipated.

- Disbursements. Disbursements are generally prearranged and are based upon either a standard payment plan that calls for fixed payments at the end of specified stages of construction or a progress payment plan, which is usually based on monthly disbursements up to a stated percentage of value with a stated percentage held back until the project is completed. Under each plan, a percentage of the loan is usually retained until a notice of completion has been filed and the stipulated period under which liens may be filed has lapsed. Disbursements should be properly authorized and supported by the inspection report. Receipted bills of work performed and materials furnished, and lien waivers should be obtained as disbursements are made. A release of mechanic's liens should also be obtained from the general contractor at the time construction is completed and before final disbursement. Appropriate institution personnel should compare draws with cost estimates to ensure that budgets are met or cost overruns are provided for. Prudent lenders often will hold back part of loan advances, requiring the developer to put equity into each phase of construction. This may be done by holding 10% or 20% of construction costs until the project is finished. Such holdbacks can be started with the initial draw, so that funds are paid out at the rate of, for example, 80% of expenses, resulting in a delay for full loan funding until correction of errors, completion, and final disposition of the project is ensured to the satisfaction of the end user or permanent lender.

- Lien Releases. The principal balance of an acquisition-and-development loan is generally repaid through lien release payments. Depending on the type of project, as each unit is sold, the proceeds are used to (1) pay interest on the outstanding balance, (2) repay a portion of the principal, (3) cover the developer's overhead and expenses, and (4) provide the developer a profit. Prudent practice requires that the principal balance of the loan shall be reduced by an amount at least equal to that portion of the outstanding loan balance attributable to the value of the property to be released" (i.e., the lien release must be at least 100% of the unit's proportional share of the loan balance). Prudent lenders, however, often require the developer to pay lien releases greater than the proportional share of the loan value of the unit sold (often 110% to 125%). Otherwise, the loan will not be repaid until the last unit is sold. The latter is undesirable because the most marketable units often sell first, leaving the loan secured by less desirable, hard to sell units.

Developer's Profit and Interest Reserves

Developer's profit and interest expense, from the inception of a project until sell-out or break- even leasing, are legitimate development costs. As such, they should be budgeted along with all other development costs when determining the adequacy of loan and equity funds to cover all expenses associated with a development. Because developer's profit and interest expense are recognized costs of developing a project, construction lenders should control the funding of these expenses through the Loans in Process (LIP) account.

Developer's Profit

Developer Profit in the Funding of a Loan. Developer profit and overhead costs should be funded by investor's equity, sales, or rents, and not construction loan funds. Such expenses do not contribute to collateral value unless the project is successful, meaning the project has been completed and the properties sold or leased up. Paying a developer a profit for an incomplete project removes his/her incentive to complete and sell the units in a real estate project and has in the past led to financial problems for some institutions.

Developer Profit and foreclosures. The institution must always ensure that it has sufficient funds (or borrower equity) in a project to complete construction. This includes all hard costs as well as amounts for interest reserves, overhead and developer's profit. If the institution should have to foreclose on the project, it would incur such items in its own development costs because it would either have to sell the project (and usually provide the financing) at an amount that would allow the new developer to cover all costs and earn a profit, or it would have to hire a developer to take over and complete the project and pay for the developer's services.

Interest Reserves

LIP proceeds allocated to interest, whether generated from loan funds or deposits from the borrower, should be clearly designated for payment of interest. Construction lenders should analyze the adequacy of the estimated interest expense as projected by the borrower/developer to cover completion of the project. Projected timing of loan draws should be provided by the applicant. The lender should analyze the timing of principal repayments/projected income in concert with the projections. The adequacy of remaining interest reserves should be continually monitored in an effort to determine whether they are sufficient. Delays in construction and slower-than-anticipated selling or leasing progress can adversely affect the sufficiency of interest reserves. Any deficiency in interest reserves is a matter of serious concern and should be cause for protective measures by the lender to control costs and to secure additional funds to cover the shortfall. The requirement on the borrower to cover any LIP shortfall should be incorporated in the loan documents.

Construction Arrangements
Loans for the purpose of acquiring, developing, and constructing improvements to real estate can be treated three different ways for accounting purposes, depending on the specific circumstances of the transaction. Significant accounting differences as to the recognition and timing of interest and fee income occur, depending on whether the transaction is a loan, a joint venture in real estate, or an investment in real estate.

Because some such transactions are treated by mortgage lenders as loans when in fact they should be treated as investments, income and capital can be overstated. Transactions containing the additional risk associated with an investment involve more risk to the lender than a loan does. These transactions typically involve speculative projects and, because the borrower cannot yet demonstrate the ability to completely repay the loan, it is inappropriate to recognize market interest rates and portions of loan fees as income before the project's success has been proven. If the mortgage lender will receive a majority of the project's profits, the transaction should be treated as an investment in real estate, and interest, fees, and profits in excess of the mortgage lender's cost of funds should be deferred and offset against the investment in the loan.

Constructions loans that are more properly treated as joint ventures or investments in real estate typically contain substantially more risk than loans do. The difference between a transaction properly treated as a loan versus one properly treated as a joint venture or investment is that, for a loan, the following generally occur:

- The borrower has a substantial equity investment in the project from its inception;
- The lender has recourse to substantive assets of the borrower other than the constructions projects or the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan;
- A reasonably conditioned full take-out commitment has been obtained from a creditworthy, independent third party; or
- Non-cancelable sales contracts or lease commitments are in effect.

A joint venture or investment transaction typically involves the following in addition to a profit participation:

- The lender provides all or substantially all of the funds to acquire and complete the project, including loan and commitment fees;
- The lender funds all interest due during the development and construction by adding interest to the loan balance;
- The lender has no recourse to any assets of the borrower other than the ADC project or has a personal guaranty from the borrower of little or questionable value; or
- The loan is structured so that during project development, the loan is unlikely to go into default and therefore be foreclosed because no payments are required until the improvements are finished.

SECTION: Troubled Debt Restructurings 240

INTRODUCTION

A mortgage lender must sometimes renegotiate loan terms to assist borrowers who are unable to meet the original terms of their loans, and maximize recovery of loans to these borrowers. Such renegotiation may result in the mortgage lender making modifications that result in loan terms it normally would not accept. These may include:

- A lower interest rate or even no interest.
- A reduction in principal.
- A lengthier term to maturity.
- A transfer of assets from the borrower.
- The substitution or addition of a new borrower.
- Some combination of these modifications.

This renegotiation, where the mortgage lender grants concessions to the debtor/borrower, results in a troubled debt restructuring or TDR.

Troubled debt restructurings are compromises of indebtedness designed to improve collection or reduce losses on problem loans. Mortgage lender policy and practice should require strict controls such as dual authorization requirements and monitoring by a senior committee to prevent unneeded compromises from occurring.

Troubled debts require accurate accounting according to Egyptian accounting standards. They also require an evaluation of the probable loss from collection. This Section of the Manual describes the following areas:

Troubled debt restructurings.
Accounting for TDRs.
Loans to one borrower.
Classification.

TROUBLED DEBT RESTRUCTURINGS

A troubled debt restructuring (TDR) occurs when a mortgage lender grants a concession it would not otherwise consider because of economic or legal reasons pertaining to the debtor's financial difficulties. A TDR may include, but is not limited to, the following transactions or any combination of the following transactions:

The <u>transfer of assets</u> from the debtor to the creditor to satisfy all or part of the indebtedness when the fair value of the assets received is less than the recorded investment in the loan. The assets transferred may be receivables from third parties, real estate, or other assets.

Issuance of an <u>equity interest</u> by the debtor to the creditor to satisfy all or part of a debt. The debtor must not grant the interest pursuant to existing terms for converting debt to equity.

<u>Modification of the terms</u> of debt such as the following:

A reduction of the interest rate for the remaining term.

An extension of the maturity date with a stated interest rate lower than the current market rate for new debt with similar risk.

Reduction in the outstanding principal amount due or a reduction in the accrued interest due.

Substitution or addition of debtor(s) when the substitute or additional debtor(s) control, are controlled by, or are under common control with the original debtor. When substitute or additional debtor(s) has no relationship with the original debtor after the restructuring, the mortgage lender should account for the restructuring as a new loan in partial satisfaction of the original borrower's loan. In this situation, recognize any losses resulting from the new financing using the fair value of the new loan.

Not all concessions granted by the creditor constitute a TDR. For example, the following situations do not constitute a TDR:

- The assets received by the creditor for full satisfaction of the debt have a fair value equal to or greater than the recorded investment in the receivable.
- The creditor reduces the interest rate on the debt to reflect a decrease in the market interest rate.

Periods of declining interest rates may make refinancing of loans appealing to borrowers whose current contractual interest rates are higher than market interest rates. However, the value of the pledged collateral may decline. MFA encourages mortgage lenders to work constructively with creditworthy borrowers, including instances where the refinancing of real estate-related loans involves an adjustment of the existing loan rates to current market rates. MFA will not criticize a mortgage lender solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral declined in value. MFA will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

ACCOUNTING

Impairment of a loan exists when current information and events indicate that the mortgage lender will be unable to collect "all amounts due" according to the contractual terms of the original loan agreement. All amounts due according to the contractual terms means the mortgage lender will collect both the contractual interest payments and the contractual principal payments of the loan as scheduled in the loan agreement.

A loan is not impaired during a delay in payment of the loan, if the creditor expects to collect all amounts, including interest at the contractual rate for the period of delay. Base support for collection of all amounts due upon the cash flow from the project and/or borrower, not the fair value estimate of the collateral. A typical measurement of impairment is based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, it allows measurement of impairment based on the loan's observable market price, or the fair value of the collateral if the loan is collateral- dependent. A collateral-dependent loan is a loan where expected repayment depends solely on the underlying collateral. Impairment occurs when the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan. The recorded investment in the loan includes accrued interest, net deferred loan fees or costs, and unamortized premium or discount.

Mortgage lenders should measure impairment based on the fair value of the collateral less costs to sell when foreclosure is probable. In addition, mortgage lenders should value and classify troubled, collateral-dependent loans on the collateral's fair value. Under Section 260, mortgage lenders should not use the present value of the expected future cash flows or the loan's observable market price to value troubled, collateral dependent loans. Thus, MFA has restricted mortgage lenders to a single option, the fair value of the collateral (less costs to sell), for troubled, collateral- dependent loans.

The effective interest rate for a loan is the rate of return implicit in the loan. A mortgage lender should consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs would likely reduce cash flows available to repay or otherwise satisfy the loan.

The cost to sell an asset generally includes the estimated incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs. Generally, costs to sell exclude insurance, security services, and utility costs. A mortgage lender recognizes impairment by doing one of the following:

- Creating a valuation allowance with a corresponding charge to provision for loan losses.
- Adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to provision for loan losses.

Therefore, in calculating the loan value for loss valuation, the mortgage lender should base the effective interest rate for such loans on the original contractual rate, not the rate specified in the restructuring agreement.

Timing
A TDR may occur before, at, or after the stated maturity of the debt. Time may elapse between the restructuring agreement and the effective date of the new terms of the restructuring. The date of consummation of the restructuring agreement is the recognition date for the restructuring, not necessarily the completion date of the restructuring paperwork. MFA acknowledges a TDR's existence when there is an agreement between the mortgage lender and the borrower consummating the restructuring. A TDR is presumed to exist if senior management of the mortgage lender and the borrower reach an oral agreement and memorialize the agreement in written documentation, such as a memorandum to the files, setting forth the terms of the TDR.

An oral agreement may reflect the restructuring of a loan, but is not a long-term substitute for a written agreement. The mortgage lender should document in writing the consummation of a TDR within a reasonable time frame. Normally, complete restructuring occurs within six months. A claim becomes dubious when negotiations continue for a long period without producing a final written agreement for a loan restructuring. The issue of timing is important when applying accounting principles because it determines when and if a mortgage lender should account for a problem loan as a TDR.

Receipt of Assets
The mortgage lender should record assets transferred in partial or total repayment of indebtedness, including an equity interest in the debtor, at their fair value less cost to sell. Fair value is the amount the debtor could reasonably expect to receive from a current sale between a willing buyer and a willing seller; that is, other than a forced or liquidation sale. Mortgage lenders should measure the fair value of an asset by the market value if an active market exists. If no market exists for the assets transferred, the mortgage lender should use a forecast of expected cash flows from the asset, discounted at a rate commensurate with the risk involved to arrive at the fair value.

Repossession in Substance
A creditor cannot avoid accounting for an asset at its fair value by simply avoiding a formal foreclosure. A mortgage lender treats an impaired collateral-dependent real estate loan as a repossession in substance (reported as REO) once it takes possession of the collateral. This treatment stands even if the lender has not obtained legal title. Examples of taking possession include managing the collateral,

proceeding with the foreclosure process, and marketing the project for sale. Mortgage lenders base loss recognition for other troubled collateral-dependent loans on the fair value of the collateral less costs to sell if they do not anticipate full payment of the amounts due. Such loans remain in the loan category.

If repossession in substance occurs, you should consider whether an independent appraisal is necessary.

Disclosure

A mortgage lender must disclose a loan modified and accounted for as a TDR in its audited financial statements and on reports to MFA. Audited financial reports should disclose the following information pertaining to all impaired loans including TDRs, if material:

- The total recorded investment in the impaired loans at the end of each period, and (1) the amount of that recorded investment for which there is a related allowance for credit losses, and (2) the amount of that recorded investment where there is no allowance.
- The creditor's interest income recognition policy including the method of recording cash receipts.
- The activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. There is an exception to these disclosure requirements.

There is no need to include a TDR involving a modification of terms in the disclosures in the years after the restructuring if both of the following conditions exist:

- The restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of restructuring for a new loan with comparable risk.
- The loan is not impaired based on the terms specified by the restructuring agreement.

Returning Non-accrual Loans to Accrual Status

TDR Multiple Note Structure

A typical example of a TDR multiple note structure is where the mortgage lender restructures the original troubled debt with the borrower and splits the debt into two notes. The first note, or the "A" note, represents the portion of the original loan principal amount that the mortgage lender expects to collect in full, along with contractual interest. The second note, or the "B" note, represents the portion of the original loan that the mortgage lender charges off. A lender may return the "A" note to accrual status conditioned on satisfaction of the following:

- The restructuring qualifies as a TDR, and there is economic substance to the restructuring.
- The mortgage lender must charge-off the portion of the original loan represented by the "B" note before or at the time of the restructuring. The mortgage lender must support the charge-off by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms.
- There is reasonable assurance of repayment and of performance in accordance with the modified terms of the "A" note.
- There is a sustained period of repayment performance (generally a minimum of six months), either immediately before or after restructuring, in accordance with the modified terms, involving payments of cash or cash equivalents.

The mortgage lender would initially disclose the “A” note as a TDR. The mortgage lender could eliminate such disclosure in the year following the restructuring, provided the “A” note meets the following additional conditions:

- The “A” note yields a market rate of interest. To be considered a market rate of interest, the interest rate on the “A” note at the time of the restructuring must be equal to or greater than the rate the mortgage lender is willing to accept for a new receivable with comparable risk.
- The “A” note performs in accordance with the modified terms.

Past Due Loans

Past due loans may be returned to accrual status, even though the loans are not fully current, and any previous charge-offs not fully recovered, provided the past due loans meet the following conditions:

- There is reasonable assurance of repayment within a reasonable period, of all principal and interest amounts contractually due (including amounts past due).
- There is a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms, involving payments of cash or cash equivalents. However, mortgage lenders would continue to disclose past due loans that meet the above conditions, until they are fully current.

LOANS TO ONE BORROWER

The restructuring of a troubled loan constitutes a renewal, but is not a new loan for purposes of the loans-to-one-borrower (LTOB) rule, provided that the mortgage lender advances no additional funds to the borrower. In the case of a non-conforming loan, the mortgage lender should take reasonable efforts, consistent with safety and soundness, to make the loan conforming. In addition, the mortgage lender should document its efforts to bring the loan into conformance. If the efforts are unsuccessful, the mortgage lender may renew, restructure, or modify the nonconforming loan with the following provisions:

- The transaction is not done with the purpose of evading the lending limits.
- There can be no substitution of borrowers.
- The mortgage lender cannot advance additional funds.

CLASSIFICATION

As with all assets of mortgage lenders, TDRs are subject to the classification requirements of regulations for Asset Classification. Conversely, a loan accounted for as a TDR is not exempt from the classification process. When evaluating TDRs for possible classification, you should use the same criteria as for all other loans. TDRs are probable candidates for adverse classification. As a practical matter, TDRs have demonstrated weakness and often require some loss recognition. MFA will not criticize a mortgage lender solely for renegotiating a loan to a current market rate, even if the pledged collateral has declined in value. You will evaluate renegotiated loans based on the borrower’s history of payment, creditworthiness and repayment capacity.

REFERENCES

SECTION: Real Estate Owned and Other Repossessed Assets 251

INTRODUCTION

When a mortgage lender repossesses property, there is a distinct possibility of loss on the liquidation of the property otherwise the borrower would not have defaulted. Real estate owned (REO) is real property that a mortgage lender holds as a consequence of defaults on loans. It is typically a poor or non-earning asset and a mortgage lender's acquisition of a limited amount of REO is an unavoidable result of normal business operations. REO includes real estate acquired in the following ways:

- Real estate in judgment.
- Real estate acquired through foreclosure.
- In-substance foreclosures.
- Real estate acquired through deed in lieu of foreclosure.
- Any real property exchanged for foreclosed real estate.

If a question arises as to whether the mortgage lender should report a parcel as REO, you should look to economic substance rather than to the legal form in which the property is held.

If the mortgage lender does not expect full payment of all amounts due for an impaired, collateral-dependent loan, the mortgage lender should measure the impairment based on the fair value of the collateral less costs to sell. Also, the lender should report the impaired loan as an in-substance foreclosure if it has physical possession of the collateral. Other collateral-dependent loans that the lender does not possess remain categorized as loans.

Other repossessed assets are non-real estate property the mortgage lender takes possession of to satisfy some or all of a borrower's debt as part of a settlement agreement. The usual types of other repossessed assets include the following properties:

- Personal property; e.g. vehicles.
- Commercial goods: equipment, furniture, fixtures, inventories, accounts receivable, lease receivables, etc.
- Investments: stocks, bonds, certificates of deposit, etc.
- Other: intangible assets, cash surrender value of life insurance policy, etc.

Throughout this Section, we use the terms foreclosure and repossession (and other forms of those terms) interchangeably.

Supervisory Concerns
An increase in a mortgage lender's REO and repossessed assets portfolios should serve as red flags to both you and management. Increases in these portfolios may indicate deteriorating economic conditions, lax adherence to loan underwriting standards, or deficient loan administration. The historical absence of REO may be indicative of overly restrictive loan underwriting criteria or a lax foreclosure policy. You should perform the following steps:

- Review the mortgage lender's internal asset review program.
- Evaluate the adequacy of internal controls.
- Interview management concerning:
    - the detection of potential problem credits.

- o the effectiveness of resolutions (workouts) and collection of problem loans.

The mortgage lender should evaluate the likelihood of repossessing an asset for all seriously delinquent loans. The mortgage lender should also consider other alternatives to repossession. Prior to foreclosure or repossession, management should check with the proper authorities to verify the existence of a valid recorded lien. At that time, the mortgage lender should determine the market value of the collateral. The mortgage lender should also obtain sufficient insurance coverage on the asset after the mortgage lender takes possession.

Appraisals
Mortgage lenders should appraise each parcel of REO at acquisition. A mortgage lender must appraise each parcel of real estate owned at the earlier of an in-substance foreclosure or at the time of the mortgage lender's acquisition of the property. Thereafter, prudent management policy dictates the timing of appraisals. The company director (or designee) may require subsequent appraisals if they deem necessary under the circumstances. Mortgage lenders must carry REO on the books at the lower of recorded cost or fair value less costs to sell. Therefore, MFA does not require an appraisal upon disposition of the property; however, the mortgage lender's policies may require one.

Accounting at Foreclosure
Mortgage lenders should initially record foreclosed assets deemed held for sale at the lower of one of the following amounts:

- Recorded investment (that is, carrying value before deduction for valuation allowances) in the loan.
- Fair value less costs to sell the foreclosed asset.

The costs to sell an asset include the estimated incremental direct costs to transact the sale of the asset. This includes such costs as broker commissions, legal and title transfer fees, and closing costs. Costs to sell generally exclude insurance, security service, and utility costs. Upon foreclosure (including in-substance foreclosure), the mortgage lender must compare the recorded investment in the loan (carrying value before deduction for valuation allowances) to the fair value less costs to sell the foreclosed property.

The mortgage lender must classify as Loss and charge off any amount in excess of recorded investment over fair value less costs to sell. The mortgage lender cannot represent this Loss classification by a valuation allowance. Mortgage lenders must expense, as incurred, legal fees and direct costs of acquiring title to foreclosed assets.

Hold or Sell Decision

- ➢ Once a mortgage lender acquires a property through foreclosure or repossession, management should begin the decision-making process of whether to hold the property or sell it (possibly in an unfavorable market). A primary consideration when selling the asset is whether the mortgage lender will have to make a loan to facilitate the sale. The mortgage lender must consider the overall cost if it regains the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the mortgage lender initially took possession. Moreover, if the most recent borrower failed to service the debt at all, the mortgage lender has sacrificed any income it could have received from an interim use of the property. In making the decision when and if to sell the repossessed property at the least cost to the mortgage lender, management should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property “as is.”
- Cost of completing, restoring, and enhancing the project.
- Cost to prevent deterioration of the asset during the anticipated holding period:
  - Insurance
  - Physical security (fencing, security service, etc.)
  - Maintenance (mowing, utilities, structural repair, etc.)
- Intangible (lost goodwill, etc.).
- Cost of selling the property (advertising, broker's commission, defects observed at inspection, etc.).
- Opportunity costs to the mortgage lender, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing (discount future and probable cash flows to present value).
- Anticipated appreciation or depreciation during the holding period.
- Benefit when property sold at end of holding period (discount proceeds to present value, determine yield based on current market rates).
- Benefit of interim use of the property in a lease or rental arrangement.

The above analysis should assist management in making an informed decision on the disposition of the mortgage lender's REO and repossessed assets.

Internal Asset Review

As a sound lending practice, mortgage lenders should conduct periodic reappraisals and reassessments of REO and other repossessed assets. REO is sometimes an unsound asset even when recorded at fair value. The mortgage lender's acquisition of the property normally indicates a lack of demand. As time passes without disposition, the lack of demand becomes more apparent and the quality of the asset becomes more doubtful. The mortgage lender should consider each repossessed item on an individual basis and, if necessary, classify it adversely on the basis of facts supporting your evaluation. For instance, if a developed parcel of REO is receiving steady cash flows at a market yield, an adverse classification may not be necessary.

Accounting after Foreclosure

For periodic evaluations of REO for impairment, *after* foreclosure, the mortgage lender must classify as Loss, and charge off or represent by a specific valuation allowance, any excess of recorded investment over current fair value less cost to sell. Mortgage lenders must deduct valuation allowances from the recorded investment to arrive at carrying value.

Real Estate Owned (REO) Workouts

Management must assess the level of in-house expertise available to manage REO workouts. Management should consider the possibility of looking outside the mortgage lender for the necessary level of expertise. This should include recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis. Management is responsible for reviewing the economic merits of out-sourcing REO disposition plans. If any mortgage lender identifies any regulatory issues of concern during its process of selecting an outside REO workout program, it should raise these issues with the appropriate examination or supervisory personnel. They will provide advice on whether the vendor’s proposal conforms with regulatory procedures and safe and sound practices. Mortgage lenders should be aware that MFA neither approves nor endorses specific REO workout proposals. Mortgage lenders should bring to MFA's attention any representations by any organization to the contrary.

Accounting for Sales of Real Estate
Accounting for the sale of real estate requires the determination of the following two issues:

- The point at which a sale actually occurs.
- How the mortgage lender recognizes the gain on the sale. When a mortgage lender does not recognize a sale they should classify the asset as REO. Generally, the mortgage lender may consummate a sale once the following events occur:
    - The terms of a contract bind the parties.
    - The exchange of all consideration.
    - The parties perform on all conditions precedent to the closing.

Gains

If, after the transaction, the mortgage lender retains some type of continuing involvement in the property, the transaction may not qualify for gain recognition. The mortgage lender should defer any gain and credit to an account descriptive of unearned gain on the sale of real estate. Mortgage lenders must account for all gains under accounting principles, which specify the amount and timing of gains the seller of real estate may recognize when the sale depends upon the seller's continuing involvement and retention of risks. The mortgage lender may recognize all gains at the time of sale as long as the sale meets the following conditions:

- The mortgage lender did not finance the sale.
- The mortgage lender has no continuing involvement with the property. In the situation where the mortgage lender makes a loan to facilitate the sale of REO, the mortgage lender may recognize the full gain if the sale meets all of the following conditions:
    - ▫ The mortgage lender and buyer consummate the sale.
    - ▫ The buyer has adequate initial and continuing investments that demonstrate a commitment to pay for the property.
    - ▫ The seller transfers to the buyer the usual risks and rewards of ownership in a transaction that is, in substance, a sale and does not have a substantial continuing involvement with the property.

Loans to facilitate the sale of real estate do not fall under the loans to one borrower rule if the mortgage lender takes a purchase money mortgage note from the purchaser and meets the following two conditions:

- The mortgage lender does not advance any new funds to the borrower.
- The mortgage lender is not in a more detrimental position as a result of the sale.

Losses
Accounting standards require that if the sale of REO results in a loss, the mortgage lender shall account for the loss in the period it sustained the loss. The inflated price may be a result of favorable terms the mortgage lender provided in a loan to facilitate. Accounting principles require discounting sales prices to reflect market interest rates for loans of similar terms and risk. You should take exception and

prompt supervisory action when mortgage lenders finance significant amounts of their REO by loans at interest rates substantially below the current market rates.

REFERENCES

SECTION: Fixed Assets 252

INTRODUCTION

Fixed assets are investments in property and equipment that contribute indirectly to a mortgage lender's operations and have economic lives of greater than one year. These assets usually consist of mortgage lender offices, leasehold improvements, and equipment. Mortgage lenders invest in fixed assets directly through the purchase of assets or indirectly by lease. A mortgage lender may also combine these ownership techniques in a sale/leaseback arrangement. Fixed assets do not constitute a large percentage of total assets, but they can involve the commitment of substantial dollar amounts. You should assess the propriety of the mortgage lender's investment in premises and equipment and determine the effect of the related expenses on the mortgage lender's operations.

This section of the manual assists you in your review of a mortgage lender's fixed asset policies, procedures, and transactions. You should consider the following areas in your review of fixed assets:

- The policies, procedures, and controls used in the acquisition, management, and disposition of fixed assets.
- Any investments in real estate to establish offices and related facilities and subsequent capital deductions as required.
- Any shared office lease agreements.
- Any sale/leaseback arrangements.
- The valuation and accounting method used.

Policies, Procedures, and Controls
The mortgage lender should establish policies, procedures, and controls to ensure that fixed asset investments are prudent. The mortgage lender should also have controls to ensure that the mortgage lender periodically conducts physical inventories and maintains adequate insurance coverage on all fixed assets. The board minutes should document the approval of material fixed asset acquisitions and dispositions. Policies should require documentary proof that acquisitions fulfill a demonstrated need, are cost effective, and fit the overall goals of the mortgage lender. Procedures should contain controls to prevent insider dealings, conflicts of interest, and misappropriation of assets. The purchase, sale, and lease of assets to or from an affiliate generally must be at arm's length and based on market value. Quantitative limitations also apply with respect to purchases of assets.

Office Premises and Land Acquired for Future Use

The mortgage lender should develop land acquired for future expansion of the mortgage lender’s facilities as its directorate intended within one to three years. You should be alert to any deviation from the intended use of land held for future expansion. Management should thoroughly explain any instances where the mortgage lender holds property and does not develop it for the mortgage lender’s use beyond three years. You should include the explanation in the report of examination. Ordinarily, a mortgage lender must file an application to MFA for an office or related facility before it develops the site.

A mortgage lender that acquires real estate for an office(s) or related purpose(s), but no longer intends to use it for that purpose may no longer account for it as a fixed asset. The institution should account for the asset as REO and must dispose of the asset within five years, or longer period as approved by MFA, after any one of the following events:

- Management determines not to file an application for approval of a proposed facility.
- MFA disapproves an application, and the mortgage lender decides not to reapply for a facility at the same site.
- The mortgage lender does not develop the asset for its own use within three years of acquisition.

The asset then becomes a non-earning, nonproductive asset. See Manual Section 251, Real Estate Owned and Repossessed Assets. A mortgage lender must account for any subsequent sale of a mortgage lender's former office property in accordance with accounting standards.

Sharing Office Quarters

A mortgage lender may lease office space to a financial institution or other company. MFA does not consider the mortgage lender engaged in the activities of that other institution or company if the lease agreement does not constitute a de facto joint venture. The nature of the lease payments can sometimes help to determine whether the mortgage lender and the other company established a joint venture or bona fide lease. For example, in some instances, the lease may require that a portion of the rent be fixed and another portion calculated as a percentage of the lessees revenues. Because the sharing of revenues may indicate a joint venture, the amount of any rent based on the lessee's revenue should be substantially less than 50 percent of the lessee's revenues. MFA would generally consider a percentage of less than 25 percent to be reasonable. In addition, the mortgage lender must receive regular fixed payments that are substantially equivalent to the fair rental value of the property for MFA to deem the agreement a bona fide lease.

Any mortgage lender that shares office space with another financial institution should follow certain guidelines to avoid conflicts of interest and usurpation of corporate opportunity. Institutions sharing common quarters must implement the following criteria:

- Maintain separate identities to avoid customer confusion.
- Create physical separation between each institution's cash transactional areas.
- Maintain adequate controls to ensure the integrity of assets, records, computers, currency, checks, safes, and vaults of the institutions.

The potential for customer confusion is greater when employees have dual responsibilities and customer contact on behalf of both institutions in a sharing arrangement. Therefore, the mortgage lender should impose appropriate safeguards to address such risk. Policies and employee training material should include activities, restrictions, and responsibilities that apply to both functions of dual employees. Both parties must make a conscious effort to demonstrate to the public their separate corporate existence.

Certain areas should not be accessible to the employees of the institution sharing office quarters. These areas include restricted office areas such as records or equipment with no security controls. Access by employees of an institution sharing office space should be no different from the limited access available to the general public. Each entity that shares common quarters should also have a plan to avoid conflicts of interest and usurpation of corporate opportunity. Such plans should address the following issues:

- Specific areas where conflicts and abuses may occur.
- Policies and actions that avoid potential conflicts and abuse.
- Procedures to deal with individuals who violate such policies.

Any mortgage lender that shares office space with another financial institution should follow these guidelines. The guidelines apply regardless of whether the other financial institution is an affiliate or the mortgage lender engages in tandem branching or agent banking. Similar guidelines apply to lease arrangements between mortgage lenders and their subsidiaries.

Sale/Leaseback

Management may consider a sale/leaseback arrangement when the mortgage lender is experiencing cash flow or financing problems or the arrangement provides income or tax advantages. A sale/leaseback is an agreement whereby the mortgage lender (seller-lessee) sells the property and immediately leases all or part of it back from the new owner (buyer-lessor). The mortgage lender makes lease payments and continues to use the asset. A sale/leaseback is a variation of a capital lease. Capital leases provide a lessee with many advantages associated with direct ownership. In a capital lease, the lessee must make a stream of payments to the lessor; the amount must equal or exceed the price of the asset leased. The period of the lease often approximates the remaining economic life of the asset. In effect, a capital lease provides a financing vehicle for the lessee and accountants usually regard it as an asset. If the owner transfers substantially all the benefits and risks of ownership to the lessee, then the owner should record the lease as a capital lease. The owner is considered to have substantially transferred the risks or benefits of ownership if the transaction meets any one of the following criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term equals 75 percent or more of the estimated economic life of the leased property. In addition, the beginning of the lease term does not fall within the last 25 percent of the total economic life of the leased property.
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the market value to the lessor less any investment credit retained by the lessor.

If the sale/leaseback agreement qualifies as a capital lease, accounting principles probably require the lessee to record the leasehold improvement as an asset and the obligation to make payments under the lease agreement as a liability. MFA considers a lease recognized as a capital lease to be an investment in real estate for office and related facilities. A capital lease obligation is subject to any borrowing limitations of MFA regulations. The lessee should initially record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term.

The minimum lease payments generally include the following items:

- The minimum rental payments.
- Any guarantee of the residual value made by the lessee.
- The penalty for failure to renew the lease, if applicable.

The discount rate in determining present value of the minimum lease payments is the interest rate implicit in the lease or the lessee's incremental borrowing rate. Because the parties generally negotiate the terms of a sale and the terms of a leaseback as a package, the accounting treatment for a sale/leaseback is typically to treat the sale/leaseback as a single transaction. If a lease agreement does not meet at least one of the four criteria specific to a capital lease, accountants classify it as an operating lease by the lessee. An operating lease is a month-to-month temporary rental of property. The accounting treatment accorded an operating lease is relatively simple. Charge the rental payment to expense as the lessor makes the payments or as they become payable. This assumes that the lease payments are paid on a straight-line basis. There is no balance sheet recognition of the leased asset.

Management should compare the cost of a sale/leaseback arrangement with that of other acquisition or disposition strategies. In simplest terms, the after-tax cost of a leaseback is the present value of the payments to the lessor plus the present value of the reversion price. This means that as lease payments increase relative to the sale price, the cost of the lease transaction increases. The lease accounting for book purposes can differ significantly from the lease accounting for tax purposes. Therefore, a prudent lease decision should consider the timing of the after-tax funds flow. Estimate cash flows on an after-tax basis by comparing book and tax income and expense.

Computer Software
The costs of computer software that the mortgage lender develops or obtains for internal use should be capitalized and amortized pursuant to accounting standards.

Valuation and Accounting Methods
The valuation of the fixed asset will rely in part on the accounting treatment that the mortgage lender applies to the asset and such factors as depreciation, tax effects, and discounting to present values.

Investments in fixed assets that the mortgage lender makes within regulatory limitations and valued properly on the mortgage lender's books should be consistent with the mortgage lender's earnings, capital structure, operations, and business plans and strategies. To properly value their fixed assets the mortgage lender should consider the tangible ownership costs such as maintenance and depreciation. In addition, the mortgage lender should consider the intangible opportunity costs that can result from the diversion of funds from alternative income-producing investments. The acquisition of fixed assets should be for sound economic reasons. The mortgage lender should consider the following items:

- Opportunity costs associated with investments in fixed assets after determining the method and direct costs of the acquisition.
- Income tax consequences.

The mortgage lender should establish the following specific records at the time they acquire an asset:

- A record of all their fixed assets at cost as required by accounting principles.
- Individual accounts of property and equipment with descriptive records for each item.
- An audit trail for property and equipment sold, exchanged, or otherwise disposed.

The mortgage lender may use groupings within equipment such as furniture, fixtures, teller equipment, and automobiles. The mortgage lender, however, should segregate land records from building records, even if consolidated for reporting purposes, because land is a non-depreciable asset. The institution should calculate the amortization of productive fixed assets, commonly referred to as depreciation, separately for financial reporting and tax purposes. The method of depreciation must result in the systematic and rational allocation of the cost of the asset, less its residual value, over the asset's expected useful life.

For financial reporting purposes, a mortgage lender may use several methods of depreciation, such as straight-line, declining-balance, or sum-of-the-years-digits.

When the mortgage lender disposes of fixed assets, the mortgage lender should eliminate the balance in both the asset account and the accumulated depreciation account, then record any value received in exchange. The mortgage lender should record depreciation on the asset up to the earlier of the date the mortgage lender sells it or takes it out of use as a productive asset. Mortgage lenders should carry fully depreciated fixed assets on the general ledger at their residual value.

REFERENCES

SECTION: Classification of Assets 260

INTRODUCTION

The system of classification of assets is one of the tools used to evaluate asset quality to determine the adequacy of valuation allowances. Classification of assets serves several purposes for both the Mortgage Finance Authority (MFA) and mortgage lenders. Asset classifications can be used as a management tool to identify and monitor portfolio risk. An analysis of a mortgage lender's classified assets is essential to the proper evaluation of a mortgage lender's asset quality and financial condition. The level of asset problems, as evidenced by classifications, also serves as a reflection of management's abilities to implement sound operating policies and procedures and to comply with regulatory requirements. All mortgage lender assets are subject to classification. Additionally, Substandard and Doubtful classifications must be considered in the determination of an adequate level of a mortgage lender's general valuation allowances. Loss classifications require either the establishment of a specific allowance or charge-off of 100% of the balance so classified.

Asset Quality Ratings

As fully developed in Manual Section 209, and subject to MFA review sampling, regulators select a sample of assets for review and analysis to determine credit quality. Each asset reviewed is assigned a quality rating based on a regulator's best judgment of the likelihood of repayment or orderly liquidation. Asset quality ratings are divided into three groups: Pass (unclassified), Special Mention, and Classified (adverse classification).

Pass
A Pass asset is considered of sufficient quality to preclude a Special Mention or an adverse rating. Pass assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral.

Special Mention
The Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Assets that could be included in this category include loans that have developed credit weaknesses since origination as well as those that were originated with such weaknesses. This includes loans the institution is unable to properly supervise because of an inadequate loan agreement, inadequate control over collateral (when such control is necessary to effect full repayment of the loan), or when a loan is made with significant deviations from prudent lending practices. An adverse trend in the obligor's operations or the obligor's highly leveraged balance sheet may warrant a Special Mention designation, provided that neither condition has deteriorated to the point that timely repayment is jeopardized. If timely payment is jeopardized, an adverse classification may be warranted.

Special Mention should not be used to identify an asset that has as its sole weakness credit data exceptions or collateral documentation exceptions that are not material to the timely repayment of the asset. For example, the failure of an institution to obtain current borrower financial statements on a performing loan does not, by itself, indicate a weakness in the loan and should not be cause for the loan to be automatically designated Special Mention. There may be cases, however, where borrowers fail to provide updated financial statements because they are reluctant to disclose their poor operating performance, which could justify Special Mention designation or adverse classification. For large amount loans, where the decision as to whether to classify the loan is heavily dependent on the borrower's (or property's) cash flows, regulators should have the institution obtain current financial statements during the examination or initiate other verification measures.

The Special Mention designation may also be appropriate when the collateral agreement of a performing loan is not properly executed. In such a case, if the borrower is dependent on the sale of, or the cash flow from, the collateral to repay the loan in a timely manner, then a Special Mention designation is appropriate (or, if timely repayment is jeopardized, an adverse classification may be warranted).

On the other hand, regulators should not designate as Special Mention a performing construction loan where the institution has failed to inspect construction in progress.. The lack of such inspections is a deficiency in the institution's loan administration function and does not (by itself) indicate a weakness in the loan that may result in deterioration of the repayment prospects of the loan.

Finally, the Special Mention designation should not include loans listed merely "for the record," such as when uncertainties and complexities, coupled with a large loan amount, create reservations about the quality of the loan. Regulators are not expected to identify all loans that will become troubled at some future date. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of an asset as Special Mention is not justified. Careful identification of assets that properly belong in this category is important to determine the extent of risk in the portfolio and to provide constructive criticism to management. Generally, Special Mention assets will not be individually detailed in the report of examination (ROE). When Special Mention assets are detailed in the ROE, however, the loans should be written up in a manner similar to that used for adversely classified assets per the instructions outlined under the subheading, "Classified Asset Comments," found later in this Section. Regulators should not combine Special Mention assets with classified assets in the ROE or other reports. As appropriate, however, regulators should continue to consider the level and trends of Special Mention assets in their analysis of the institution's overall asset quality.

Adverse Classifications
There are three adverse classifications:

Substandard: An asset classified Substandard is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged. Assets so classified must have a well- defined weakness or weaknesses. They are characterized by the distinct possibility that the mortgage lender will sustain some loss if the deficiencies are not corrected.

Assets classified Substandard may be characterized by one or a combination of the following weaknesses:

- Primary source of repayment is gone or severely impaired and the mortgage lender may have to rely upon the secondary source;
- Loss does not seem likely, but sufficient problems have arisen to cause the mortgage lender to go to abnormal lengths to protect its position in order to maintain a high probability of repayment;

- Obligors are unable to generate enough cash flow to reduce their debts;
- Deterioration in collateral value or inadequate inspection or verification of value (if the collateral is expected to be the source of repayment);
- Flaws in documentation leave the mortgage lender in a subordinated or unsecured position when the collateral is needed for the repayment of the loan.

The presence of one or more of these factors does not mandate that the asset be adversely classified if, in the regulator's judgment, the presence of such factors does not indicate a weakness that jeopardizes the timely liquidation of the asset or disposition of the collateral, at the asset's book value.

Doubtful: An asset classified Doubtful has the weaknesses of those classified Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

The likelihood of a loss on an asset or portion of an asset classified Doubtful is high. Due to important and reasonably specific pending factors, however, its classification as Loss is not appropriate. Factors that may result in a Doubtful rather than Loss classification include: real property collateral whose value is uncertain due to waste cleanup; proposed borrower merger, acquisition, or liquidation procedures; capital injection; perfection of a lien on additional collateral; or loans restructuring.

The Doubtful classification should not be used to defer the full recognition of an expected loss. Management should attempt to identify, and then recognize, losses in a timely manner.

Loss: That portion of an asset classified Loss is considered uncollectible and of such little value that its continuance as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off a basically worthless asset (or portion) even though partial recovery may be affected in the future.

Self-Classification

Mortgage lenders are required by regulations to independently review, classify, and set aside appropriate valuation allowances for their assets. MFA's classification system encourages mortgage lenders to identify weaknesses inherent in their lending strategies and practices in addition to quantifying current problems. It serves as an early warning system and is a crucial tool to reduce the risks of loss to the mortgage lender. It can reveal lending patterns or deficiencies in portfolio administration that consistently cause a mortgage lender collection problems. Once the mortgage lender identifies such patterns or deficiencies, management and the board of directors can avoid practices that have resulted in a higher level of classified assets. In this way, the classification process can serve as a preventive, as well as a protective, function. This will serve to facilitate the examination process and the preparation of quarterly reports to MFA of aggregate totals in each of the three asset classification categories.

The regulator's primary focus should be to highlight and correct weaknesses in the mortgage lender's self-classification system. A well-organized, competent, and independent internal asset review function that encompasses the self-classification process will ultimately result in less regulator time spent on loan reviews and asset classifications. It would be expected that the asset review function will segregate problem and potential problem loans and other assets, and provide a comprehensive analysis of these and larger credits. In those mortgage lenders with a qualified asset review department, a regulator's time may be spent in review and possible update of the work performed by that function. Internally prepared credit quality analyses should be reviewed to determine concurrence with the mortgage lender's assigned ratings. Larger credits that have not been assigned an adverse classification should be sampled to determine concurrence with the Pass rating and the integrity of the system.

Mortgage lender management is expected to update classifications between examinations, based on improvements or deterioration that occurs. The proper monitoring of asset quality necessitates the mortgage lender's ability to either upgrade or downgrade classifications. It is expected that a regulator's classifications should closely parallel those of the mortgage lender. Where they do not, a careful review of the mortgage lender's self-classification procedures is warranted to determine the reasons for the disparity.

Classification Considerations

Presented below are considerations that should be kept in mind when specific asset portfolios are reviewed. (Refer to individual asset quality sections of this manual for more detailed analysis considerations.)

Commercial Real Estate Loans
In the analysis of commercial real estate loans for classification purposes, consideration is given to the purpose of the loan and the risk inherent in the project; the nature and degree of collateral security; the character, capacity, financial responsibility, and performance record of the borrower; and the feasibility and probability of orderly repayment of the loan in accordance with specified terms. The willingness and ability of a debtor to perform as agreed is the primary measure of the risk of the loan. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and provide for reduction or liquidation of principal as agreed at a reasonable and foreseeable date.

It does not mean, however, that borrowers must at all times be in a position to liquidate their loans, for in many cases that would defeat the original purpose of extending credit. Commercial real estate loans are often primarily dependent on the cash flows of the underlying security to meet scheduled debt service. Regulators should analyze historical and projected cash flows and underlying assumptions of the property to determine if there is sufficient debt service coverage (the net cash flows of the property divided by the required debt service). Secondary sources of repayment, such as guarantors, must be evaluated for ability and willingness to provide debt service when the primary repayment source is unable to perform.

Regulators should consider the mortgage lender's track record. Has it been able to successfully collect on such guarantees in the past? Secondary sources of repayment may mitigate the loss potential on real estate commercial loans. Regulators should review the guarantor's current financial information and past payment history, and judge whether orderly repayment of the debt through a secondary source will continue.

When a troubled commercial real estate loan is analyzed for a possible Loss classification, the regulator must consider the likelihood of the mortgage lender

obtaining title to the property through either foreclosure or a deed in lieu of foreclosure. Loans that a mortgage lender has restructured are neither automatically classified nor exempt from classification. The credit must be analyzed in the same manner as other loans to determine risk of nonpayment.
Commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral are generally not classified. Similarly, loans to sound borrowers that are renewed in accordance with prudent underwriting standards to creditworthy commercial borrowers should not be classified unless well-defined weaknesses exist that jeopardize repayment. An institution should not be criticized for continuing to carry loans having weaknesses that result in classification as long as the institution has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage these loans.

In evaluating commercial real estate credits for possible classification, regulators should apply the standard classification definitions. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and the cash flow provided by, all collateral that supports the loan, and any support provided by financially responsible guarantors.

The loan record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. It would be appropriate, however, to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual loans, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each loan should be based on the fundamental characteristics that affect the collectability of the particular loan. The problems broadly associated with certain segments of an industry should not lead to overly pessimistic assessments of individual loans that are not affected by the problems of the troubled sectors.

Valuation and Classification of Troubled, Collateral Dependent Loans
The policy described in this Section does not apply to smaller balance homogeneous loans (such as residential home mortgage loans) that are generally classified on the basis of delinquency status.

MFA's policy for troubled, collateral-dependent loans (where proceeds for repayment can be expected to come only from the operation and sale of the collateral) is as follows:

For a troubled, collateral-dependent loan where, based on current information and events, it is probable that the lender will be unable to collect all amounts due (both principal and interest), the amount classified Loss should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard. For a troubled, collateral-dependent loan, it is probable that the lender will be unable to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are less than the principal and interest payments due according to the contractual terms of the loan agreement. The term “all amounts due” is based on the original contractual terms, except as discussed below.

For a troubled, collateral-dependent loan (whether or not restructured) where, based on current information it is probable, but not reasonably assured, that the lender will be able to collect all amounts due (both principal and interest), the amount classified Doubtful should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard. For a troubled, collateral-dependent loan, it will be deemed probable, but not reasonably assured, that the lender will be able to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are equal to or greater than the principal and interest payments due according to the contractual terms of the loan agreement.

MFA does not allow mortgage lenders to use general valuation allowances to cover any amount considered to be a Loss under the above policy; however, Specific Valuation Allowances (SVAS) may be used in lieu of charge-offs.

Mortgage Loans (Residential, Owner-Occupied Dwellings)
The primary indicator for classifying owner-occupied home loans is the past payment history. As such, slow loans provide a good starting point to determine the mortgage loans to be adversely classified. Due to the volume of such loans in the mortgage industry, a regulator’s time should not be invested in individual review of all slow mortgage loans to determine if adverse classification is appropriate. Rather, all slow mortgage loans are presumed to be Substandard, with the burden placed on management to provide reasons for non-adverse classification of individual credits. Possible reasons for not adversely classifying a slow mortgage loan might be the imminent sale of the property (evidenced by a signed agreement) that will liquidate the loan, or payments received during the examination that eliminate the loan from a slow status.

Loans or contracts to facilitate the sale of foreclosed mortgages, though generally of higher risk due to high loan-to-value ratios, are not, by definition, slow loans. These loans are not presumed Substandard. The loan should be evaluated on the borrower’s perceived ability to service the debt.

Loans should not be adversely classified merely due to high loan-to-value ratios. In those mortgage lenders with a material volume of loans to facilitate, the regulator should sample such loans to assure that sound underwriting criteria are followed; if sound underwriting criteria are not followed, all such loans may be reviewed. If a review of these loans provides the regulator with a sufficient degree of confidence that loans to facilitate are granted to borrowers with an ability to service the debt, then adverse classification may be limited to those loans that are slow. Again, management has the opportunity to provide documentation to support a Pass classification.

Investment Securities
Classification of investment securities is based on credit risk, not interest-rate risk. A decline in the market value of a security simply due to interest rate fluctuations is not a basis for adverse classification. Classification should be based on the credit risk and collectability of interest and principal that the mortgage lender has booked as an asset.

Real Estate Acquired by Foreclosure

At foreclosure, foreclosed assets, including real estate acquired by foreclosure, are to be reported at the lower of: (1) the recorded investment in the loan (i.e., cost) or (2) the fair value of the foreclosed asset. Any excess of recorded investment over fair value is to be classified Loss and is to be charged-off. This Loss classification may not be represented by a valuation allowance. Accordingly, the lower of: (1) the recorded investment in the loan or (2) the fair value of the foreclosed asset becomes the new recorded investment in the foreclosed asset. Legal fees and direct costs of acquiring title to foreclosed assets are to be expensed as incurred.

The recorded investment in the loan includes the balance of principal, accrued interest, deferred origination fees and costs, and purchase premium or discount. The recorded investment in the asset does not reflect any valuation allowances; the carrying value of the asset does reflect valuation allowances. Fair value is to include a reduction for the seller's disposition costs, and is to be substantiated by a current appraisal at the time of acquisition.

Subsequent valuations of foreclosed assets should follow the guidance provided in Manual Section 251, "Real Estate Owned and Repossessed Assets." Real estate acquired by foreclosure may be an unsound asset, even when recorded at fair value. The mortgage lender's acquisition of the property is normally indicative of a lack of demand. As time lapses, the lack of demand becomes more apparent, and the soundness of real estate for which there is no demand (at least at the current "asking price") becomes more questionable. Each parcel of REO is to be reviewed and classified on its merits. In making that judgment, it is necessary to: identify the reason for the foreclosure of the property; determine the mortgage lender's intentions as to disposition of the property; compare the property's carrying value to its current market value; find out the "asking price" and any offers the mortgage lender has received; determine the length of time the property has been held and reasons it has not been sold; and review other pertinent factors, such as insurance coverage, additional liens, present occupancy, income, and expenses, etc. A careful evaluation of the relevant factors, many of which are mentioned above, should enable the regulator to make an accurate and reliable judgment with regard to classification. (Refer to Manual for Supervision Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Debt and Equity Investments in a Subsidiary
A mortgage lender's investment in a subsidiary may take many forms, some of which are listed below:

- Debt investment through collateralized loans
- Capital stock
- Capital infusions
- Guarantees of debt
- Retained earnings
- Assumption of debt

Mortgage lenders are required to periodically evaluate their investments in subsidiaries, and to make any appropriate adjustments to the carrying value based on that evaluation. An examiner should first determine that the mortgage lender does this evaluation and adjustment. Also, the examiner should ascertain that the subsidiary's assets reflect accounting principles' valuation standards. Losses and allowances should be booked on the subsidiary's accounts for any asset deserving such treatment. The effect on the subsidiary's financial statements of such losses and allowances may also be reflected in the mortgage lender's investment in the subsidiary.

According to accounting principles, all consolidated losses (i.e., ownership exceeds 50% and control is exercised) of subsidiaries flow through to the parent mortgage lender. Losses of subsidiaries that are accounted for by the equity method (i.e., ownership of 20% to 50% without control) decrease the book value of equity investments in subsidiaries and are run through the parent mortgage lender's income statement. The equity investment is then adjusted for profits/losses and can even be reduced below zero under certain circumstances. For example, if losses exceeding the amount of the investment are recorded and guarantees exist, or management continues to fund losses, the investment may be reduced below zero. Adjustments to the book value of an investment in subsidiaries accounted for by the cost method (i.e., less than 20% ownership without control) are made only when permanent impairments in value occur.

For a majority-owned service corporation, an examiner should review and, where appropriate, classify the assets of the subsidiary. Such a subsidiary is generally treated as a department of the mortgage lender and, for classification purposes, should be fully consolidated with the mortgage lender (e.g., the assets of the operating subsidiary are combined with the assets of the mortgage lender and all intercompany transactions are eliminated).

For a subsidary, the examiner should review and, as appropriate, classify the mortgage lender's loans to and investments in the subsidiary. Again, the examiner should first ensure that the mortgage lender has evaluated its investments in and loans to the subsidiary and that any appropriate adjustments to the carrying value of such assets have been made. After ensuring this evaluation and appropriate adjustments have been made, the examiner should evaluate the assets of the subsidiary to determine the worth of an equity investment by the parent institution and the ability of the subsidiary to repay debts owed to the parent. Like any other asset at the lender level, for purposes of classifying an mortgage lender's loans to or investments in these subsidiaries, the examiner should analyze the financial strength of the borrower and the quality and sufficiency of collateral to determine the orderly repayment of debt.

In those instances where the subsidiary is not being operated within an adequate degree of separation such that the parent is insulated from the operations of the subsidiary, the parent may be deemed liable for the obligations of the subsidiary. Regulations require that each mortgage lender and service corporation thereof be operated in a manner that demonstrates to the public their separate corporate existence.

Off-Balance-Sheet Items
All amounts listed under an adverse classification heading for an off-balance-sheet item may be footnoted in the ROE to indicate that the adverse classification is contingent upon funding. However, the gross amount of the item is the basis or determining the balance of the classified asset.

Specific allowances or charge-offs must be established for such items classified Loss. Off-balance-sheet items classified Substandard or Doubtful should be considered when assessing the adequacy of general valuation allowances.

Loan Commitments: A loan commitment may be classified if it is ascertained that the commitment is legally binding or management has provided assurance that funding will occur. The commitment should be evaluated as if it were a loan presently on the books of the mortgage lender, and the portion classified should be based on the amount to be disbursed. Current financial statements of the prospective borrower, along with collateral, should be reviewed to determine risk of nonpayment.

Loans in Process, Including Lines of Credit:
Similar to loan commitments, it should be ascertained that additional funding will occur. If losses are probable and estimable in loans where full funding has yet to occur, the appropriate amount classable is the gross amount of a loan, rather than only the funds disbursed.

Litigation: Probable and estimable losses from litigation are generally accounted for by the establishment of a liability, as opposed to a contra asset account (specific or general allowance). If, however, an adverse ruling is expected from a litigious matter and such adverse ruling will result in the non-collection of an asset presently outstanding, an adverse classification of the asset is warranted, and a specific allowance or charge-off should be established.

Fixed Assets
Fixed assets used for business operations are depreciated and are generally not subject to adverse classification. Situations may arise, however, where such a classification is warranted. For instance, if property had been acquired for future expansion and it has since been determined that the expansion will not occur, the property should be reclassified as real estate held for development, investment, or resale. If held for resale, the property should be carried at the lower of cost or fair value. If the property is classified real estate held for development or investment, it should be carried at the lower of cost or net realizable value (NRV).

For example, a mortgage lender holds a trailer that had formerly been used as a branch office and has ceased business operations at the facility. The asset should be classified as a property held for resale and carried at the lower of cost or fair value.

Other Assets

Repossessions: Repossession should be booked at the lower of the recorded investment in the loan satisfied or the property's fair value on the date the mortgage lender takes clear title and possession of the property. Any excess of the recorded investment in the loan over fair value must be first charged against a specific allowance, if any. Any remaining loss amount should be charged against the general allowance. Generally, repossessions should be disposed of in a reasonably short period of time. As noted with REO, the longer an asset remains in the repossession account, the more suspect is the demand for and value of the asset. (Refer to Manual for Supervision Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Accrued Interest Receivable: Accrued interest is considered a part of the investment in the loan that must be evaluated for collectability by considering the value of the collateral and any other sources of repayment. Any accrued interest where collection is less than probable should be classified Loss. Otherwise, accrued interest should be accorded the same classification as the underlying loan.

Differences in Accounts and Stale Items: Any unreconciled difference in accounts should be accorded a Loss classification if the difference cannot be located in a reasonable period of time. Types of other assets frequently found in mortgage lenders are the various temporary holding accounts such as suspense, inter-office, transit, and bookkeeping differences having debit balances. These accounts should be used only for temporary recording until the offsetting entry is identified and posted to the proper account. Nothing should be allowed to remain in those accounts for any significant length of time, normally no more than a few business days. All differences in accounts should be closed out at least quarterly. Unreconciled differences in "Due from Banks" accounts should be reviewed, with long outstanding and undocumented differences considered for a Loss classification. Other stale items, such as returned checks and overdue accounts receivable deemed uncollectible, should also be reviewed for possible adverse classification.

Treatment of Guarantees in the Classification Process: The original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third-party guarantors should be the primary basis for the review and classification of assets. Regulators should, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor" as described below, may be sufficient to preclude classification or reduce the severity of classification.

A guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for the remaining indebtedness, in whole or in part, during the remaining loan term; and
- The guarantee should be legally enforceable.
- The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations Relating to the Guarantor's Financial Capacity: The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by the guarantor in order to determine that the guarantor has the financial capacity to fulfill all such contingent claims.

Considerations Relating to a Guarantor's Willingness to Repay: Regulators should normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the guarantor's "track record," including payments made on the asset under review and those made on the guarantor's other financial obligations.

Regulators should give due consideration to those guarantors who have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees of similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. Regulators should give little credence, if any, however, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review. Regulators should also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the loan; or

- Where the guarantees are collateralized by readily marketable assets that are under control of a third party.

Other Considerations: In general, only guarantees that are legally enforceable will be relied upon. All legally enforceable guarantees, however, may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee. The nature of the guarantee should also be considered by regulators. For example, some guarantees for real estate projects pertain only to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases. Regulators should also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of the guarantees should be a positive consideration in the classification process.

Work Paper Documentation

Examination findings must be adequately documented in the examination work papers. As with all examination work papers, Classification of Assets work papers should contain clear conclusions and concise analysis, provide sufficient documentation of findings, be properly indexed, and reference all pertinent information sources. In addition, documentation supporting classification of assets must include:

- clear documentation of the examiner's reason(s) for classification decisions;
- a comparison, by classification category (Substandard, Doubtful and Loss), of the examiner's total classified assets with the institution's total classified assets; and
- a clear conclusion concerning the adequacy of the institution's self-classification policies and procedures.

REFERENCES

SECTION: Adequacy of Valuation Allowances 261

INTRODUCTION

A valuation allowance is a contra account, established and maintained through charges against current earnings to absorb losses inherent in an institution's portfolio. Valuation allowances established to absorb unidentified losses inherent in an institution's overall loan portfolio are referred to as the general reserve (also, allowance for loan losses; those established to absorb losses identified for specific assets are referred to as specific valuation allowances (SVAs).

MFA expects mortgage lenders to carry non-loan assets on their balance sheets in accordance with MFA policy and generally accepted accounting principles as appropriate for the asset. If significant problems with an institution's valuation methodologies for such assets are noted, however, general allowances may be required for these assets until the problem is corrected. MFA regulations require mortgage lenders to classify all assets and establish prudent valuation allowances to absorb losses. The regulation specifies that, for assets classified Substandard or Doubtful, mortgage lenders shall establish prudent general allowances for losses. For assets or portions thereof classified Loss, mortgage lenders shall either establish an SVA for 100% of the portion classified Loss or charge off such amount. The rule further specifies that adequate valuation allowances, consistent with accounting principles, be established for classified assets.

Because of the uncertainty surrounding the likelihood of repayment or realization of classified assets, the determination of the adequacy of valuation allowances requires considerable judgment. Further, when economic conditions change, valuation allowances that once may have been considered adequate may prove inadequate. Understandably, disagreement between examiners and institution management over the amount of valuation allowances considered adequate is not uncommon.

Deficiencies in Valuation Allowances

The examination procedures at the end of this Section can be simplified into two steps. The examiner will: (1) assess management's valuation allowance policies and calculation methodology and (2) perform his/her own analysis to assess the adequacy of the mortgage lender's allowances. If the examiner's estimate of the appropriate general reserves departs significantly from the institution's general reserves, the examiner must thoroughly review the process and methodology used by the mortgage lender. The examiner should discuss the mortgage lender's process with management and come to a conclusion as to what is appropriate given the findings. Unless otherwise instructed by the MFA regional office, the examiner in charge (EIC) should obtain his/her field supervisor's concurrence as to the amount of and reasons for any recommended increases in the general reserves prior to any discussions with management. This is to ensure that any requirements for additional allowances are reasonable and justified.

Examiner Documentation

The report of examination (ROE) comment must reasonably support the examiner's conclusions about the mortgage lender's reserves. Examination findings must also be adequately documented in the examination work papers. As with all examination work papers, general reserve work papers should contain concise analysis and clear conclusions, provide sufficient documentation of findings, be properly indexed, and reference all pertinent information sources. In addition, documentation supporting the general reserves must include:

- clear documentation of the examiner's calculation methodologies;
- a comparison of the examiner's estimate of an adequate reserves with the institution's actual reserves and an analysis of the reason(s) for any difference; and
- a well-defined conclusion as to whether the institution's general reserve is adequate.

REFERENCES

Appendix A: Adequacy of Valuation Allowances Section 261

Nature and Purpose of the General Reserve

Mortgage lending institutions ("institutions") must maintain a General Reserve at a level that is adequate to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. To the extent not provided for in a separate liability account, the reserve should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments. For purposes of this policy statement, the term "estimated credit losses" means an estimate of the current amount of the loan portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the reserve.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectability of the portfolio as of the evaluation date. For individually-analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans in these pools as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years – coupled with appropriate adjustments as noted above for factors that affect repayment – to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical purposes, an institution may attribute portions of the General Reserve to individual loans or groups of loans. However, the reserve is available to absorb all credit losses that arise from the loan and lease portfolio and is not segregated for, or allocated to, any particular loan or group of loans.

Responsibility of the Board of Directors and Management

Adequate General Reserve Level. It is the responsibility of the board of directors and management of each institution to maintain the General Reserve at an adequate level. For purposes of Prudential Reports an adequate General Reserve should be no less than the sum of the following items *given facts and circumstances as of the evaluation* date (after deduction of all portions of the portfolio classified loss):

1) For loans and leases classified substandard or doubtful, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans.
2) For components of the loan portfolio that are not classified, all estimated credit losses over the upcoming 12 months.

Furthermore, when determining the appropriate level for the reserves, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the reserves through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio.

The adequacy of the General Reserve should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each Prudential Report date.

This evaluation will be subject to review by examiners.

Related Responsibilities. In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to:

- Ensure that the institution has an effective loan review system and controls (which include an effective credit grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner. To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.
- Ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible.
- Ensure that the institution's process for determining an adequate level for the reserves is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectability of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in Attachment 1, it is essential that institutions maintain effective loan review systems, although smaller institutions would not be expected to maintain separate loan review departments. An effective loan review system should work to ensure the accuracy of internal credit grading systems and, thus, the quality of the information used to assess the adequacy of the reserves. The complexity and scope of the institution's reserves evaluation process, loan review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectability of the portfolio.

Analysis of the Loan Portfolio

- In determining the appropriate level of the reserves, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the reserves, institutions should segment their loan portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past due status, type of loan, industry or collateral.

Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectability of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses are not, by themselves, a sufficient basis to determine the appropriate level for the reserves. Management should also consider any factors that are likely to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including but not limited to:

- Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
- Changes in national and local economic and business conditions and developments, including the condition of various market segments.
- Changes in the nature and volume of the portfolio.
- Changes in the experience, ability, and depth of lending management and staff.
- Changes in the trend of the volume and severity of past due and classified loans; and trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications.
- Changes in the quality of the institution's loan review system and the degree of oversight by the institution's board of directors.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the reserves. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the reserves to classified and non-classified loans and leases, to past due and non-accrual loans, to total loans and binding commitments, and to historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the reserves. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectability.

Examiner Responsibilities
Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the reserves. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectability of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will:

Consider the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's credit grading system and loan review function. The review of an institution's loan review system (including credit grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan review system indicate problems with the loan review system, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan review system.

Evaluate the ALLL evaluation process that management has followed to arrive at an overall estimate of the ALLL, and the related assumptions made by management, in order to ensure that the institution's historical loss experience and all significant factors that affect the collectability of the portfolio (including changes in the quality of the institution's loan review function, and other factors previously discussed) have been appropriately considered.

Review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement.

Perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL.

Review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept managements estimates in their assessment of the adequacy of the ALLL when management has: (i) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner, (ii) analyzed all significant factors that affect the collectability of the portfolio in a reasonable manner, and (iii) established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL evaluation process is deficient or based on the results of an unreliable loan review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination.

General Reserve Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with accounting standards. When an institution's reported ALLL does not meet the objectives for an adequate ALLL, the institution will be required to increase its provision for loan and lease losses expense sufficiently to restore the level of the ALLL reported on its Prudential Report to an adequate level as of the evaluation date.

Attachment 1

Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, problem loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem loan reporting process, to maintaining the integrity of the credit grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan losses. Regardless of the structure of the loan review system in an institution, at a minimum, an effective loan review system should have the following objectives:

- To promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized;
- To project relevant trends that affect the collectability of the portfolio and isolate potential problem areas;
- To provide essential information to determine the adequacy of the reserves;
- To assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations;
- To evaluate the activities of lending personnel;
- To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio; and
- To provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Grading Systems

The foundation for any loan review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit grading system provides important information on the collectability of the portfolio for use in the determination of an adequate level for the reserves.

Regardless of the particular type of loan review system employed, an effective credit grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by: (a) peers, superiors, or loan committees; (b) an independent, qualified part-time or full-time person(s); (e) an internal department staffed with credit review specialists; or (d) outside credit review consultants. A credit grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- A formal credit grading system laid down by MFA;
- An identification or grouping of loans that warrant the special attention of management;
- Documentation supporting the reason(s) why a particular loan merits special attention;
- A mechanism for direct, periodic and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management; and
- Appropriate documentation of the institution's credit loss experience for various components of its loan portfolio.

Loan credit grades should reflect the risk of credit losses. In addition, the loan review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

Loan Review System Elements

The following discussion refers to the primary activities comprising a loan review system that were previously addressed, ranging from the credit administration function to the independent internal loan review function. An institution's written policy and documentation for its loan review system should address the following elements:

- Qualifications of loan review personnel;
- Independence of loan review personnel;
- Frequency of reviews;
- Scope of reviews;
- Depth of reviews;
- Review of findings and follow-up; and
- Work paper and report distribution, including distribution of reports to senior management and the Board of Directors.

Qualifications of Loan Review Personnel

Persons involved in the loan review function should be qualified based on level of education, experience, and extent of formal credit training; and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel

An effective loan review system utilizes both the initial identification of emerging problem loans by loan officers, and the credit review of loans by individuals independent of the credit approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over-reliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. Whether or not the institution has an independent loan review department, the loan review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

Frequency of Reviews

Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the reserv determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of Reviews

The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past due, non-accrual, restructured loans; loans previously classified or designated as special mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflect the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of Reviews

These reviews should analyze a number of important aspects of selected loans, including:

- Credit quality;
- Sufficiency of credit and collateral documentation;
- Proper lien perfection;
- Proper approval by the loan officer and loan committees;
- Adherence to any loan agreement covenants; and
- Compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-up

Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the time frames for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned time frames for correction should be promptly reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis. In addition to reporting current credit quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

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SECTION: Oversight by the Board of Directors 310

The board of directors oversees management activities and is ultimately responsible for the affairs of a real estate lender. Laws and regulations governing board activities require directors to exercise care and loyalty toward the real estate lender and not to advance their own personal or business interests at the expense of the real estate lender.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS
As the financial services industry continues to evolve, the duties of directors are becoming more complex and demanding. Today's board of directors must take an active role in shaping and controlling a real estate lender's business operations and risks.

The following are some basic responsibilities the board has in actively overseeing the mortgage lender's affairs:

- Establish business goals, standards, policies and procedures, and operating strategies and understand the risks involved in following certain strategies.
- Approve standards for ensuring that the real estate lender's transactions with affiliates are sound, and are considered solely from the mortgage lender's interests.
- Establish a compliance program emphasizing the importance of regulatory compliance as an inherent part of business operations ensuring compliance with external standards, such as laws and regulations, and the mortgage lender's own policies and procedures.
- Hire and retain executive officers with the skills, integrity, knowledge, and experience appropriate for the nature and scope of their responsibilities and periodically evaluate management's performance.
- Establish and maintain appropriate committees that have written charters delineating the committee's functions, responsibilities, and membership qualifications.
- Ensure that the mortgage lender maintains a corporate existence that is separate from its affiliates, subsidiaries, holding company, and sister institutions.
- Review operating results, compliance performance and performance of new and existing activities.

In fulfilling these responsibilities, the board of directors should observe the following standards:

• Operate independently from management.
• Stay well informed and be attentive to risk.
• Attend board meetings regularly.
• Conduct business affairs ethically; avoid conflicts of interest and self-serving practices.

Number of directors is set out in MFA regulations and in founding documents of lender. A quorum for board meetings is the majority number of directors that a mortgage lender's bylaws prescribe, even if the mortgage lender has not yet elected the prescribed number.

For a list of board of directors' statutory and regulatory responsibilities, see the References at the end of this Manual Section and the Questionnaire.

Analyzing Board Performance

Evaluating the effectiveness of a board of directors is an important examination function. The results often provide a useful indicator of a mortgage lender's future condition and help MFA design a regulatory profile.

In carrying out the evaluation, you should perform the following steps

- Tailor the scope of the examination to the risk profile of the mortgage lender. A comprehensive assessment of each director and officer usually is not necessary.
- Concentrate on issues rather than on personalities. Analyzing the board's performance is a sensitive process that requires focusing on problem solving, not fault finding.
- Determine the level of director awareness and accountability. Board members should know and fulfill their responsibilities.

To evaluate board effectiveness you must review board minutes and other documents, interview management, and check on the board's response to supervisory directives. In rare instances, you may need to expand the scope of the examination and interview individual directors. You should only need to do this if the information is unavailable from other sources. Meetings with the entire board provide an additional means of evaluating a board's effectiveness. See Manual for Supervision Section 070.

Directors generally welcome regulatory review and specific recommendations for improvements. In unusual cases, however, directors may be uncooperative or attempt to hide instances of incompetence, lack of care, or even fraud or criminal malfeasance.

Possible causes for the condition of a troubled mortgage lender include any of the following reasons:

- Self-dealings or other conflicts of interest.
- Unsafe and unsound practices.
- Management incompetence.
- Lack of director participation.
- Domination of the board by one director or officer.
- Disregard for the regulatory process.
- Lack of independence.

The board is ultimately responsible for prevention or correction of these problems. If the board is unable or unwilling to correct serious problems, you must act immediately to protect the mortgage lender and ensure its safety and soundness. For more information in this regard, refer to Manual Section 370, Enforcement Actions.

Board Minutes

The primary sources of information you need to evaluate a board of directors and its actions are the minutes of its regular and committee meetings. You should review these minutes to determine the status of the following areas:

- Adequacy of management's reports to the Board – Management reports submitted to the board should be thorough and accurate and cover all aspects of the mortgage lender's operations.

Management should provide such reports to the directors before regular board or committee meetings to allow adequate time for review before the meetings.

Reports should document any significant changes to capital, financial performance results, compliance performance, and major business activities, including information technology risks.

Reports for technology risks should address information security, technology audit work, business continuity planning, and vendor oversight activities.

• Oversight of management – Minutes should reflect the board's discussion and approval of any major strategic or operating decisions and the adoption of major operating policies and procedures. Management should obtain board approval before implementing new policies or engaging in new activities.

• Attendance and participation – The minutes should evidence "regular" attendance by board members. Attendance at 75 percent of all regularly scheduled board meetings is the benchmark for "regular" attendance. Minutes should also identify board members who ask questions or make motions, indicating that they are active in the meetings. Another indicator of active involvement is participation on committees.

• Performance evaluations – Minutes should reflect the board's election of officers, its review of management performance, and its deliberations regarding salaries and compensation for officers and fees for attorneys, appraisers, directors and others.

• Compliance with board directives – Real estate lenders should have internal systems to monitor operations and ensure that management's actions are appropriate and conform to board-approved policies and directives. Board minutes should be a complete and accurate representation of meeting discussions including dissenting opinions or votes. Minutes should indicate that the directors studied. Pertinent documentation and based their decisions upon such documentation. Each director should have the opportunity to review and, if appropriate, modify the minutes before the board ratifies them. However, board minutes should never be altered to distort facts.

Reports to the Board

A board's excessive reliance on benchmark financial statistics rather than on comprehensive financial analysis suggests that the directors may not be overseeing the mortgage lender's affairs appropriately. Undue reliance on only a few indicators may result in erroneous evaluations of the mortgage lender's condition.

Therefore, you should determine that the reports to the directors include information that is complete, supported, understandable, and accurate.

The quality of report information that management provides to board and committee members is critical in a board's decision-making process. Not only must directors carefully review information that management provides, they must also ensure themselves that the information is complete and contains all pertinent data required to oversee the mortgage lender.

Each regular board meeting should include a review of financial reports. Directors should not accept questionable report figures at face value, but should question the information and verify it when necessary. The mortgage lender should promptly follow examination report recommendations. The audit committee composed solely of outside directors, if necessary, should provide for annual audits by an independent accounting firm, and should ensure the establishment of and adherence to a system of internal controls.

Audit Committee

The board should appoint an audit committee composed of directors who are independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member. Members should also be independent of operating personnel who audit procedures, systems, or records. Operating personnel may, however, attend meetings to provide necessary information.

The major responsibilities of the audit committee include:

- Handling relations with the independent auditor (such as to select the auditor and to discuss the scope and results of the audit).
- Improving internal auditing functions and controls.
- Establishing policies and procedures that ensure full and accurate disclosure of the mortgage lender's financial condition.
- Monitoring management and staff compliance with board policies, laws, and regulations.
- Measuring the effectiveness of the mortgage lender's compliance management program.

All regulated mortgage lenders must have an independent audit yearly.

If any real estate lender is a subsidiary of a holding company, it can satisfy this requirement by an independent audit of the holding company. See Manual Section 350, Independent Audit. Ideally, independent auditors provide an objective look at the performance of the mortgage lender. You should carefully review independent audits for the following red flags:

- A qualified or adverse opinion.
- Significant adjustments to net income or capital.
- Internal control deficiencies, especially if recurring or not reported by the internal audit.
- Significant variances in time spent by auditors on the premises or in the audit expense incurred by the institution.
- Significant disagreements between management and the independent auditors.
- Significant variances from findings in the reports of examination.
- Failure of management to submit a plan for the correction of deficiencies.
- Late audit reports (more than 90 days from fiscal year-end).

Qualified Management

A board's most important responsibility is to select a capable managing officer (or chief executive officer) for the mortgage lender. The board is also responsible for appointing or approving other senior management. Although economic conditions are a major influence on a real estate lender's well being, capable management and personnel are the dominant factors that contribute to a mortgage lender's success.

Directors should give the chief executive the latitude he or she needs to run day-to-day operations; therefore, the board must be certain that the person is competent and trustworthy. As a further control, the board should define a managing officer's duties and responsibilities in writing and establish an adequate management succession plan. (See Manual for Supervision Section 330, Management Assessment.) The board should also establish reasonable compensation packages, including appropriate incentives, for executive officers. In addition, the directorate is responsible for evaluating the performance of top management.

Board Oversight of Management
The board of directors must ensure that a real estate lender's management has procedures in place to implement board-adopted policies. The board should ensure that management performs the following functions:

- Hires and retains employees and agents with the skills, integrity, knowledge, and experience appropriate to the nature and scope of their responsibilities. Proactively engages and supervises vendors.
- Provides ongoing comprehensive training programs, including the mortgage lender's information security program.
- Follows the board's direction and provides periodic reports to the board concerning policy compliance, such as interest rate risk exposure reports, earnings and capital projections and analysis, and information security.
- Develops, implements, and monitors a comprehensive compliance management program predicated on systems, real-time monitoring, periodic self-assessment, organizational accountability, responsiveness to needed improvements, and effective training.
- Maintains an awareness of regulatory issues and developments.
- Reviews the board's policies periodically and suggests changes when appropriate.
- Develops, tests, and implements a comprehensive, mortgage lender-wide business continuity plan that reflects the technology environment.
- Implements and manages operations to achieve the board's financial objectives and establishes operational policies for financial functions.
- Supervises investment portfolio management activities. Invests excess liquid funds in securities that complement the mortgage lender's overall risk/return profile.
- Maintains an awareness of the economic and interest-rate environment, particularly local economic conditions, prepayment trends, volatility, and related regulatory developments.
- Reviews asset quality, including trends in delinquencies, non-accrual loans, real estate owned, and charge-offs and recoveries. Also reviews the adequacy of reserves and quantifies the effect of nonperforming assets on the risk/return profile.
- Develops, reviews, and monitors capital plans, business plans, information technology plans, and strategic plans. Integrates this role with the budgeting function. Also generates variance and rate and volume analysis reports.
- Provides adequate support, planning, and oversight when the mortgage lender enters nontraditional activities, new business lines, or acquires and implements significant new technology. Considers these activities, which may be organizationally distinct from the mortgage lender's operations, in connection with the mortgage lender's overall risk/return profile. Sets specific standards concerning risks and assumptions.
- Manages capital market activities, including capital raising, debt issuance, dividend policies, and merger and acquisition analysis. Considers these activities with the management of the mortgage lender's overall risk/return profile.
- Ensures that product development activity and pricing comport with the mortgage lender's overall risk/return objectives. Compares the real estate lender's product pricing to a sample of key competitors.

Use of Consultants
Real estate lenders sometimes hire third parties, such as consulting firms, investment bankers, lawyers, accountants, or other professionals, to provide services not usually required in the normal course of business. Consultants normally provide such services before and during proposed mergers, systems conversions, implementation of new technology, capital raising efforts, major asset sales, boards of director's internal investigations, and defenses against regulatory determinations. The board of directors must justify and approve contracts that the mortgage lender

enters into with third parties. Using a third party to perform services does not diminish the board's responsibility to ensure that services are provided in a safe and sound manner, and in compliance with applicable laws and regulations.

Generally, the risk management policies that apply to a real estate lender conducting an activity directly, also apply to third parties conducting activities on the mortgage lender's behalf.

The board of directors should remind management to take care in contracting with outside parties that propose to provide business plans or financial models at no direct cost to the mortgage lender. Such vendors usually expect the mortgage lender to transact business with them on an exclusive basis, and management may feel an obligation to do so. These vendors will have exclusive access to detailed information about the mortgage lender that could lead to proposals or transactions that are not in the mortgage lender's best interest.

The board should ensure that management does not rely on outside consultants to excess, or use overly simplistic assumptions.

Policies and Procedures

The board establishes policies as guidelines for a mortgage lender's activities. Procedures represent the methodology for implementing an activity. Operating policies and procedures are necessary to establish management's strategy to communicate the mortgage lender's goals and to provide a basis for gauging performance.

The directors must provide a clear framework so that the managing officer can operate and administer the mortgage lender's affairs. These areas include the business strategy as set forth in the business plan, investment and loan policies, capital planning, funds management, risk management, including technology risks and controls, information security policies and procedures, and compliance policies and procedures. The Manual covers these areas in other sections. The board of directors must approve all major policies.

Board policies and procedures should meet the following guidelines:

- Establish and provide guidance and direction for a mortgage lender's operations.
- Exist for all major phases of the mortgage lender's operations.
- Be tailored to the mortgage lender's operations and risk profile.
- Provide guidance and promote controlled and efficient operating practices.

Management's implementation of board policies and procedures and the mortgage lender's adherence to operating standards indicate the effectiveness of the board. Positive indications of successful implementation of policies and procedures include:

- Current policies and procedures.
- Established systems to support stated objectives.
- Required evaluations and benchmarks for measuring and monitoring performance.

Business Plan

Directors are responsible for establishing a business plan that documents major financial policies, including funds management, lending, investments, dividends, growth, and interest rate risk management. While management may develop such policies at the direction of the board, the directors must thoroughly review and give final approval to each contemplated policy. Directors must also approve the mortgage lender's budget and ensure that it is realistic, allows for secure transactions, and reflects adequate capital.

Ideally, the board should have access to information on economic issues because the performance of the economy affects the real estate lender's performance. Early recognition of changes in the economy provides notice of new opportunities or potential deterioration of asset quality.

Setting Financial Goals: The Risk vs. Return Balance
Real estate lenders generally express overall financial return objectives in terms of net earnings maximization or net equity value maximization. These financial goals are subject to internal and external risk factors. The greater the risk embedded in individual assets, portfolios, or the overall institution, the greater the variability of returns over time.

The board of directors and management must realize that the real estate lender can generate higher returns (earnings or equity value) only if the mortgage lender takes on greater risk; this is the risk/return balance or tradeoff. The choice between these two alternatives relates to the management of all the mortgage lender's financial functions.

To manage risk effectively, a real estate lender must have an informed board of directors that is capable of guiding the mortgage lender's risk strategy. It is important for the board to develop a rational decision-making process for determining a real estate lender's optimal risk/return profile.

Types and Sources of Risk Exposure
There are several significant types and sources of risk exposure applicable to real estate lenders. For each type and source, the board of directors must provide direction to management as to the extent of risk the mortgage lender may undertake.

Credit Risk – The risk that the borrower or issuer will not repay principal or interest on loans or investments. This area of risk includes counterparty credit risk, which is the risk that the counterparties will not honor their commitments for items such as over-the-counter option transactions or derivative instruments.

Interest Rate Risk – The vulnerability of a mortgage lender's financial condition to movements in interest rates. Interest rate risk arises from four sources: repricing (mismatched) risk, yield curve risk, basis risk, and options risk. Repricing risk, the primary source of interest rate risk, comes from timing differences in the maturity and repricing of assets, liabilities, and off-balance sheet positions. Yield curve risk arises when unexpected shifts of the yield curve affect a real estate lender's income or economic value. Basis risk arises from the imperfect correlation in the adjustment of the rates earned and paid on different financial instruments with otherwise similar pricing characteristics.

Options risk arises from options, embedded in many financial instruments, that provide the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flows of the instrument.

Liquidity Risk – The risk that funds may not be available to meet cash outflows when they arise. Liquidity risk occurs when a mortgage lender is unable to liquidate assets or obtain adequate funding to continue operating. This situation may occur if the mortgage lender cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions.

Compliance Risk – The risk to earnings, capital and market viability as well as on investor, customer, and regulatory relationships arising from violations of or noncompliance with laws, rules, regulations, industry practices, internal policies and procedures, ethical standards, or customer service goals. It exposes a mortgage lender to fines, civil money penalties, litigation costs, diminished reputation, reduced franchise value, and reduced business opportunities.

Other Risks – Includes operational risk, legal risk, reputation risk, fraud and insider abuse risk, and disasters or catastrophe risks.

Documentation

An integral part of a real estate lender's books and records includes documentation of all business transactions. The records should reflect regulatory compliance and adherence to safe and sound procedures. The directors should have full access to such records and use them in approving loans and other investment transactions.

To facilitate examinations each real estate lender, affiliate, and subordinate organization should establish and maintain accounting and other records that provide an accurate and complete record of all business it transacts. Mortgage lenders, affiliates, and subordinate organizations must also ensure that the documents, files, and other material or property comprising the records shall always be available for examinations. For supervisory purposes, mortgage lenders should retain these original business transaction records until the real estate lender has two regular examinations and the mortgage lender and MFA resolve any supervisory matters raised in the examinations. Real estate lenders must also comply with the records retention requirements of safety and soundness, enforcement, compliance, nondiscrimination and consumer affairs laws and regulations.

Due to differing local customs and laws, mortgage lenders should obtain recordkeeping (including microfilming, microfiche, and digital imaging) guidance and advice from local sources, such as attorneys, independent auditors, and income tax consultants. MFA encourages mortgage lenders to develop and follow a formal written recordkeeping policy and records retention schedule.

Employment Contracts and Executive Compensation

This section provides guidance for review of compensation provisions and clarifies MFA policy on unsafe and unsound practices relating to executive compensation and employment contracts.

Definitions

Compensation includes any payment of money or other items of value in consideration of employment. Compensation includes the following items:

- Base salary
- Bonuses
- Pension and profit sharing plans
- Severance payments
- Retirement
- Director or committee fees
- Fringe benefits

MFA does not ordinarily consider the grant or exercise of stock options as compensation unless they are sufficiently material in amount or conditioned upon factors that result in incentives that cause supervisory concerns.

A senior executive officer includes any individual who holds the title or performs the function of one or more of the following positions (without regard to title, salary, or compensation):

- President
- Chief executive officer
- Chief operating officer
- Chief financial officer

• Chief lending officer
• Chief investment officer
• Chief compliance officer

Senior executive officer also includes any other person identified as an individual who exercises significant influence over, or participates in, major policymaking decisions, whether or not hired as an employee.

An employment contract is any agreement, intended to be legally enforceable, that materially affects the terms and conditions of a person's employment.

A real estate lender is in troubled condition if MFA informs the institution, in writing, of its troubled condition based on information available to MFA. Such information might include current financial statements, reports of examination, or limited scope review of the institution.

General Policy

A real estate lender may enter into employment contracts with its officers and other employees with the specific approval of the board of directors.

Mortgage lenders may not enter into contracts that constitute an unsafe or unsound practice, which is any that could lead to a material financial loss or damage. Compensation to officers, directors, and employees must be reasonable and commensurate with their duties and responsibilities.

Determining Compensation and Directors' Fees

MFA considers all CAMEL components rated under its Rating System in its review of employment contracts and other compensation arrangements.

MFA generally defers to the real estate lender's board of directors concerning executive compensation arrangements, provided that the following conditions exist:

• The institution is not in troubled condition.
• The compensation arrangements do not present significant safety or soundness concerns that could lead to material financial loss or damage to the mortgage lender.
• Members of the board complied with their assigned duties in approving the compensation arrangement.

MFA requires the board of directors of each real estate lender to annually review all employment contracts and compensation arrangements for senior executive officers and directors. The board must also document its justification and approval in board minutes. Directors who have a personal interest in the compensation arrangements should not participate in the deliberations or vote on the arrangements. Renewal or extension of employment contracts requires approval by the board of directors.
In determining the compensation of principal officers, the board of directors should consider at least the following factors:

• The qualifications and experience of the officer.
• The compensation paid to other persons that the mortgage lender or service corporation employs.
• The compensation paid to persons having similar duties and responsibilities in other mortgage lenders or service corporation affiliates.
• The size of the mortgage lender and the complexity of its operations.
• The financial condition, especially capital position and income level, of the mortgage lender and the individual's contributions to the mortgage lender.
• Any other amounts the officer receives, either directly or indirectly, for other services

performed for the mortgage lender such as fees for serving as appraiser, attorney, escrow agent, insurance agent.

- The value of personnel fringe benefits provided to the employee, and perquisites such as an automobile, club membership, and expense account.

Directors should be keenly aware of their fiduciary responsibilities when they establish fees and benefits for themselves. Each director should keep in mind that a primary responsibility is to establish policies that protect the assets of the mortgage lender. Thus, in setting its own fees, directors should use factors similar to those used in setting officers' compensation.

The board of directors must also determine and document whether the fees of outside appraisers and attorneys are reasonable and commensurate with the services performed. This is particularly important if the outside appraiser or attorney is an affiliated person. The board should determine whether the fees are comparable to those that other appraisers or attorneys performing similar services charge. The board should also consider the comparative advantages of employing a staff appraiser or attorney to perform appraisal or legal services for the mortgage lender.

Unsafe or Unsound Compensation Practices

MFA generally does not require changes to preexisting contracts in healthy mortgage lenders. Contract provisions, however, that raise significant safety and soundness concerns will be subject to examination comment or formal enforcement action until the mortgage lender terminates or modifies the contract. MFA may, on safety and soundness grounds, insist that the board replace unacceptable managers and use its best efforts to renegotiate employment contracts that are excessively burdensome on the mortgage lender.

MFA reviews compensation provisions in real estate lenders in troubled condition under the following circumstances:

- During examinations.
- In conjunction with applications that contain compensation arrangements.
- When the mortgage lender submits employment contracts and compensation payments for review. You should review, comment, or take other appropriate action to correct unsafe or unsound employment contracts.

MFA considers the guidelines below illustrative examples of unsafe or unsound compensation provisions. Other compensation provisions may also be objectionable depending on individual circumstances. MFA bases these guidelines on safety and soundness concerns that are especially important for real estate lenders in troubled condition. You must use judgment in the application of the guidelines, taking into account the condition of the mortgage lender, the reason for the provision, and the materiality of the provision. The illustrative examples of unsafe or unsound compensation provisions include the following:

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the mortgage lender. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. The board of directors should closely monitor compensation tied to current operating results.
- Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other mortgage lenders of similar size, in similar locations, and under similar circumstances, including financial health and profitability.

- Contracts that contain automatic renewals or extensions without providing for the board of directors explicit review and approval.
- Contracts that provide for an excessive term. Generally, a term exceeding three years is objectionable.
- Total compensation paid out upon the departure of an employee, regardless of the reason, that exceeds three times the employee's average annual compensation. (The mortgage lender should not make any payment when termination is for cause.) Total compensation must include payments for the remaining contract term, if applicable, as well as any severance payments. Mortgage lenders should base average annual compensation on the five most recent taxable years.
- Contracts that do not adequately reflect or define the duties and responsibilities of the employee.
- Compensation programs (including deferred compensation, retirement, and insurance) for independent directors that are not commensurate with their duties, or that jeopardize their independence. For example, vesting requirements that require an independent director to forfeit previously accrued amounts if they do not serve for a minimum number of years.
- Contracts that the real estate lender collateralizes or otherwise guarantees, unless one of the following conditions are present:

  The terms provide that the contract is unenforceable if the mortgage lender becomes an mortgage lender in a troubled condition.

  The MFA approves the contract.

  Note: Contracts guaranteed by the holding company are permissible.
- Contracts that provide for employer reimbursement of costs that employees incurred seeking to enforce employment contract terms in the absence of legal judgment or settlement.
- Change in control provisions that provide for immediate vesting, particularly for mortgage lenders in a troubled condition.
- Contracts that require payment upon the voluntary resignation of the employee. The foregoing does not apply to employment contracts or other compensation arrangements between a holding company and a holding company executive. MFA does not comment on employment contracts between a holding company and a real estate lender executive unless such contract or arrangement is likely to adversely affect the financial or managerial condition of the mortgage lender. If applicable, MFA requires separate employment contracts between a real estate lender executive and the mortgage lender, and the real estate lender executive and the holding company.
- Real estate lenders should include the following golden parachute provision in new and renewed employment contracts.

Operating Results

The board of directors is responsible for maintaining an adequate level of capital for the mortgage lender. You should be alert to salary increases and dividend payouts in a mortgage lender experiencing unstable or declining levels of capital or earnings. If a mortgage lender fails to meet any capital standard, you should question the board of directors and management of the mortgage lender. They should justify any increases in compensation for principal officers and directors or dividend payouts.

The board of directors is responsible for maintaining an adequate level of capital for the mortgage lender.

MFA bases its regulatory and supervisory scheme on performance-based standards that tie directly to capital compliance. Well-capitalized, well-managed institutions that do not pose significant supervisory concerns receive significantly less intrusive oversight, including a longer examination cycle.

Presented below are some of the more common restrictions placed on undercapitalized mortgage lenders or those institutions in troubled condition.

Capital Plan
MFA requires a capital restoration plan when a mortgage lender falls below its adequately capitalized level. The mortgage lender must adhere to an MFA approved capital restoration plan and comply with all prompt corrective action restrictions.

Capital Distribution Restrictions
MFA may limit or restrict capital distributions, such as dividends, if the real estate lender is failing its capital test, is experiencing operating losses, or is in serious non-compliance with other regulations or safety and soundness issues.

Prior Approval of Officers and Directors
Real estate lenders in troubled condition should provide 30 days prior notice to MFA if the mortgage lender wishes to add a director or employ a senior executive officer. MFA has the authority to disapprove the addition or employment of the individual within a 30-day period. MFA may extend the 30-day period for an additional period not to exceed 60 days and must notify the individual in writing of the extension.

Prior Approval of Employment Contracts
A real estate lender in troubled condition must submit all senior executive officer and director employment contracts to the Head of Monitoring and Enforcement for prior review. The MFA may extend this requirement to other employees of the mortgage lender as well. Compensation at mortgage lenders in troubled condition requires regulatory scrutiny on a case-by-case basis. MFA must balance the mortgage lender's need to lower operating expenses against the need to provide a higher than normal level of compensation to attract and retain qualified management.

Golden Parachute Provisions
Troubled mortgage lenders are prohibited, with certain exceptions, from making golden parachute payments. A golden parachute payment generally is defined as any payment that meets the following criteria:

• The institution makes the payment to an institution-affiliated party.
• The payment is contingent on this person's resignation.
• The institution makes the payment while it is in troubled condition.

An institution-affiliated party includes any director, officer, employee, or controlling stockholder (other than a holding company) of, or agent for, a mortgage lender or holding company. The rule excepts legitimate business expenses such as the following from the golden parachute payment prohibition:

• Qualified retirement plans.
• Nonqualified "bona fide" deferred compensation plans.
• Nondiscriminatory severance pay plans.
• Other types of common benefit plans.
• Certain payments required by law.
• Death benefits.

There could be other limited exceptions in cases involving the hiring of a new manager to improve the institution's condition or when the owners sell a troubled institution without MFA assistance.

Regulatory Review of Third-Party Contracts
A real estate lender defined as "in trouble" by MFA must first notify and receive MFA approval before it enters into third-party contracts for services outside the normal course of business. MFA has particular concerns regarding third-party contracts at troubled mortgage lenders because they frequently waste scarce resources. The MFA may establish a *de minimis* threshold amount to apply on a case-by-case basis. The requirement for MFA pre-approval does not apply to contracts in the normal course of business, such as annual audits, debt collection, or routine legal services.

Third-party contracts must not contain provisions that are detrimental to the real estate lender or contrary to public interest. You should scrutinize them closely since the costs may ultimately increase the cost of a mortgage lender's failure. You should use the following guidelines when reviewing such contracts for troubled mortgage lenders:

- Mortgage lenders must clearly identify the services the consultant will provide and discuss how they relate to the mortgage lender's approved business or capital plan.
- The mortgage lender must provide evidence that fees to be paid and terms of payment are within prevailing market norms and are consistent with the interests of the insurance fund.
- Reimbursable expenses, if provided, should include only necessary costs directly related to the service provided. (MFA does not consider costs such as entertainment and unnecessary travel as reasonable.)
- Each contract must contain a provision stating that the mortgage lender may cancel for unsatisfactory or nonperformance.

- In most circumstances, mortgage lenders should enter into only one contract for each service a consultant will perform. MFA generally considers multiple contracts to different providers for the same service to be a dissipation of assets.
- The mortgage lender must receive written approval from MFA to enter into a proposed third-party contract.

Other Requirements
Directors should be ever-mindful of the real estate lender's obligation to serve the community. Directors represent the mortgage lender and their behavior can enhance or detract from the mortgage lender's image and ultimately its fiscal well-being. A director's business and personal affiliations should be compatible with those of the mortgage lender. You should be alert to self-serving practices that include:

- Gratuities to directors to obtain their approval of financing arrangements.
- The use of particular services.
- The use of mortgage lender funds by insiders to obtain loans or transact other business.
- Transactions involving a conflict of interest.

Composition of the Board of Directors
The composition of the board should meet the following conditions:

- A majority of the directors must not be salaried officers or employees of the real estate lender or any subsidiary or (except in the case of a real estate lender having 80% or more of any class of voting shares owned by a holding company) any holding company affiliate thereof.
- Not more than two of the directors may be members of the same immediate family.
- Not more than one director may be an attorney with a particular law firm.
  Accordingly, boards should be made up of both inside and outside directors, each providing a distinct role:

- *Inside directors* are responsible for approving high-level budgets prepared by upper management, implementing and monitoring business strategy, and core corporate initiatives and projects. Inside directors are either shareholders or high-level management from within the company. Inside directors help provide internal perspectives for other board members.
- *Outside directors* have the same responsibilities as the inside directors in determining strategic direction and corporate policy; however, outside directors are different in that they are not directly part of the management team. The purpose of having outside directors is to provide unbiased and impartial perspectives on issues brought to the board.

Conflicts of Interest

Directors must particularly avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. Also, because a director's personal characteristics may reflect on the mortgage lender's trustworthiness, a director should be a responsible and trusted member of a community. MFA will criticize persons who owe a fiduciary duty to a real estate lender who have advanced his/her own personal or business interests at the expense of the mortgage lender. This principle also criticizes persons who owe a fiduciary duty to the real estate lender who have advanced the personal or business interests of others with whom they have a personal or business relationship at the expense of the mortgage lender.

The following examples are types of transactions that MFA will criticize:

- A person who owes a fiduciary duty to an institution receives money or other benefits (such as a loan, forgiveness of debt, goods or services) from a third party. In return, the third party receives a benefit from the mortgage lender (such as granting a loan to or buying property from the third party).
- A third party makes payments to a spouse, child, parent, sibling, or business partner of a person identified in the rule. Those payments generally provide a benefit to the person identified in the rule because of the personal or business relationship.
- A person who owes a fiduciary duty to an institution facilitates a transaction between the real estate lender and companies in which that person owns shares, is on the board of directors, or is an officer, at the expense of the institution.

  In addition, if persons who owe a fiduciary duty to a real estate lender have an interest in a matter or transaction before the board they must take the following steps:
- Make full disclosure to the board.
- Refrain from participating in the board's discussion of the matter.
- Recuse themselves from voting on the matter if they are board members.

Corporate Opportunity

MFA's corporate opportunity directive prohibits directors, officers, and persons that have the power to direct the management or policies of a real estate lender, or otherwise owe a fiduciary duty to a mortgage lender, from taking advantage of corporate opportunities that belong to the mortgage lender. MFA follows common standards governing usurpation of corporate opportunity. The following are examples of issues the board should consider under this standard:

- The institution's financial condition and management resources.
- The level of risk presented by the business.
- Potential profit from the business weighed against any profits that might arise from transfer of the business.

The rule does not apply when an institution receives fair market value consideration for the transfer of a line of business. In addition, the rule does not generally apply if a disinterested and independent majority of the real estate lender's directorate, after receiving a full and fair presentation of the matter, rejects the opportunity as a matter of sound business judgment. A disinterested director has no interest in the matter or transaction before the board of directors. An independent director must not be a salaried officer or employee of the real estate lender, any subsidiary or holding company affiliate. In addition, an independent director must not be dominated or controlled by an interested officer or director.

Securities Laws
Directors of stock mortgage lenders must take care not to violate securities laws in their own securities trading activity. These laws prohibit anyone, insider or not, from purchasing or selling securities with the use of material corporate information that is not available to the general public.

Examples of such material inside information include:

• Significant corporate actions.
• Reduced or increased earnings.
• Changes in loan loss reserves.
• Mergers, acquisitions, or proposed tender offers.
• Actual or potential enforcement or supervisory actions.
  • A change in supervisory status (such as a prompt corrective action category or troubled status). Securities laws also prohibit insiders from passing inside information to other persons, even if the insider does not actually trade securities based on such information.

Corporate insiders have a fiduciary responsibility of trust and confidence to refrain from trading based on material nonpublic information concerning their corporation. The misuse of material nonpublic corporate information is a fundamental breach of fiduciary duty and an unsafe and unsound practice.

Other Areas of Review *Insurance*

Life Insurance
It is common practice for real estate lenders to buy life insurance policies for the benefit of employees. If the beneficiary of the policy is the employee, MFA considers the cost of the coverage to be compensation. The board should annually review and approve the policy for reasonableness.

REFERENCES

SECTION: Management Assessment 330

One of the most important examination objectives is to evaluate the quality and effectiveness of management. The success or failure of almost every facet of operations relates directly to management.

Assessments of the various areas under review during an examination all reflect ultimately on the effectiveness of management. Among other things, management is responsible for:

- Implementing board established policies and strategic goals.
- Identifying and managing risk through an effective risk management function.
- Ensuring an effective system of internal controls and management reporting.
- Ensuring the adequacy and depth of resources.
- Ensuring compliance with laws and regulations.
- Ensuring the overall safe and sound operation of the institution.

In this Section, management refers to executive officers, such as chief executive officer, president, vice presidents, chief financial officer, treasurer, controller, secretary or any other person, including division managers, who have the ability, with or without explicit authority, to implement and interpret the mortgage lender's strategic goals and policies.

In evaluating management, you should consider the knowledge, skills, and abilities of the executive officers, their track record, regulatory compliance, and financial performance of the institution. Sound compliance management is a major consideration when evaluating the quality and effectiveness of the board and management. An effective compliance management function should include a process for assessing and monitoring compliance performance, training, and for implementing corrective action based on identified deficiencies. You should consider determinations made in each of the core examination areas (Capital, Asset Quality, Earnings, Liquidity, Sensitivity, Compliance) in your overall assessment of management.

The management rating for a given examination clearly reflects all of the examination findings in a comprehensive examination as well as:

- A demonstrated willingness and ability to serve the lending needs of the community
- Avoidance of conflicts of interest and usurpation of corporate opportunity
- Good corporate governance
- Responsiveness to recommendations for corrective action
- Risk management and financial performance
- Compliance management.

EFFECTIVENESS OF MANAGEMENT

Assessing management performance involves more than noting whether a mortgage lender is profitable.

Effective management requires the cooperation and active involvement of both management and the board of directors. The board should provide the guidelines, and management should make operating decisions consistent with the guidelines. You must judge management performance on the basis of how well management uses available resources to accomplish the mortgage lender's objectives.

Evaluations of management provide indicators of future operations; in some instances they may reveal a need for preventive supervision. For mortgage lenders experiencing problems, evaluations are necessary to determine the capabilities of management so that you may initiate appropriate supervisory action.

Experience in developed lending markets has determined that inefficient, incompetent, or dishonest management are the principal causes for the problems of most troubled mortgage lenders. Although there are many other reasons (high expenses, poor lending practices, high delinquencies, and so on), most of the causes ultimately relate to management deficiencies.

In reviewing executive officers' performance, you need to determine that the following conditions exist:

- Sound corporate governance polices including conflict of interest and corporate opportunity policies.
- Sound and consistent objectives, policies, and procedures in the asset, liability, and operational areas, including information technology and customer information security.
- The timely identification, assessment, and mitigation of risk.
- The ability, knowledge, and attitude to manage compliance responsibilities.
- Personnel throughout the mortgage lender adhere to policies and receive training ensuring clear communication of relevant legal and regulatory requirements, and procedural guidelines.
- A strong system of internal controls, including technology risk controls.
- Management information systems facilitate efficient operation and ensure effective communications and monitoring of activities.
- The mortgage lender's planning processes facilitate achievement of goals and objectives. The planning process includes business continuity and disaster recovery.
- Senior management delegates appropriate authorities to middle management and staff personnel.
- Management's experience and depth ensures sound decisions and assures continuity of operations.
- Management is capable of handling situations the mortgage lender may reasonably encounter in the future.
- Track record, including track record in remedying previously identified problems.

<u>Risk Management</u>

Risk management—that is the timely identification, assessment, and mitigation of risk—is an integral part of management's responsibilities. An effective risk-management framework identifies potential events that may affect the institution and establishes how an institution will manage its risk given its risk appetite and strategic direction. A risk management program should be consistent with the size, complexity, and risk profile of a mortgage lender.

In evaluating risks, managers need to consider both current and planned or anticipated operational and market changes and identify the risks arising from those changes. Once risks have been identified, assessed and evaluated as to their potential impact on the organization, management must determine the effectiveness of controls and develop and implement additional appropriate mitigating controls where needed. The effectiveness of those controls should be evaluated independently of the group that develops the controls.

Traditional risk management has focused on quantifiable risks, such as credit and market risks. There is need for greater focus on the risks that are harder to quantify - that is, operational, legal, and reputation risks. A strong regulatory compliance program is an integral part of the risk-management function. The compliance area is critical to identifying, evaluating, and addressing legal and reputation risks, particularly in complex financial firms.

Safety and Soundness and Compensation Standards

Operational and managerial standards for mortgage lenders to follow in maintaining safety and soundness of operations include the following activities and practices:

- Internal controls and information systems (includes controls and systems for compliance)
- Internal audit systems
- Loan documentation
- Credit underwriting
- Interest rate exposure
- Asset growth
- Asset quality
- Earnings
- Compensation, fees, and benefits.

Also administrative, technical, and physical safeguards should be in place to protect the security, confidentiality, and integrity of customer information. A mortgage lender must:

- Implement a board-approved, written information security program.
- Conduct and document a risk assessment of customer information security.
- Require in contracts that service providers implement security programs designed to meet the objectives of this section.
- Monitor, evaluate, and adjust for changes within the mortgage lender.
- Report to the board annually on the mortgage lender's compliance and status of the program.

The compensation guidelines require mortgage lenders to maintain safeguards to prevent the payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the mortgage lender. The guidelines define compensation to be excessive when it is unreasonable or disproportionate to the services that an executive officer, employee, director or principal shareholder performs, in consideration of the following factors:

- The combined value of all cash and non-cash benefits provided to the individual.
- The compensation history of the individual and other individuals with comparable expertise at the mortgage lender.
- The financial condition of the mortgage lender.
- Comparable compensation practices at comparable mortgage lenders.
- For post-employment benefits, the projected total cost and benefit to the mortgage lender.
- Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the mortgage lender.
- Any other factors MFA determines to be relevant.

If MFA determines that a mortgage lender fails to meet a safety and soundness standard, MFA may request the submission of a safety and soundness compliance plan.

Compliance Management Program

Sound compliance management, like other areas of operations management is predicated on establishing a comprehensive program of risk controls, periodic reviews, and self-assessments. Actively managing compliance risk starts at the

board of directors' level through senior and middle management down to staff personnel.
Your assessment of management's performance in compliance management should focus on their compliance management program and how well it addresses components the agency expects in a comprehensive program: systems, monitoring, assessment, accountability, response, and training (SMAART components).

In assessing the board and management performance in compliance management, consider the following factors:

• Management allocates sufficient resources for the implementation of a formal written compliance program tailored to its size, organizational structure, business strategy, complexity of operations, market products offered, and staff expertise. The program should:

Emphasize the importance of regulatory compliance as an inherent part of business operations.

Establish standards of accountability for all personnel charged with compliance-related responsibilities.

Include the means for the board and management to actively assess compliance performance.

• The compliance management program provides for and results in:
Comprehensive policies and procedures, and the systems to implement them.

Internal controls that afford ongoing monitoring to ensure transactions are executed in accordance with program standards.

Periodic reviews of systems records and operations to identify transactional violations and program deficiencies.

Prompt correction of compliance violations or deficiencies identified during ongoing monitoring, the internal review process or in response to consumer complaints.
An ongoing comprehensive training program that ensures the clear communication of relevant legal and regulatory requirements, and the mortgage lender's procedural guidelines to all affected officers and staff personnel.

<u>Internal Controls</u>
Both the directors and senior management have important roles in a mortgage lender's programs of internal control, loan review, internal audit, and compliance management. Although directors have overall audit responsibility and should require that the auditor report directly to them, directors normally charge senior management with the duty of developing and maintaining a strong system of internal controls, including technology risk controls, and a formal compliance management program. Relying on the independent auditors to establish the mortgage lender's internal controls is inappropriate. Senior management is responsible for the design and implementation of effective controls to prevent errors, conflict of interest situations, and fraud.

<u>Management Information Systems</u>
An effective management information system (MIS) contains information from a number of sources. Such information must serve a number of users, each having varying needs. The MIS must selectively update information from all available sources and coordinate it into meaningful and clear formats. You can determine the effectiveness of MIS on the basis of the following measurements:

• Quality. This relates to the relevance and accuracy of the information. Poor quality information usually stems from inadequate controls, analysis, and evaluations of information needs, or from ineffective design of reports.
• Quantity. Too many reports or too much information on a single report may hamper or discourage their use completely. Too little information may reflect insufficient analysis of information needs.
• Timeliness. The improper design of information processes and the failure to identify the frequency of need for information usually causes untimely processing and distribution of information.

Prompt Corrective Action

Undercapitalized and significantly under-capitalized mortgage lenders that fail to submit and implement an acceptable capital restoration plan are subject to the prompt corrective action. MFA will not accept continuation of any director or senior executive officer that held is held responsible for under-capitalization. The mortgage lender should employ qualified senior executive officers. MFA will take action to prohibit critically undercapitalized mortgage lenders from paying excessive compensation or bonuses.

Also, the prompt corrective action provisions will impose restrictions on management fees and senior executive officer compensation. Undercapitalized, significantly undercapitalized, and critically undercapitalized real estate lenders will be subject to restrictions on management fees and senior executive officer compensation. Undercapitalized mortgage lenders that fail to submit and implement an acceptable capital restoration plan shall not do either of the following without prior MFA approval:

• Pay a bonus to a senior executive officer.
• Compensate a senior executive officer at a rate exceeding the officer's average rate of compensation for the year prior to the month when the mortgage lender became undercapitalized.

Notice of Change of Senior Executive Officers

Capital deficient or troubled mortgage lenders must notify MFA 30 days before taking either of the following actions:

• Employing a senior executive officer.
• Changing the responsibilities of any senior executive officer so that the person would assume a different senior executive position. The same regulatory notice requirement also applies to holding companies in a troubled condition. Capital deficient mortgage lenders meet one of the following conditions:
• Do not comply with all minimum capital requirements.
• MFA notifies the mortgage lender, in connection with their capital restoration plan, that it must file a notice.

MFA will disapprove a notice if, based on the competence, experience, character, or integrity of the proposed senior executive officer, that it would not be in the best interests of the mortgage market or the public to permit the mortgage lender to employ the individual.

PLANNING

Sound planning is fundamental to effective management and is a key to anticipating and dealing with rapid change, and managing risk. Senior management and the board of directors should inventory the mortgage lender's resources, examine changes in its operations, monitor changes in external factors, including legislative, regulatory, industry and, market conditions on its compliance program, and determine its responses to those changes. To be effective, planning should be dynamic in nature. The real estate lender should carefully monitor and support the planning function. Management must revise projections periodically as circumstances change and the board formulates new strategies to meet stated objectives.

Planning requires the collection and coordination of large amounts of information and the thoughtful efforts of all members of the management team. Written plans help ensure that the board of directors, executive officers, and all division managers within the mortgage lender share the same goals, objectives, and strategies. A common and shared perception of future actions is critical to the execution of a successful plan.

Any of the following management failures warrants the attention of the mortgage lender's directors. You should accordingly note such failures in the report of examination:

- Lack of a satisfactory strategic and operational planning process.
- Failure to develop a comprehensive, mortgage lender-wide business continuity plan.
- Lack of adherence to plans.
- Ineffective monitoring and control of plans.
- Failure to adjust existing plans to recognize and conform to changing economic and market conditions, legislative and regulatory requirements.

You should also be alert, particularly with respect to new mortgage lenders, for any deviations to strategic or operational plans that may be potentially detrimental to the mortgage lender.

Such deviations, which you should also note in the report of examination when assessing management performance, include the following examples:

- The excessive use of or reliance on short-term or callable borrowings.
- The initiating of new, novel, or higher risk lending, investment programs, or new technology without appropriate planning, expertise, or controls.
- The failure to independently and adequately investigate and document extensions of credit, particularly those made outside a mortgage lender's normal lending territory.
- The willingness to forgo long-term stability in favor of short-term profits.
- Many newly chartered real estate lenders are subject to approval conditions, usually contained in the director's order. You should carefully review the mortgage lender's adherence to these conditions.

The Planning Process

To be effective, planning requires a structure and a process. Planning can be segmented into two categories: **strategic** and **operational**. Strategic planning focuses on the long-term, extensive allocation of resources to achieve corporate goals and objectives. Operational planning, such as a business plan, concentrates on shorter-term actions designed to implement those strategies outlined in the strategic planning process. For an effective planning process, the operational plans must flow logically from the strategic plan.

Management Succession

You should evaluate the mortgage lender's quality of plans for maintaining its present condition and for improving its future condition. This should include an evaluation of the board and management's efforts to provide for succession of senior officers.

The projection of future management needs involves an appraisal of the quality and quantity of senior and middle management. This assessment must be relative to the size, complexity, and market circumstances of the mortgage lender. Determination of what management will do with the mortgage lender in the future is most important. The supervisory goal is to prevent problems from developing rather than wait for future examinations or monitoring to identify deteriorating conditions.

Regulatory Concerns

You should not evaluate mortgage lender planning with the preconception that every mortgage lender should have a model planning process. You should evaluate the planning process and the plan itself. If a well-designed planning process exists, the plan will generally be thoughtful and realistic. Management's failure to have a satisfactory planning process warrants the attention of the mortgage lender's directors and you should accordingly report the failure in the report of examination.

You must treat a mortgage lender's strategic, operational, and business plans with maximum confidentiality. They contain sensitive information that directly affects the mortgage lender's market position and financial condition.

<u>MANAGEMENT OF HUMAN RESOURCES</u>

People are the link between a mortgage lender's organizational structure and the attainment of its organizational goals. The board of directors is responsible for employing a competent chief executive officer. Thereafter, senior management is responsible for recruiting and making certain that there are competent employees available to staff all positions. Personnel management includes establishing procedures for promoting and replacing employees, reviewing their performance, devising a system of compensation, and selecting and training future managers.

The following areas warrant your particular attention in evaluating personnel management, as they are important indicators of a mortgage lender's viability:

- Detailed position descriptions and standards.
- Carefully planned recruiting and proper screening of new employees.
- Appropriate security training for protecting the mortgage lender's customer information.
- Performance review and comparison to standards.
- Salary administration.
- Provision for communication.

You should determine the appropriateness of a mortgage lender's employment contracts, bonus and incentive plans, salary levels, and employee benefits program. You should compare compensation paid and benefits provided with those that an appropriate peer group offers, and should determine reasons for any substantial differences.

<u>Use of Consultants and Outsourcing</u>

It is fairly common for real estate lenders to outsource certain functions of the mortgage lender. Outsourcing functions can reduce operating expenses; however, mortgage lenders should be careful not to rely on vendors or consultants to perform critical functions without adequate controls. These controls should include monitoring performance as it relates to products and services delivered by or performed on behalf of the mortgage lender. Monitoring controls are management's first line of defense against operational risk and compliance risk. Use of a vendor or consultant does not lessen the burden on management to supervise and control the mortgage lender's systems, policies, and procedures.

Management must obtain complete information for vendors and consultants. This should include performing regular due diligence when retaining the services of any third-party provider, vendor or consultant. The mortgage lender must have a written agreement with the vendor or consultant that outlines the conditions, rights, and responsibilities of each party.

AVOIDANCE OF CONFLICTS OF INTEREST

The phrase conflict of interest refers to any situation where the safety and soundness or opportunity of a mortgage lender is in conflict with the personal interests of any of the following persons:

- A director.
- An officer.
- Any other employee or person who has influence over a mortgage lender's policies, procedures, or actions.

Conflicts of interest (or even the appearance of such) can compromise safe and sound operations and reputation for integrity. Conflicts can undermine public confidence in the lender industry. Sometimes those who owe a fiduciary duty to a mortgage lender subtly disguise a conflict, making it difficult to detect. In other instances, they may openly acknowledge a conflict. Some conflicts may be detrimental while others may appear to be beneficial to the mortgage lender. Where a conflict exists, however, its very appearance alone could damage a mortgage lender's image. A conflict could cause a financial loss to a mortgage lender if the individual involved considers self-interest and personal gain more important than a mortgage lender's interests.

Management has a fiduciary responsibility to avoid any conflicts of interest or appearance of conflict of interest. Personal affiliations should not be incompatible with those of the mortgage lender. Furthermore, when both of the following circumstances exist, no officer should take advantage of a business opportunity for his or her own or another person's personal benefit:

- The opportunity is within the corporate powers of a mortgage lender or its service corporation(s).
- The opportunity is of present or potential advantage to the mortgage lender.
  You should review the mortgage lender's formal policy for avoidance of conflict of interest situations. The policy at a minimum should address the following concerns:

- Areas where conflicts of interest and usurpations of corporate opportunity could arise. This includes transactions involving the mortgage lender and persons related to directors or officers, or transactions for their benefit.
- Controls that the mortgage lender maintains to avoid abuses and the procedures in place for dealing with policy violations.
- Business activities in which the mortgage lender's directors and senior management are active.
- Business activities that the law permits the mortgage lender to conduct.
- A specific plan for dealing with conflicts of interest and corporate opportunity problems in these areas.

You should determine if directors and officers are complying with the policy. Accordingly, you should comment on and take appropriate action on any actual or apparent conflict of interest transactions that adversely affect the mortgage lender, even though an MFA regulation may not specifically address the conflict. Also, you should include comment, and supervisory objection taken, whenever any person involved in the conflict participates in the approval of the subject transaction.

Loans to Executive Officers

You should have knowledge of MFA regulations which govern loans to executive officers, directors, and principal shareholders.

Management Questionnaire

The pre-examination information, Management Questionnaire, is an important and useful tool in determining objectives and strategies for conducting an examination. In this regard, much of the information that the questionnaire asks for may provide leads in determining the existence of possible conflict of interest situations or transactions. The Management Questionnaire deals with transactions or arrangements with affiliates or affiliates persons, tie-in arrangements, and ownership and control concerns.

You must satisfy yourself as to the completeness and accuracy of responses to the Management Questionnaire, and must follow up on and report any inconsistencies between the responses and your examination findings.

RESPONSE TO SUPERVISION

You must determine the mortgage lender’s compliance with conditions of approval, orders, supervisory agreements, and directives. Supervisory authorities look to management to implement corrective action in response to directors’ requests and regulatory supervision requirements. Management should establish procedures to ensure continuing compliance. Corrective action must be responsive to the cited criticism and implementation of appropriate action must be timely. Management must explain any noncompliance with supervisory requirements, including plans for corrective action.

If management or the board of directors continues to operate in an unsafe and unsound manner, supervision may have to initiate formal enforcement action. The following are some other types of management or director’s actions that MFA examiners should record and maintain in the continuing examination file (CEF) and elsewhere:

- Criminal referrals.
- Referrals to a professional group for disciplinary purposes.
- Significant business transactions between a mortgage lender and an individual that raises supervisory concern. You should contact the Head of the Monitoring and Enforcement Department for guidance as to whether a particular event warrants an inclusion in MFA records.

REFERENCES

SECTION: Internal Control 340

INTRODUCTION

MFA requires all real estate lenders, their affiliates, and subsidiaries to establish and maintain adequate systems of internal control. Lenders must have a process in place to identify, monitor, and control risk. Audits by public accountants and examinations by MFA have placed a greater emphasis on evaluating the appropriateness of the processes in place, and less reliance on transaction testing.

This section of the Manual defines internal control, describes objectives and components of internal control, and explains how to consider internal control in planning and performing an examination. In general, when beginning an examination, first review and evaluate the adequacy and effectiveness of the internal control system. If you discover areas where internal controls are inadequate, expand the scope of examination to determine whether there are any safety and soundness concerns.

OBJECTIVES

An effective internal control system better ensures the following important attributes:

- Safe and sound operations.
- The integrity of records and financial statements.
- Compliance with laws and regulations.
- A decreased risk of unexpected losses.
- A decreased risk of damage to the mortgage lender's reputation.
- Adherence to internal policies and procedures.
- Efficient operations.

A system of strong internal control is the backbone of a mortgage lender's management program. Strong internal control helps a mortgage lender to meet goals and objectives, and to maintain successful, healthy operations. Conversely, a lack of reliable records and accurate financial information may hamper the long-term viability of a mortgage lender. An effective internal control system integrated into the organization's overall risk management strategy serves the best interest of the shareholders, board of directors, management, and regulators.

REGULATORY CONCERNS

MFA requires management, and the board of directors to implement and support effective internal controls appropriate to the size of the mortgage lender, its nature, and scope of activities.

DIRECTORATE RESPONSIBILITIES

The board of directors has the primary responsibility of establishing and maintaining an adequate and effective system of internal control. An effective board generally has members who have financial or banking experience, and stature. The board is responsible to report to the MFA on internal control over financial reporting and compliance with certain laws and regulations, as well as filing annual audited statements.

The board is also responsible for approving and periodically reviewing the overall business strategy and significant policies of the mortgage lender, as well as understanding the major risks the mortgage lender takes. The board should set acceptable levels for these risks, and ensure that senior management takes the required steps to identify, measure, monitor, and control these risks. To remain effective in the dynamic and ever broadening environment that mortgage lenders operate in, the board of directors should periodically review and update the internal control system. To oversee internal control and the external and internal audit function of a mortgage lender, an audit committee comprised of outside directors (or at least a majority of outside directors) is desirable.

An active board or audit committee independent from management sets the mortgage lender's control consciousness. The following parameters determine effectiveness:

- The extent of its involvement in and its scrutiny of the mortgage lender's activities.
- The ability to take appropriate actions.
- The degree to which the board or audit committee asks difficult questions and pursues the answers with management.

AUDITOR RESPONSIBILITIES

Internal Audits

Both the internal and external auditors play key roles in the monitoring of internal control systems. Each mortgage lender should have an internal audit function that is appropriate to its size, and the nature and scope of its activities. The internal auditor is typically very involved in the ongoing review and assessment of a mortgage lender's internal control. The board of directors should assign responsibility for the internal audit function to a member of management who has no operating responsibilities, and who is accountable for audit plans, programs, and reports. When properly structured and conducted, internal audits provide directors and senior management with vital information about any weaknesses in the system of internal control allowing management to take prompt, remedial action. Through directed reviews of the internal control systems and as part of the regular audit program, the internal auditor can be the first line of defense against a corrupted control system.

External Audits

Established policies and practices look to the external auditor to play a significant and vital role in a mortgage lender's internal control systems. In this role, the external auditor performs examination procedures to attest to management's assertion that the internal control over financial reporting is functioning effectively, and that it is in compliance with designated laws and regulations. The external auditor may consider the work done by the internal auditor as part of the auditing procedures.

Auditors should take into account the effect of information technology on internal control. An auditor should obtain an understanding of internal control sufficient to plan the audit and determine the nature, timing, and extent of tests to perform, including assessment of control risk.

Significant responsibility rests on the external auditor to look at internal control, though the external auditor may not extensively review controls over all areas of the mortgage lender, and may use different levels of testing depending on the risk of a specific area.

<u>*Communication of Internal Control*</u>
Related Matters Noted in an Audit The external auditor should identify and report conditions that relate to a mortgage lender's internal controls observed during an

audit of financial statements. The reportable conditions discussed in this pronouncement are matters coming to the attention of the auditor that, in the auditor's judgment, should be communicated to the audit committee because the conditions represent significant deficiencies in the design or operation of internal control. These conditions, in the opinion of the auditor, could adversely affect the mortgage lender's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. In some instances, a reportable condition may be of such magnitude to be a "material weakness." A material weakness in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not sufficiently reduce the level of risk that material misstatements caused by error or fraud may occur, and employees in the normal course of business would not timely detect the misstatements.

Auditors generally do not search for reportable conditions or material weaknesses. They usually become aware of them through consideration of the components of internal control, application of audit procedures to balances and transactions, or during the course of the audit. The auditor makes a judgment as to which matters are reportable, taking into consideration various factors, such as an entity's size, complexity and diversity of activities, organizational structure, and ownership characteristics. When examining the communication of internal control matters noted in an audit, be aware that there is no standard form of communicating reportable conditions or material weaknesses to the audit committee. Once the auditor has chosen to discuss reportable conditions or material weaknesses, the auditor may do so either through a formal presentation to the audit committee, or informally, through conversations. The auditor may also submit written reports. Generally, the auditor will document oral communications by appropriate memoranda or notations in the working papers.

INTERNAL CONTROL COMPONENTS

MFA urges mortgage lender management and boards of directors to consider recognized standards in developing and maintaining an effective system of internal control. Five interrelated components derive from the way management runs a business, and are integrated with the management process. The components are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring.

The Control Environment

The effectiveness of internal controls rests with the people of the organization who create, administer, and monitor them. Integrity and ethical values are essential elements of a sound foundation for all other components of internal control. The commitment for effective control environment rests at the top. Reaching a conclusion about a financial institution's internal control environment involves a degree of subjectivity because of the intangible nature of measuring effectiveness.

Control Environment Assessment Process

Draw conclusions as to the quality of risk management and assess the effectiveness of the control environment in the following areas:

Integrity and Ethical Values Integrity and ethical values are the products of the mortgage lender's ethical and behavioral standards. How management communicates and reinforces these values in practice establishes the "tone" for the organization. Management should strive to remove or reduce incentives and temptations that might prompt employees to engage in dishonest, illegal, or unethical acts. Management must also communicate their values and behavioral standards to personnel through policy statements and codes of conduct.

Management Philosophy and Operating Style Management's approach to taking business risks and their attitude toward financial reporting (conservative versus aggressive) and information processing weigh heavily in the control environment. Consider the level of commitment by management and the board of directors to establish the necessary foundation on which to build an effective system of internal control. Management must have the will to make policies work or even the best-written policies on internal control lose effectiveness.

Organizational Structure The mortgage lender must have an organizational structure that supports its objectives. Management must plan, execute, control, and monitor mortgage lender objectives. It must establish key areas of authority and responsibility and appropriate lines of reporting.

Assignment of Authority Assignment of authority includes policies relating to the following areas:

- Appropriate business practices.
- Knowledge and experience of key personnel.
- Resources for carrying out duties. Human Resource Policies and Practices Human resource practices send messages to employees regarding expected levels of integrity, ethical behavior, competence, and conflict of interests.

Risk Assessment

All entities, regardless of size, encounter risk in their organizations. The ability to identify and manage these risks will affect an entity's ability to survive in a competitive market. In order to assess risk, management must first set objectives to quantify the amount of risk they can prudently accept. Risks relevant to financial reporting include external and internal events, and circumstances that may adversely affect a mortgage lender's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such risks can arise or change due to the following circumstances:

- Operating environment changes
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines, products, or activities
- Corporate restructuring
- Accounting pronouncements.

The Risk Assessment Process Determine whether management has identified and analyzed the risks, and has methodologies in place to control them. Consider also the following areas in assessing the risk process:

- Prevalence of external and internal factors could affect whether strategic objectives are achieved.
- Effectiveness of systems used to manage and monitor the risks.
- Capacity of existing processes to react and respond to changing risk conditions.
- Level of competency, knowledge, and skills of personnel responsible for risk assessment.

Control Activities

Control activities are the policies and procedures that help ensure management carries out its directives. Control activities should assure accountability in the mortgage lender's operations, financial reporting, and compliance areas.

The Control Activities Assessment Process:
Assessment of control activities relevant to an examination includes the elements discussed below.

Performance Reviews Management should establish policies and procedures to ensure control activities include reviews of actual performance versus budgets, forecasts, and prior period performance. Management should conduct independent checks or verifications on function performance and reconciliation of balances.

Information Processing
There are two broad groupings of information systems:
General controls and Application controls.
Management should establish policies and procedures to ensure that general controls are commonly in place over the following areas:

- Data center operations.
- System software acquisition and maintenance.
- Security access.
- Application system development and maintenance. Management should also establish policies and procedures for application controls, which apply to the processing of individual applications. These controls ensure valid, complete, properly authorized, and accurately processed actions. Physical Controls Management should establish safeguards and physical controls over the following activities:
- The physical security of assets, such as secured facilities.
- Access to books, and sensitive records and systems.
- Authorization for access to computer programs and data files.

Segregation of Duties Management should reduce the opportunities to perpetrate and conceal errors, irregularities, or any wrongdoing. Management must assign different people the responsibility of authorizing transactions, recording transactions, and maintaining custody of assets. For these safeguards, management should ensure that vacation requirements or periodic rotation of duties for personnel in sensitive positions occurs.

Information and Communication Systems
Management must identify, capture, and communicate information to enable people to carry out their responsibilities. Internally generated data, along with external events, activities, and conditions is necessary for a business to make informed decisions. To be effective, management must communicate information to the people who need it to carry out their responsibilities. Management must design ways to downstream messages from the top, as well as upstream significant information. An information system should provide sufficient detail to properly classify the transaction for financial reporting, and measure the value of the transactions in a manner that permits recording the proper monetary value in the financial statements in accordance with accounting principles.

Information and Communication Systems Assessment Process
Communication involves an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Determine whether policy manuals, accounting and financial reporting manuals, and other memoranda effectively communicate internal control responsibilities. Determine if management

established systems to capture and impart pertinent and timely information in a form that enables staff to carry out their responsibilities. Also, determine whether the following safeguards exist:

- Accounting systems identify and record all valid transactions in the proper accounting period, ensure accountability for related assets and liabilities, and present transactions and related disclosures in the financial statements.
- Management information systems identify and capture relevant internal and external information in a timely manner.
- Contingency plans exist for information systems.

Monitoring

Monitoring is a process that assesses the quality of the internal control performance over time. Management must build ongoing monitoring activities into the normal recurring activities of their mortgage lender, and monitor the internal control system on an ongoing basis to ensure that the system continues to be relevant and addresses new risks. In many cases, the internal auditor is responsible for monitoring the entity's activities and regularly provides information about the functioning of internal control, including the design and operation.

The Monitoring Assessment Process

Determine who oversees and assesses the monitoring process. Review the type of periodic evaluation of internal control that occurs. For example, is it by self-assessment or by independent audit? Check whether systems ensure timely and accurate reporting of deficiencies and whether there are processes to ensure timely modification of policies and procedures, as needed.

ASSESSING CONTROL RISK

Control risk is the risk that the entity's internal control system itself will not prevent or detect on a timely basis a material misstatement. Assessing control risk is the process of evaluating the design and operating effectiveness of an entity's internal control. You can assess control risk in quantitative terms, such as percentages, or in non-quantitative terms that range from maximum to minimum.

Assessing Control Risk at the Maximum

You should assess control risk at the maximum when there is risk that internal control will not prevent or detect material misstatements on a timely basis. In addition, you should review control risk at the maximum if management's representations conflict with controls or reduce the effectiveness, or you have concern that you cannot obtain sufficient competent evidential matter to evaluate the effectiveness of internal controls.

Assessing Control Risk at Less than Maximum

Assessing control risk below the maximum involves performing tests to evaluate the effectiveness of such internal control. Tests of controls should determine whether the control is suitably designed to prevent or detect material misstatements. These tests ordinarily include evidence obtained from the following actions:

- Conducting management inquiries.
- Inspecting documents and reports to review how staff performs controls.
- Observing directly how management applies the controls.
- Retesting how management applies the controls.
- Evaluating if management designs an effective internal control system to monitor and correct noncompliance.

After examining the components and their risk, draw an overall conclusion as to the adequacy of the mortgage lender's system of internal control and include the assessment in the report of examination. MFA may notify a mortgage lender with an inadequate assessment of the need to file a plan of compliance as provided for under the regulations. The plan would establish the manner in which the mortgage lender will rectify its internal control deficiencies.

Overall Assessment
The overall risk assessment should determine whether management takes the following actions:
- Supports fully the concept of effective internal control.
- Encourages their employees to comply with the controls.

LIMITATIONS OF INTERNAL CONTROL
When operating under the best of conditions, internal control provides only reasonable assurance to management and the board of directors that the mortgage lender is achieving its objectives. Reasonable assurances do not imply that the internal control systems will never fail. Many factors, individually and collectively, serve to provide strength to the concept of reasonable assurance. However, because of inherent limitations, management has no guarantee that, for example, an uncontrollable event, a mistake, or improper reporting incident could never occur. Thus, it is possible for the best internal control system to fail. The limitations inherent to internal control are:
- Judgment
- Breakdowns
- Management override
- Collusion
- Fraud
- Cost versus benefits. We discuss each of these limitations below.

Judgment
Human judgment can limit the effectiveness of internal controls. Management makes business decisions based on the information at hand and under time constraints. With hindsight, these decisions may produce less than desirable results.

Breakdowns
The best internal control system can experience any of the following breakdowns:
- Misunderstood instructions
- Careless employees
- Inadequate training
- Time limitations.

Management Override
Management override means management overrules prescribed policies or procedures for illegitimate purposes with the intent of personal gain or to enhance the presentation of financial statements. Override practices include deliberate misrepresentations to regulators, lawyers, accountants, and vendors. Do not confuse management override with management intervention. Management intervention represents management's actions that depart from prescribed policies for legitimate purposes. At times, management intervention is necessary to deal with nonrecurring and nonstandard transactions or events, that otherwise might be handled inappropriately by the control system.

Collusion

When two or more individuals act in concert to perpetrate and conceal an action from detection, they can circumvent any system of internal control.

Fraud

Fraud is a broad legal concept, and involves intentional illegal acts that generally cause misstatement in the financial statements. Management bears the primary responsibility for detecting fraud. Internal control systems implementation is part of management's fiduciary responsibilities to prevent fraud and abuse by insiders. While the primary objective of an examination is the qualitative analysis of the mortgage lender, fraud detection is certainly a goal when reviewing a mortgage lender's internal control system. Recent problems concerning insiders at some mortgage lenders have some commonalities. Potential red flags that could signal fraud include the following situations:

- Management that is hostile or uncooperative towards examiners.
- Significant insider transactions that the mortgage lender improperly approves or fails to full document.
- Basic internal control deficiencies, such as failure to separate functions or rotate duties.
- Poor or incomplete documentation.
- Financial accounting systems and reports are unreliable, underlying controls are deficient, or the reconciliation process is lacking.
- Repeated and significant Lender Financial Report reporting errors.
- Continuing unsafe and unsound conditions. You should be aware of the potential warning signs of fraud and the examination and audit procedures that you should employ when warranted. If you encounter any red flags, you should bring the situation to the attention of the EIC and Head of Monitoring and Enforcement. For more information, see Manual Section 360, Fraud and Insider Abuse.

Costs versus Benefits

The challenge is to find the right balance between the proper controls and the costs to design and implement internal controls. Excessive control is costly and counterproductive. Too few controls present undue risks.

EXAMINATION APPLICATIONS

Internal Control Questionnaires

The objective of examining the internal control of a mortgage lender is to assess the extent to which management has established internal control procedures and programs to identify and mitigate the mortgage lender's internal control risks. In planning the examination, be aware of the following situations that may suggest that there is a breach in the control system that warrants attention:

- Management does not implement effective procedures to correct internal deficiencies noted in audit reports.
- Management scales back or suspends the internal audit function.
- The internal auditor has an operational role in addition to audit responsibilities. For example, the internal auditor reports through operating management and not directly to the board of directors or a committee. Ideally, the internal audit function should be under the board of directors or the audit committee, and the internal auditor should report directly to them. The extent to which the internal auditor reports to management may warrant attention to ensure that such reporting does not impair the independence of the internal auditor.
- The mortgage lender's external audit firm lacks mortgage lender or bank audit experience, or the auditors assigned have limited experience.

- The mortgage lender enters new areas of activity without first implementing proper controls, or engages in new activities without experienced staff and appropriate controls in place.
- The mortgage lender fails to provide adequate reports to the board of directors.
- The mortgage lender does not have proper controls in high-risk areas.
- The mortgage lender often deviates from board approved policies with exception documentation.
- The mortgage lender fails to effectively segregate duties and responsibilities among employees.

Level I Procedures

Review the list of objectives in the Internal Control Program, included in the Appendix of this Manual section, and follow the Level I Procedures to design the examination. These procedures are generally sufficient when a mortgage lender has an effective internal audit function. Although the five components of internal control provide a useful framework for you to review the effect of an entity's internal control in an examination, they do not reflect how the mortgage lender considers and implements internal control. Therefore, you should consider the five components in the context of the following criteria:

- Size of the mortgage lender.
- Organization and ownership characteristics.
- Nature of the mortgage lender's business.
- Diversity and complexity of the mortgage lender's business.
- Methods of transmitting, processing, maintaining, and accessing information.
- Legal and regulatory requirements.

Management's Responses

MFA sends questionnaires to the mortgage lender as part of the pre-examination information. Mortgage lender management answers the Internal Control Questionnaire, which contains questions regarding the overall internal control system of the lender. You should verify answers provided by management to ensure that the answers accurately reflect the mortgage lender' activities.

In both the Internal Control Questionnaire, there are certain "flagged" questions that are the minimum verifications you should perform.

Internal Audit Work Papers

Examine samples of work papers from internal audits, and include samples from outsourced functions or director's examinations. The samples should be sufficient to provide a basis to validate the scope and quality of the mortgage lender's internal control system, and determine the amount of reliance, if any, you can place on the system. Review also, whether the external auditor communicated any reportable conditions, either orally or in writing, to management. If you determine that external audit work papers are necessary for your review, contact the Head of Monitoring and Enforcement before requesting external audit work papers, or other pertinent documents related to the external auditor's judgment about the mortgage lender's internal control. See Manual Section 350 for requesting external audit work papers, Appendices D and E. Make requests for work papers specific to the areas of greatest interest. The request may include related planning documents and other pertinent information related to the internal control areas in question. If management or the internal auditor refuses to provide access to the work papers, contact the EIC and Head of Monitoring and Enforcement. If the internal audit work papers review or the external auditor's communications with management on reportable conditions raises concerns about audit effectiveness, discuss the issues with management, the board of directors, and the audit committee. If issues remain unresolved regarding external audit work, consult the EIC and Head of Monitoring and Enforcement.

Level II Procedures

Based on management's responses to questionnaires, or when a mortgage lender does not have an effective system of internal audit, or when warranted based on examination findings, consider expanding the scope of the examination to include Level II procedures provided in the Internal Control Program. Also perform appropriate Level II procedures if the mortgage lender outsources any significant activities and Level I procedures are insufficient to determine how the mortgage lender controls the outsourced activity. Issues that would require expanded procedures under Level II include:

- Concern about the competency or independence of internal auditors
- No internal audit program is in place.
- Unexplained or unexpected changes occurring in the internal or external auditors, or significant changes occurring in the audit program.
- Inadequate controls in key risk areas.
- Deficient audit work papers in key risk areas, or work papers that do not support audit conclusions.
- High growth areas exist without adequate audit or internal control.
- Inappropriate actions by insiders to influence the findings and scope of audits. If significant concerns remain about the adequacy of internal control, the next step, after completion of Level II procedures, should be to consider expanding the scope of the review to include procedures under Level III of the Internal Control Program. The following situations may warrant Level III procedures:
- Account records are significantly out of balance.
- Management is uncooperative or poorly manages the lender.
- Management restricts access to records.
- Significant accounting, audit, or internal control deficiencies remain uncorrected from previous examinations or from one audit to the next.
- Internal auditors are unaware of, or unable to sufficiently explain, significant deficiencies.
- Management engages in activities that raise questions about its integrity.
- Repeated violations of law affect audit, internal control, or regulatory reports.
- Other situations that you believe warrant further investigation.

Consult with the EIC or Head of Monitoring and Enforcement to determine which procedures you should perform.

OUTSOURCING RISKS

Mortgage lenders rely increasingly on services provided by third parties to support a wide range of activities. Outsourcing, both to affiliated companies or third parties, may help manage costs, improve and expand services offered, and obtain expertise not internally available. At the same time, reduced operational control over outsourced activities may expose a mortgage lender to additional risks. Outsourcing involves some of the same operational risks that arise when a mortgage lender performs a function internally. Such risks include the following:

- Threats to the availability of systems used to support customer transactions.
- The integrity or security of customer account information.
- The integrity of risk management information systems.

Under outsourcing arrangements, however, the risk management measures commonly used to address these risks, such as internal controls, are generally under the direct control of the service provider, rather than the mortgage lender that bears the risk of financial loss, damage to its reputation, or other adverse consequences.

MFA expects mortgage lenders to ensure that controls over outsourced activities are equivalent to those that the mortgage lender would implement if they conducted the activity internally. The mortgage lender's board of directors and senior management should understand the key risks associated with the use of service providers. They should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance. See discussion of outsourcing in Manual Section 355, Internal Audit.

REFERENCES

Appendix A: Questionnaires

This discussion briefly addresses subjects in the Internal Control Questionnaire. The mortgage lender completes this Questionnaire as part of the pre-examination information. You should follow up with an interview and indicate on the form any answers that you verified. The mortgage lender must explain negative responses and you should review through interview and observation any problems needing supervisory attention. Many of these topics are somewhat self-evident and the Manual covers others in more detail in other sections.

Internal Control Questionnaire

Internal Audit

Mortgage lenders should have an internal auditing program that is appropriate to its size and the nature and scope of its activities. Mortgage lenders should follow specific procedures to test accounting information and internal routine and controls. Preferably, the internal auditor should report findings to the board of directors or an audit committee consisting of outside directors. Internal audit reports should include suggested corrective actions to noted problems. The board or audit committee should ascertain whether management made adequate corrections when recommended. A full-time internal auditor should preferably serve the board or audit committee. If this is impractical, at least the board or audit committee should review the auditor's performance. It should set the salary to keep the auditor independent of the audit subjects, especially top management. Refer to Manual for Supervision Section 355, Internal Audit.

General Items

The records and systems should enable others to trace any given item as it passes through the mortgage lender's books. Exception or large item reports list all transactions over a specific amount, regardless of whether they involve cash, check, etc. The mortgage lender should have a person not involved in the transaction review the report for unusual items. You may suggest to management that they create such reports if the mortgage lender does not currently prepare them.

Cash and Cash Items

Cash items are "near cash" checks received as deposits from customers in settlement of due installments. In the normal course of business, the mortgage lender sends these items to a correspondent that collects them from the drawee institution. The mortgage lender receives immediate credit for them. The correspondent will return some items as near cash items in which the mortgage lender will have to resend for collection again. Management should use software controls and a daily drawing on uncollected funds report to monitor these checks.

Mortgage lender (Official) Checks

Many mortgage lenders use checks drawn on their accounts with banks for payment of expenses, interest, dividends, and loan proceeds. The mortgage lender must honor its own checks or risk its reputation. For these reasons, management must have policies in effect to control official checks. One common control is to require two authorized signatures. If management does not require two signatures, someone without signature authority should control the unsigned blank checks. This person should fill out the check amount and payee based on an approved voucher. The approving officer should compare the voucher to the check before signing it. Ideally, the appropriate staff person should verify unused check supplies to a shipping invoice to ascertain that the supply has not been lost and subject to misuse. After checks are paid, someone should review the checks for authorized signatures and compare them with vouchers for alteration. Someone should reconcile copies of outstanding checks to vouchers and the respective liability accounts.

Due from Banks
Due from banks describes assets that consist of demand and time deposits maintained in financial institutions to facilitate the transfer of funds. Also called correspondent bank balances, these accounts enable the transfer of funds between financial institutions, resulting from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of short-term funds, and from many other causes. Shortcomings in procedures and controls, as they relate to due from bank accounts, can lead to manipulation and shortages. The mortgage lender must check incoming statements from banks to record copies in each instance to protect against fraud and errors.

Investments and Securities
Transactions in investment securities are typically large and involve liquid movable assets, thus making controls in this area very important. To ensure accurate records as well as discourage fraud, appropriate staff should implement the following controls:

- Document transactions and maintain them separately from the initiating officers.
- Record all transactions and all holdings in a securities ledger system.
- Reconcile the transactions and the securities ledger to confirmations and broker statement daily.
- Reconcile transactions and the securities ledger to the general ledger at least monthly.
- Maintain accrual accounts to ensure income is collected.
- Review broker statements and confirmations and reconcile them to the books before they go to the investment officers (this action limits the chance of abuse by unauthorized officers in concert with brokers).

Management should enforce policies that limit, by amount, board granted investment authorities. They should require dual approval for unusually large transactions. Management should make this policy clear to brokers doing business with the mortgage lender. Brokers should never have the authority to manipulate mortgage lender assets without prior approval for every transaction. Investment advisors should advise the mortgage lender, not the broker.

General Lending To control the income from loan originations, management should provide a written schedule of fees and interest rates for originators to follow. Loan administration personnel should test loan originations to assure compliance with policy. Mortgage lenders must establish a lending limit to prevent over-lending to any one borrower. Loan administration should enforce the limit by ensuring that it does not fund loans in excess of the mortgage lender’s legal lending limit. The internal auditor should report any excess loans to the board of directors. Management should base the general reserve (allowance for loan losses) on an internal asset review (IAR). They should then periodically review the credit quality and collectibles of the mortgage lender’s loans and leases. Staff members that review and grade assets as part of the IAR should not be responsible for originating or servicing activities. Loan originators may request loan disbursements.

Until loan administration verifies that the disbursement is in agreement with the contract and the loan complies with policies, management must not authorize the disbursement. Loan administration staff should obtain and verify credit information. They should not be involved in the loan origination. These are essential segregation of duties preventing loan officers from misapplying funds. Internal lending limits are an extremely important control. The board of directors should implement all of the following safeguards:

- Set low individual lending limits for all officers.
- Require two or more officers to co-approve larger loans.
- Require advisory committees to co-approve especially complex or very large loans. All loans not meeting strict board approved limits and policies should require prior board approval before commitment or funding. A central loan (or liability) ledger should tie together all direct and indirect credits and commitments for each borrower. Otherwise, the mortgage lender runs a risk of lending too much to one borrower in violation of internal policies or regulations.

Construction Lending

Construction lending involves many disbursements to cover construction costs as construction progresses. The mortgage lender must have a construction inspector on site to verify that requests for funds (draws) are legitimate. The inspector should check to make sure material is on site and that the contractor follows construction plans. It is also prudent to occasionally alternate inspectors at each site.

Their supervisor should occasionally perform a review inspection to ascertain that inspections are reliable. Before disbursement of funds, loan administration should match inspection reports to draws. They should compare them with construction plans to ensure that work is progressing accordingly. Loan administration should never authorize cash disbursements. Staff should not make payments to third parties directly. To prove that a borrower received funds, the appropriate staff should make the payments to the borrower's account for payment of specific draws. Checks, however, may be payable jointly to the borrower and a supplier or subcontractor. When a contractor provides paid bills and materialmens' lien wavers, staff should compare them with draws to be certain that the loan funds will pay for actual expenses.

Loan administration should compare progress from draws with construction plans to ensure that they are not funding cost overruns without due consideration. Refer to Manual for Supervision Section 213, Construction Lending. *Loan Servicing and Recordkeeping Functions* After loan approval, staff should take the following steps:

- Maintain records under careful control to ensure that collection will be possible if legal action is necessary.
- Keep all collateral secure, so it cannot be lost, stolen, or released to the borrower early.
- Place collateral under dual control so that employees do not release it in error or through collusion with a borrower.
- Maintain complete collateral documents to ensure perfected collectible liens.
- Control advance payments on loans with appropriate accounting procedures.
- Whenever possible, cross-collateralize loans with the same obligor, that is, all collateral should cover all loans of the obligor.

Loan administration must be careful to adjust interest rates according to contracts. Collection efforts should follow official procedures to avoid legal complications. Collectors should keep log of all contacts with delinquent borrowers, detailing any promised action. Management should use insurance ticklers to ensure that borrowers pay insurance premiums on time.

Accrued Interest Receivable

To prevent diversion of interest earned by the mortgage lender and to ensure that interest calculations are correct, the appropriate staff should perform audit tests on interest calculations.

Advance Payments by Borrowers for Taxes and Insurance Borrowers often make regular payments to a mortgage lender for real estate taxes and insurance on collateral real estate. The mortgage lender credits these funds to escrow or impound accounts. Staff should analyze these accounts annually to make sure the mortgage lender is receiving adequate funds to cover the next expense payments. As a further control practice, the mortgage lender should send the borrower an annual statement of escrow account activity. It should involve the audit department in any customer disputes.

Loans in Process
The mortgage lender typically places funds allocated for construction loans in a "loans-in process" (LIP) account and pays draws from this account. Management should review, approve, and audit draws from LIP to ensure proper application of funds. Refer to Manual Section 213, Construction Lending.

Commercial Lending
The variety and risks of commercial lending require administrative controls on both information and collateral. Management should put a tickler system into operation to ensure timely requests for financial statements from borrowers and guarantors, and to track exceptions. Qualified persons should evaluate collateral and appraise it for adequacy. Management should control collateral release to prevent loss from untimely release.

Credit Quality Review
Credit quality review, also known as the internal asset review or the internal classification review, is a vital credit quality control program. Refer to Manual Section 260, Classification of Assets.

Real Estate Owned and Other Repossessed Assets
The mortgage lender must establish ownership of real estate, acquired because of debts previously contracted according to local laws and customs under legal advice. Accounting practices require a prompt appraisal to determine the correct carrying value of the new mortgage lender asset. Management must periodically inspect properties for needed maintenance to limit deterioration. If properties have material value, the mortgage lender's management should bond collection and management agents, or at least ensure that they are bondable. The mortgage lender should acquire hazard insurance, when available. Refer to Manual Section 251, Real Estate Owned and Other Repossessed Assets. *Real Estate Held for Investment*
Management should control each parcel separately to provide for informed decisions to hold or sell. They must maintain accounting controls to create reliable records.

Fixed and Other Assets
While these assets may not require as much attention as others, management must maintain routine accounting controls as support for the general ledger and tax returns. Refer to Manual Section 250, Other Assets/Liabilities, and Section 252, Fixed Assets.

Deferred Credits

Generally accepted accounting principles require recognition of loan origination fees as income over the life of the loan in accordance with accounting principles. The mortgage lender should carry such deferred income as a deferred credit. See the Manual for Supervision Section 251, Real Estate Owned and Other Repossessed Assets, for comments on accounting conventions for sale of these assets.

Other Liabilities
Management should periodically review miscellaneous accounts to deter misuse. These accounts should be minimal.

Capital (Reserves, Undivided Profits, etc.)
Management must carefully control all changes in the ownership records of the mortgage lender through the officially designated registrar. Management should report all capital account entries to the board of directors. Refer to Manual for Supervision Section 110, Capital Stock and Ownership.

Funds Transfer Questionnaire

Background Information
Transfers may originate internally or externally. They can be among internal accounts or external accounts and can involve one customer or many customers. Essentially, all transfers are instructions by an authorizer to debit an account at an institution for credit to another account at either the same or another institution. For this discussion, funds transfer includes the transfer of control over funds, to a mortgage lender. External transfers are payments involving more than one depository institution. All mortgage lenders engage in transfers. Most are involved in large transfers relative to their capital accounts, and blanket bond coverage with deductibles. Mortgage lenders, without deposit Accounts, may not have a large volume of transactions. Many routine control procedures exist that can limit risk from funds transfer activities. The procedures in use must be compatible with the following parameters:

- The volume of activity the mortgage lender expects related to capital.
- Insurance coverage and deductibles.
- The size and diversity of the mortgage lender's staff. Mortgage lender management must ensure that staff encrypts all data transmissions using algorithms. This protects information from improper disclosure or alteration.

Transfer Process
Mortgage lenders may execute external transfers through any of the following means:

- Official (drawn on us) checks
- Drafts on correspondent accounts
- Customer checks or drafts
- Computer link to independent transfer systems
- Direct computer link to a correspondent
- Voice telephone (voice transmission) call to a correspondent.

Common Effective Control Procedures Authorizations may be specific or general. General authorizations may be blanket for any amount or repetitive for the same amount. A general\ authorization must include who may give instructions to make transfers, how much the transfers can be, and when the transfer can occur.

Transfers of funds outside of the mortgage lender (external transfers) must be through accounts of the mortgage lender at correspondents. The appropriate mortgage lender personnel should initiate the transfer through regular communication channels. Daylight overdrafts are overdrafts existing between the daily closing of accounting records. Even when daylight overdrafts are properly controlled, they are a credit risk. If inadequately controlled, daylight overdrafts may be a very serious transfer risk. When a correspondent permits daylight overdrafts, funds available for transfer may be virtually unlimited and may be unrecoverable. To facilitate maximum volume of transactions, controls on daylight overdrafts usually do not prevent excessive over drafting; instead, they stop continued over drafting after the mortgage lender exceeds a certain limit. For this reason, internal controls on external transfers must be rigid and subject to frequent testing and review to discourage and prevent loss.

Other common control safeguards include the following procedures:
- Limited signing authorities.
- Dual controls over forms.
- Supervisor's key controls on computer terminals.
- Unique passwords for transfer clerk (sender) and releaser.

You should check whether the institution has routines that require action by two people to complete a transfer, one to receive or initiate the request and another to confirm authenticity. Due to the detail involved, you should review the internal controls on funds transfers by interview and observation rather than by audit methods. Any procedures allowing one person to remove unlimited funds from an account without immediate detection should receive report comment and follow-up at the next examination. Initiate enforcement action to correct unsafe and unsound operating procedures whenever mortgage lender management is uncooperative in resolving inadequate controls.

SECTION: Technology Risk Controls 341

INTRODUCTION

Financial institutions, including mortgage lenders, operate in a technology-intensive industry. Almost all aspects of operations are automated and most business transactions are consummated without the exchange of currency. Instead, transactions are stored, processed, and transported electronically using information systems and technology. Financial institutions have long stored information in electronic form. Historically, however, transaction entry remained largely a manual process, providing a traditional paper trail through which the accuracy of electronically produced output reports could be verified. Today, advancements in communication technology are increasingly replacing institution-controlled, paper documented transactions with electronic entries initiated by customers, by telephone or PC, etc. Financial institutions need new methods to control transaction input, to ensure its accuracy.

Institutions are also becoming more dependent on electronic information to make strategic and daily management decisions. Institutions use computer models to:

- Develop budget projections and business plans.
- To underwrite loans.
- To measure interest rate risk.
- To manage assets.
- To produce loan documents and consumer protection disclosures.
- To measure management performance.
- Manage virtually every other aspect of financial institution activities.

Increasingly, institutions download electronic data from third parties, such as credit bureaus, and run that data through a variety of internal electronic decision models. Institutions use the results to determine:

- Where to market their products.
- How to price them.
- Who to grant loans to.
- What the terms should be.
- When to cross-market other products.
- When to adjust credit limits or interest rates on individual accounts and by how much.
- To determine the most effective collection strategy.

As this dependence on electronic information grows, it is increasingly important to take appropriate measures to ensure the integrity of the input, to protect against corruption of the data or the programming, and to test the accuracy of the output. Risks are inherent in all electronic capabilities. Threats can come from both internal and external sources. Outside hackers, disgruntled employees, and inadvertent errors can adversely affect reliability. Unauthorized parties may inappropriately alter Web sites or hackers may initiate denial of service attacks to prevent customers from transacting business. Electronic mail containing confidential or proprietary information may be distributed in error. Unauthorized parties might access networked systems that are directly connected to an institution's main operations database, revealing sensitive data.

At the same time, traditional information integrity and availability responsibilities and risks continue to be present. Management's responsibility to protect records from fires and natural disasters predates what we call technology, but the responsibility to safeguard the confidentiality of customers' records is the same whether that means physically restricting access to ledger cards and file vaults or establishing and maintaining logical access controls such as strong password and log-on practices to protect information stored in electronic form. Institutions increasingly are seeking control enhancements to mitigate risks that impact data integrity and data availability, and provide new opportunities to remain competitive, enhance profitability, and improve customer service.

Recent lessons learned from Year 2000 renovation work, use of the Internet as an alternate delivery channel, and regulators' emphasis on risk management processes are\ prompting institutions to give greater attention to planning for use and control of information technology. The Year 2000 project was one of the most expensive and resource-intensive information technology challenges ever faced by the financial services industry. The project posed a technology-based problem that had to be managed on an enterprise- wide basis by more than technology experts. It transcended corporate boundaries and hierarchies and required organizations to work together to review information technology (IT) systems and business practices and develop a comprehensive strategy to address technology related risks\ and business continuity plans.

This manual section, which supplements Section 340, Internal Control, describes a safety and soundness examination program to evaluate technology risk controls. If management does not identify and address technology risks, problems such as unauthorized access to records, data integrity deficiencies, inadequate disaster contingency planning, interruption of customer service, lack of internal controls and fraud can cause significant losses for the institution. You can use this examination program to determine if an institution's controls are adequate to reasonably ensure a safe, sound, and secure infrastructure for use of information technology. We generally refer to "you" as the safety and soundness examiner. When necessary, we make the distinction between regular examiners (Safety and Soundness [S&S]) and those with special expertise in Information Technology (IT).

INFORMATION TECHNOLOGY IN LENDER INSTITUTIONS

Financial institutions have a number of choices available to meet their information systems and technology needs. Many lenders outsource most of their data processing functions to one or more third-party service providers; these are sometimes called "serviced lenders." A much smaller portion of lenders maintain internal data centers to run software licensed from vendors or developed in-house. Some lenders rely on IT from parent companies.

Mixes or hybrids of these basic approaches are common. A lender might contract with one service provider for its general ledger systems, with a second service provider for loans, and with a third for its web site. The same lender might use licensed software for certain investments and interest rate risk analysis and might use complex spreadsheets developed in house for some asset quality and board reports. In addition to doing business with the primary and secondary service providers, most lenders are interconnected with various other entities. And, most lenders now maintain one or more internal networks known as Local Area Networks (LANs) or Wide Area Networks (WANs). More and more of the internal networks are configured in a client-server environment. Each of these arrangements requires a different type and level of management involvement with regard to data integrity controls, security measures, and business continuity plans.

Outsourcing

Many lenders, including large entities, use outsourcing to some extent. Contracts with service providers typically provide for a standard package of routine and standardized services and reports and allow for some special reports. Additional costs may be incurred for certain special reports or for nonstandard processing of standard reports. Client institutions may request services and products beyond those provided for in the contract, for example, for a new loan product. Clients generally must pay extra for unique software requirements that are not enhancement priorities to the provider/ vendor and client-base at large. In these situations, institutions frequently build their own supplemental systems (for example, using PC-based applications) to augment outside products and services.

The delegation of data processing or other technological functions to a third party requires reasonable due diligence in selecting and contracting with service providers and vendors, and in monitoring performance. Conditions, rights, and responsibilities of the institution and the third-party service provider or vendor should be governed by written agreements. This is particularly important in an electronic environment because short-term engagements, new developments, and untested entities are not uncommon. Further, management must coordinate all outsourcing arrangements to ensure that security, reliability, and integrity are not compromised.

Independent Service Providers

Contracting with independent service providers is common at lenders of all sizes. An independent service provider can provide experienced staff, proven software, and reliable hardware that might otherwise be difficult if not cost-prohibitive for an individual lender to maintain. However, the selection of an independent service provider is important. Most contracts are long-term, and it is important that the institution ensure that the service provider can deliver the appropriate type and quality of service that the institution will need over the life of the contract. If the service provider does not provide the needed services, or cannot promptly add services the institution needs later to meet market conditions, it may constrain the institution's operations. For example, its choice of loan products may be more limited than what changing competitive factors might otherwise dictate. Similarly, dissatisfaction with a service provider will typically lead to a conversion from one data service provider to another. While converting to a service provider that better meets the institution's needs is a business decision, and not automatically a regulatory concern, conversions can be disruptive to the normal flow of business. Fees or penalties for early contract termination can be considerable. Appropriate upfront due diligence and planning should help institutions avoid unnecessary conversions.

Most serviced lenders have one primary service provider and one or more secondary service providers. Typically, the primary service provider is responsible for (and paid for) ensuring compatible setups, connections and data transmissions with the secondary service providers as well as with other companies and entities included under the technology umbrella. Data is forwarded to the service provider's computer center, usually via on-line data entry terminals. Output reports are available at the institutions on line terminals and printers, or in some cases, or for certain reports, hardcopy or microfiche reports may be delivered. Client institutions are responsible for establishing and maintaining appropriate controls over those portions of the serviced systems that are under their control. Other common controls that clients, rather than service providers, are responsible for include certain balancing and reconciling activities. Client responsibilities should be addressed in the contract and may be discussed in greater detail in other documentation from the service providers or independent auditors conducting third-party reviews (discussed later). Lender management is also responsible for ensuring that employees are properly trained on the systems they use and related control steps.

Affiliated Service Providers
Lenders that are part of a holding company structure may have an affiliated company handle their technological needs. This may be a department of the holding company or a separate affiliated company. This frequently happens where there are several financial institutions with common ownership. The related institutions can eliminate some duplication of efforts and equipment and realize economies of scale. Where there are such contracts or arrangements, Transactions with Affiliates provisions may apply. For additional information, see Section 380 of this Manual.

In-House Computer Centers
In-house computer centers vary in size and complexity. Computer equipment may vary in size from large “mainframe” to smaller microcomputer systems. Also, the level of responsibility assumed by the institution can vary. Under the traditional in-house computer arrangement, the lender would own the hardware and would be responsible for developing, maintaining, and operating the program. However, most lenders have implemented a hybrid arrangement, where they outsource some of the responsibilities traditionally associated with in-house systems. One type of hybrid arrangement is often referred to as a turnkey operation. Under this type of set up, lenders will acquire software from a third party, and run the software on equipment owned and operated by the lender. One variation of a turnkey operation is when a lender enhances the standard software to better suit their information needs. The additional programming is referred to as “surround code.” Facilities management is another type of IT environment occasionally seen in financial institutions. In these cases, the financial institution has an in-house data center, but employees of a service provider provide the programming and operate the systems.

Other “Internal” Technologies Whether the institution’s main data processing functions are handled internally or outsourced, some technologies common to most financial institutions have emerged in recent years.

End-User Computing
With the advent of PCs, lender officers and employees began creating applications to supplement those provided by service providers or internal data centers. As PCs and software applications simultaneously became more powerful and easy to use, and downloading information from service providers and in-house data centers became more feasible, these business users, as opposed to IT professionals, created yet more complex “end-user” applications. These business users may create new software programs or mini-programs or customize existing routines from vendor software. PC users originate data, download and manipulate information from main databases, and upload data to secure databases. Each of these activities can create information that management may use to make decisions that affect corporate strategies, customer relationships, and governmental reporting. Management should take steps to implement and maintain control techniques for the programming, testing and documentation of end-user applications to ensure the integrity of the software and the production of accurate reports. TB 29, End- User Computing, contains more detailed guidance on basic controls that should be implemented and maintained in this area.

Computer Networks

The power of PCs also helped information processing to evolve well beyond the traditional central environment to decentralized or distributed networked operations. MFA regulated lenders have one internal network of PCs, whether the lender is serviced or operates an in-house data center. Computer networks offer substantial benefits in productivity and information access. A Local Area Network or LAN refers to a network that interconnects systems within a small geographic area such as a building, or even just a floor or portion of a building. Through PCs or other terminals, users have access to common systems, databases and software; communicate via electronic mail (email), and share peripherals such as printers. A Wide Area Network or WAN is a wider network that connects users in other locations. A lender might have a LAN within its headquarters building and a WAN for its branches to communicate with each other and the home office.

Other types of computer networks include MANs (Metropolitan Area Networks) and VPNs (Virtual Private Networks). These networks provide high-speed interconnection and data exchange and facilitate communications within the institution and between the institution and the users (staff and customers). Institutions using LANs, WANs, or other types of computer networks need to have policies and procedures that govern the purchase and maintenance of hardware and software. They must also establish and maintain sound controls that allow reasonable access to data but also protect data's confidentiality and integrity.

An **Informational Website** provides general information about the financial institution's products and services, and is usually located on a separate server. Informational websites often highlight loan programs, list branch locations and hours, and provide "email" addresses for customers or the public to contact the lender. Some informational web sites provide links to other web sites deemed of interest to their community.

For MFA's regulatory purposes, a **Transactional Website** is defined as one that allows customers to do one or more of the following activities:

- Access an account
- Obtain an account balance
- Transfer funds
- Process bill payments
- Open an account
- Apply for or obtain a loan
- Purchase other authorized products or services.

PROTECTION OF CUSTOMER INFORMATION

A mortgage lender has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic information. MFA intends to establish appropriate standards for the mortgage lenders subject to its jurisdiction relating to administrative, technical, and physical safeguards–

(1) to insure the security and confidentiality of customer records and information;
(2) to protect against anticipated threats or hazards to the security or integrity of such records; and
(3) to protect against unauthorized access to use of such records or information which could result in substantial harm or inconvenience to any customer.

Lenders are expected to create, implement, and maintain an information security program. This program must include administrative, technical, and physical safeguards appropriate to the size and complexity of the institution and the nature and scope of its activities. This process require a lender to:

- Identify and assess the risks that may threaten customer information.
- Develop a written plan containing policies and procedures to manage and control these risks.
- Implement and test the plan.
- Adjust the plan on a continuing basis to account for changes in technology, the sensitivity of customer information, and internal or external threats to information security.

The guidelines also set forth an institution's responsibility for overseeing outsourcing arrangements. MFA examination procedures include review activities to determine an institution's level of compliance with the enacted regulatory guidelines in this regard.

TECHNOLOGY RISK CONTROL ACTIVITIES

The level of technical knowledge required by boards of directors and senior managers varies depending on the size and nature of its operations, and by the degree of complexities within its technology environment. Nonetheless, directors and senior officers should have a clear understanding of the risks posed by technology, provide clear guidance on risk management practices, and take an active oversight role in monitoring risk mitigation activities. Institutions must establish and maintain adequate functional control systems so management can identify, measure, monitor, and control information technology risks that could adversely affect performance or pose safety and soundness concerns. Similar to basic internal controls, institutions should design technology risk controls to prevent errors and problems that realistically can be prevented and to promptly detect and address those problems that do occur.

Risks may be grouped as following:

- Information Integrity Risk
- Business Continuity Risk
- Vendor Management Risk.

Although the volume and mix of risks will vary depending on the institution's technology environment, each of these types of risk is present at all lenders. The board of directors and senior management must take steps to prevent, to the extent feasible, the exploitation of any of these risks and to quickly detect and resolve weaknesses and breaches.

Management Oversight

In addition to control activities already discussed, management and board of director oversight responsibilities includes:

- Planning for use of information technology.
- Establishing general control systems.
- Verifying (or auditing) those controls.
- Educating and supporting information technology users, including both staff and customers.

Planning and Implementing Information Technology

Technology is ever changing. From time to time, management will determine to upgrade various parts of its technology environment. This may entail adopting new technologies; upgrading hardware or software; or converting its "environment" (e.g., outsourcing systems previously operated internally or vice versa, or switching from one service provider to another). Institutions should have an information technology plan that establishes the framework for the deployment and operation of technology. Management should update the plan annually to coordinate technology initiatives and activities to the business planning process. Technologies in place should be subject to periodic review to evaluate performance against current strategic plans and objectives, technological developments, and operating policies and procedures. The substance and form of any formal plan will vary significantly, depending on the complexity of the institution's information systems and technology.

The key element for you to consider is whether the information plan meets the institution's needs. Management should also ensure that appropriate resources, including the correct mix of staff and a realistic amount of time, are brought to bear on program development or upgrade. A common misunderstanding is that limitations of the computer systems inhibit the development of high quality management information systems. In reality, management has sufficient flexibility under most computer systems to design a management information system that meets the needs of the institution. Therefore, business managers should play a significant role in the development and ongoing assessment of information systems.

General Controls

An institution should require additional data controls for technology that is used to process information. At a minimum, these data input and output controls should provide for accurate data preparation before data input procedures, and segregation of duties between the input of information and the review of that information after it is processed. Such controls generally require the reviewer to reconcile the processed information. In situations involving large amount transactions, institutions should require that certain\ functions be performed under dual control. Management should establish appropriate controls in the early stages of development and deployment and the institution's operating policies and procedures should describe them in detail. Certain types of input data do not readily lend themselves to robust verification for accuracy and completeness by means of automated edits. Common examples are data from mortgage loan notes, new-account input forms, and PC-prepared spreadsheets. However, verification procedures may still be warranted, depending on the sensitivity or significance of the data or resulting output. Verification could consist of manually comparing the system output with the source document, or reviewing the data for reasonableness.

Information Integrity Risk

Information is one of an institution's most treasured intangible assets. A major performance factor for institutions is their ability to manage, safeguard, and optimize the use of customer and corporate data. Information must be:

- Available
- Accurate
- Complete
- Valid
- Secure.

Information integrity concerns are sometimes expressed in the following terms: Transactional Risk: This is the risk that weaknesses will cause errors to occur in transactions or will prevent a lender from completing a transaction (or delivering products or services). Individuals may exploit weaknesses to perpetrate fraud via unauthorized transactions. Reputational Risk: This is the risk that real and perceived errors and lapses in information technology compromise the customer's trust in the accuracy of their account records or the lender's ability to safeguard the confidentiality of those records.

Compliance Risk: This is the risk that information technology weaknesses will manifest themselves in errors and omissions that cause the institution to be out-of-compliance with laws and regulations. The weaknesses may or may not be strictly technological. For example, an interest rate risk model might create invalid results due to either faulty programming or inappropriate assumptions. Inaccurate information leads to bad management decisions. Similarly, individuals who perpetrate fraud through technological tools sometimes also employ simple deception – also known as social engineering – to gain passwords from unsuspecting employees. To combat information integrity risk, the institution should have an active corporate information security program that delineates policy, standards, and management responsibilities. In addition to the policy statement, the program should provide for incident response to security exceptions (for example, employee violations and external unauthorized access attempts), security awareness, and training.

To maintain information integrity and confidentiality, management should establish and enforce controls that safeguard information from unauthorized access and use of data, provide for timely detection and correction of erroneous transactions, and provide for complete audit trails of transaction activity.

Management should develop methods to maintain confidentiality, ensure the intended person receives accurate information, and prevent eavesdropping by others. In addition, both the sender and the receiver in a transaction should create undeniable proof of participation. The scope of information security should address all of the institution's information technology activities, including personal computer activities, Internet-based electronic banking services, and processing by the institution's information service providers. Effective security does not rely on one solution. Management should use several types of controls to manage information integrity risk:

- User-ID controls.
- Password controls.
- System log-on and log-off controls.
- Virus protection controls.
- Other controls to limit "powerful user" access.
- In some situations the institution will also need to use firewalls and encryption. User-ID controls, along with password controls, are intended to restrict system access and promote user accountability.

User-ID controls include the following:

- Approval: Management-level staff should approve the issuance of user IDs.
- Uniqueness: Each user ID should be identified with only one user (sharing of user IDs should be prohibited).
- Number of IDs per User: In general, each user should only have one user ID, to promote activity monitoring efficiency and employee accountability. Multiple user IDs are sometimes justified (for example, for technical support reasons), but related approval and monitoring controls should be in place.
- Expired or Discontinued Use: User IDs of terminated employees or expired authorizations should be disabled immediately and deleted from the system based on institution policy.

Password controls include the following:

- Length: Experts recommend a minimum of six characters for passwords.

- Composition: Passwords may be alphabetic, alphanumeric, or other. Many experts recommend alphanumeric passwords and avoiding common words like “password” and the names of professional sports teams. Note, however, that complicated passwords may cause users to write them down, especially if the employee needs several passwords to access different systems or applications, and thus compromise the password’s confidentiality.
- Expiration: Users should change passwords on a regular basis. The more sensitive the system being protected by the password, the more often the password should be changed. Highly sensitive systems should require password changes at least every 90 days.
- Reuse: The institution should restrict reuse of previous passwords (for example, disallow reuse of the last five passwords used).
- Suppression: All systems should suppress the display of user passwords in any form.
- Encryption: The institution should ensure encryption of password files (the vendor usually encrypts password files for outsourced systems). Maintenance procedures should ensure that only the user has knowledge of his or her password. Procedures should allow users to change their own passwords.

Access to sensitive data or powerful processing capabilities should require the use of a password. Institution management should promptly reverse temporary privileges, for example, additional access given to an “acting” teller supervisor or branch manager, when no longer needed.

System log-on and log-off controls should limit the number of unsuccessful log-on attempts a user can make. An added enhancement would be to notify the user, upon successful log-on, of unsuccessful attempts since the last log-on interval. PCs and other terminals should automatically log off after a period of inactivity.

Virus-protection controls include policies and software. Policies should restrict employees from importing software from high-risk sources, such as bulletin boards or informally obtained floppy disks. The institution should install virus-protection software on all PCs and servers. Such software should be updated regularly to protect against new viruses. The institution should establish

Controls to limit powerful user access to system resources. For example, the institution should appropriately limit “Security Administrator” access, usually to no more than two persons, and the Security Administrator should not have access to customer records.

User Access

Authorized managers grant employees access assignments, which are information retrieval and transaction-processing capabilities. Authorized managers may also grant access to no employees such as consultants, vendor systems-support personnel, and others. For purposes of these procedures, “users” are employees and no employees who have authorized system access. For outsourced systems, service providers may set up generic access assignments for various banking job categories in their access control software. In many cases, lenders accept and use the vendor provided access assignments without reviewing or questioning them. This practice increases the risk of inappropriate user access assignments, which in turn weakens controls over user access to sensitive data fields and powerful transaction processing capabilities. To help ensure that user access assignments are appropriate, institution managers should:

- Identify the system’s sensitive customer-record fields (such as account activity status, social security number, and mother’s maiden name) and powerful transaction processing features (such as account-linking capabilities and the ability to increase overdraft limits).

- Assign job responsibilities that provide for proper segregation of duties and dual control over sensitive fields and transactions. Institutions should require dual control when using the system's "supervisory override" capability (for example, when approving a transaction keyed in by a supervisor).
- Assign user information retrieval and transaction processing capabilities according to employees' defined job responsibilities. This step produces user "access profiles."
- Authorize and forward the access profiles to the information security officer for implementation in the system. If you find any inappropriate user access assignments, determine if the condition was caused by either of the following:
- Control deficiencies in the granting of user access assignments.
- Deficiencies in the system's security controls (system rules or software). Common deficiencies in security software controls include:
- Deficiencies in implementing certain security software rules. A common example is the inappropriate grouping ("bundling") of transactions by information security officers who maintain the security software. In such cases, large numbers of transaction screens are inappropriately bundled to ease the burden of maintaining security access rules. However, bundling gives many users more system access than required by their job responsibilities.
- Deficiencies in the use of the system's supervisory override feature. In such cases, the dual control (supervisory override) capability of the software has not been properly invoked over certain sensitive fields (such as the loan account status field) or powerful transactions (such as the ability to modify loan terms).
- Inherent security software deficiencies. For example, the security software cannot restrict access to certain fields within a record. That is, a user granted access to a record could view or update any field in the record. To alleviate this problem, some companies create additional programs to enhance the capabilities of the basic security software. Management should determine the frequency of user access assignment reviews. These reviews should be performed at least annually. Management should document these reviews to evidence the performance of the review and approval of changes made.

Firewalls

Firewalls are a combination of hardware and software placed between two networks through which all traffic must pass, regardless of the direction of flow. They provide a gateway to guard against unauthorized individuals gaining access to an institution's network. Institutions should consider firewalls for any system connected to an outside network. Nonetheless, a firewall does not ensure that a system is impenetrable. Firewalls must be configured for specific operating environments and the institution must review and update firewall rules regularly to ensure their effectiveness.

Encryption

Encryption is the scrambling of data so that it cannot be read without the proper codes for unscrambling the data. Confidential or sensitive data should always be encrypted when being sent over the Internet and the sender and receiver of the data are not behind the same firewall. This includes email containing confidential and/or sensitive information as well as Internet Banking transactions. Management should perform a risk assessment to identify types of sensitive data requiring protection and determine the type and strength of encryption to use for various protected communications. The assessment should include databases and password files.

Other Controls

Other information controls that an institution may use to safeguard information integrity include:

- Secure data storage (sensitive data is encrypted; access is stringently controlled).
- Acknowledgement practices (batch totals, sequential numbering and one-for-one checking against a control file can be used to verify that a transaction is complete or has not been interrupted).
- Modem sweeps (efforts to locate and remove unauthorized modems).
- Physical controls (secure storage of hard copies of sensitive data; locks, alarms, etc.).
- Audit procedures (discussed later in this section). In sum, management should periodically perform a thorough update of its information integrity risk profile and select the appropriate mix of controls to monitor and manage that risk.

Business Continuity Risk

Financial institutions need to be prepared to resume operations as quickly and efficiently as possible after a disaster or other adverse incident. Business continuity risk for an institution relying on one or more service providers includes the risk that it will not be adequately prepared to execute its disaster recovery responsibilities in the event of a disaster affecting the service provider, thereby delaying complete recovery of the institution's financial records. (*Note*: The risks associated with routine service provider system outages are generally low and are not addressed in this Manual section.)

In the context of internally operated systems, business continuity risk is the possibility that the institution will not be adequately prepared to promptly recover from a disaster affecting the computer hardware and software it owns and operates, resulting in significant losses for the institution. An institution-wide contingency plan provides for timely business continuity if there is disruption to the institution's information technology. Contingency planning, also known as business resumption planning, is a process of reviewing an institution's departments or functions and assessing each area's importance and risks to the viability of the organization. Institution management should establish and maintain disaster recovery plans that address all of its mission critical systems whether those are operated internally or outsourced.

Overall, the extent of a preparedness plan will depend upon the level and complexity of information technology and the institution's available resources.
Management should establish requirements for all operating departments to establish disaster recovery plans for their respective areas of activity. The policy may describe the required components of an acceptable disaster recovery plan (for example, individual responsibilities, resources to be recovered, backup location, and time-line for recovery). The contingency plan should cover the following areas:

- Define the roles and responsibilities for each team member in the event of a problem situation.
- Identify the risks posed by each system deployed.
- Detail strategies and procedures for recovery.
- Establish criteria for testing and maintenance of plan.
- Identify the principal departments, resources, activities, and constituencies potentially affected by a problem.
- Assess the response capability of key disaster recovery service. Management should formally appoint and empower individual(s) with the latitude and authority to respond during an incident. A full understanding of the recovery time line is essential. Full recovery, for example, is usually not achieved when the affected system(s) come "back up" or "back on line."

The institution may have to correct transactions that were in process when the disaster or other disruptive event occurred. In some cases, the institution may have to track down and re-enter the entire day's worth of business. Management should periodically test and update the contingency plan as needed. Management may accomplish this testing through walk-throughs, tabletop simulations, or other exercises. Although management is responsible for institution- wide contingency planning, they should consider different factors depending on whether a particular system is outsourced or internally operated.

Outsourced Systems

Disaster recovery plans for outsourced systems should provide for the following:

- Recovery of lost data for re-submission to the service provider (i.e., day-of-disaster online input).
- Management-approved timeline for completion of recovery. It is the service provider's responsibility to provide a recovery plan for its computer processing capabilities in the event of a disaster affecting its computer resources. Management should obtain and review (relevant portions of the) contingency plans of its service provider(s):
- To determine that the institution is reasonably protected.
- To ensure that the institution-wide contingency plan is compatible with its service providers' plans.
- To supplement the external contingency plans with appropriate steps the institution itself should take. The institution's contingency plans for systems involving service providers should do the following:
- Identify all the categories and sources of data input into the service provider's systems by the lender.
- Describe the steps required to recover previously input data and prepare them for resubmission when requested by the service provider. (Institution management should realize that if the disaster takes place on a business day, online data entered on that day will not have been backed up offsite and will likely be lost.)
- Identify the persons or teams responsible for executing the recovery steps.
- Provide a management-approved time line showing key points, from the point of receipt of notification that the service provider has experienced a disaster to the completion of the preparation of input for resubmission.

Internally Operated Systems

The institution needs additional disaster recovery steps for internally operated systems, especially in the area of backup. The plans should provide for the recovery of key resources, including the infrastructure (computer and operating system software), application software, and data (previously backed up data and day-of-disaster data), as well as, one or more alternate work areas/ locations.

Disaster recovery plans for internally operated systems should provide for the following:

- Recovery of lost data (for example, day-of-disaster online input).
- Replacement of damaged resources (such as hardware and software.
- An alternate processing location.
- A management-approved time line for completion of recovery.
- Testing and periodic updating of the plans.

"Recovery" is defined as the point at which application system records (for example, customer balances) have been brought to current status. The recovery time line should provide a breakdown o the various phases of recovery and corresponding elapsed time for each phase of the recovery process. The institution should periodically copy and store certain data and software components of a system at a prudently distant or remote location to facilitate recovery efforts in the event of a disaster. The institution should perform periodic tests, and resolve within an appropriate time period, any problems the tests reveal. In particular, the tests should verify that the backup files are readable, that is, not corrupted by a record-writing problem. Management should document backup procedures and keep a current inventory of files maintained at the backup site(s).

Vendor Management Risk
Vendor management risk is the risk that the service provider will not perform the contract terms and conditions as specified, causing undesirable consequences for the institution's operations. When employing the services of an outside service provider or software vendor, management should carefully review proposed service contracts or agreements or renewals thereof to minimize the institution's exposure to risk. Legal counsel should review the draft contract to determine if the interests of the institution are adequately protected. Before entering into contracts, management should assess and review the following factors:

- Alternate vendors and related costs.
- Financial stability of the vendor.
- Capacity of vendor to stay current with industry developments.
- Requirements for contract termination.
- Contract provisions allowing examination of the vendor.

After signing a contract for services, management should maintain close oversight of the institution's relationship with the vendor. The institution should establish a contract administration process to ensure that the vendor fulfills its contractual obligations. Most IT related contracts specify performance measures for the products or services provided by the vendor. Two common and important measures are online “up time” and “terminal response time.” These performance measures generally have a high impact on the institution's business processes, customers, and employees.

Up time usually refers to the hours and days that online services will be available to the institution. For IT-related contracts, these hours are often the institution's branch operations hours plus two or three additional hours daily. IT contracts should stipulate the vendor's commitment to achieve a high, ongoing level of performance (for example, “99% up time”). Terminal response time usually refers to the standard elapsed time between a user request (for example, the moment when the user presses the Enter Key) and the delivery of information to the user's terminal screen. Current response time standards range from three to five seconds. In addition, contracts often specify non-production- related “deliverables” (products or services) that may enhance the value of the contract for the client. Deliverables may include:

- Commitments to provide the institution with system performance reports.
- Audited financial information.
- Summaries of disaster recovery test results.
- Third-party operations audit reports.
- Other useful materials.

Management should monitor vendor performance. Performance level reports supplied by the service providers should be verified, at least occasionally. Receipt of special services should be verified and payment approved by the business unit receiving those services or the unit monitoring vendor performance. Delivery of non-production deliverables should also be monitored. Senior management should be informed promptly of significant deficiencies in vendor performance.

Audit

Institution management is responsible for design and maintenance of a sound system of internal\ controls that include information technology. The scope of the examiner's assessment of technology risk controls will vary depending on adequacy of the audit function to test and report on those controls. How formal the audit plan is and whether audit work is conducted internally or by external auditors will depend on a number of factors including the institution's size, operations, and technology environment. However, management must ensure that qualified independent (internal and/or external) individuals periodically assess basic technology controls.

The audit plan should provide for review of information technology risks in operations and management activities. This is consistent with an institution's priority to ensure the accurate processing of information, privacy of financial and customer records, and continuation of service in case of business interruptions. In developing audit programs, the institution must consider the full scope of each application to protect financial and information assets, system reliability, and user confidence.

The audit function should cover the flow of critical data through interrelated systems and should generally include the following:

- Tests of balancing procedures of automated applications, including the disposition of rejected and unposted items.
- Periodic samples of customer record files (master files) to verify them against source documents for accuracy and authorization.
- Spot-checks of computer calculations, such as interest on loans, securities, ARM calculations, service charges, and past-due loans.

Some of these audit functions will not be conducted separately as a "technology" audit but may be incorporated into audits of specific departments or lines of business. Lender clients of service providers should obtain "third-party reviews" and take appropriate action in response to control considerations or weaknesses addressed therein. A "third-party review" is a type of independent audit designed to meet the audit needs of financial institutions without overburdening the service provider. That is, without this vehicle a service provider that processes work for several financial institutions could be subject to redundant audits by audit firms for each of its clients. A qualified auditor who is independent of both the service provider and the serviced institutions conducts the third-party review. The scope of the audit should be detailed enough to satisfy the audit objectives of the serviced institutions and the servicer.

In general, the third-party review audits should determine the adequacy of controls in all areas of the data center, including computer operations, systems and programming, and input/output controls. Many of the controls that the third-party auditor is to check at the service provider have companion pieces at the individual financial institution. In the third party review report the auditor typically will address corresponding controls, sometimes known as "client control considerations" that should be maintained at the lender institution. MFA reports covering service providers may also contain client control consideration. You should review these reports as part of the initial assessment of the institution's IT environment.

Training
Institutions must educate and support customers and staff to achieve user acceptance of and confidence in information technologies. Institutions should provide training so participants properly use applications and respond to problem situations. If an institution fails to provide reasonable training and support for customers and staff, the users' commitment to the system is weakened, administrative expenses increase, and avoidable errors occur. These deficiencies raise the risk of data integrity problems, complaints, and possible legal actions. Risk also increases when

an institution fails to educate users on proper security precautions such as locking personal computers and confidentiality of passwords.

Support staff, such as help-line or customer service representatives, should be kept informed of changes and updates to systems. They should be trained on how to execute disaster recovery plans. Management should also provide backup training for key job functions so that human emergencies will not disrupt service.

Internet Activities

The information integrity, business continuity, vendor management, and the management oversight control activities discussed thus far in this chapter pertain to all types of information technologies including Internet activities. This section discusses risks and controls specific to Internet financial activities and other Internet activities.

Internet Financial Activities The level of risk posed by Internet financial activities depends in part on whether the web site is informational or transactional, and if the latter, the nature of the transactions the customer can effect. Informational or information-only web sites are less risky, but not without their vulnerabilities. The web site, for example, may be vulnerable to alteration, so management should establish controls to prevent unauthorized access. Configurations that provide for electronic mail between the lender and its customers require additional controls, such as encryption, to protect the confidentiality of customer's accounts and other sensitive data. Customers should be forewarned about including sensitive data such as account numbers in unprotected emails to the institution. Customer passwords rules should be structured to minimize the potential for unauthorized access.

For example, institutions should not use readily available customer information for the initial default password, such as, ID national number, customer initials, etc. Configurations that permit transactions, including balance/account inquiries, require yet more controls. MFA-regulated institutions intending to establish a transactional web site must file a notice with MFA, of the site opening for business. If an institution implemented a transactional web site since the previous examination, examiners should determine that the institution filed a notice with MFA office. Examiners should contact the EIC to determine if there were any issues that require a follow-up review.

In planning a transactional web site, it is important to consider the implications on the long term goals and strategy of the institution and to have input from all of the parties impacted, including managers from both the business and technology sides of the organization, other internal users, auditors, and customers. Planning should begin with a thorough review of objectives to achieve and areas of risk associated with the new activity. Financial institutions often contract with outside providers to help plan, implement, and maintain Internet financial services. If this is the approach used, institutions should exercise care in selecting a service provider.

Also, institution management should give someone in the organization responsibility for monitoring and overseeing their performance on an ongoing basis. In this regard, it is crucial to negotiate a contract that clearly addresses both parties' rights and responsibilities. Security and internal control are major concerns. Data encryption can be used to protect data and verify the identity of parties communicating online.

An array of firewalls and intrusion detection systems are available to help protect data from theft or alteration. It is important to recognize, however, that those systems do not provide complete protection from attack, and all must be continually monitored and maintained. It is also important to augment electronic security measures with adequate physical security and procedural controls. When adding a transactional web site, institutions need to review and update access to PCs and data, power protection, back-up files, physical locks, security guards, and other common security measures. Institutions should anticipate the consequences of high demand for electronic services or interruption of service. Institutions should update contingency and recovery plans to address the new activities.

Before opening the transactional web site for use by customers, lenders must update and approve policies and procedures, train employees, and thoroughly test the systems. A plan for periodic risk assessments and audit review should also be in place. Institutions should schedule periodic testing by independent experts in computer security issues, and obtain and review such tests that are conducted for the institution's service providers.

Consumer Compliance and Privacy Issues
The lender must address consumer compliance and privacy issues in the context of online business. Compliance and legal staffs should review and update procedures for information posted to the web site and all types of transactions to be conducted online.

General Internet Activities Management should have policies and controls in place to govern the general Internet activities of its employees. These should include: Software import: Rules designed to minimize risks (viruses, or other damaging program code) associated with the downloading of software over the network or other sources.

Browsing the Internet: Rules should require the browser to be configured to only access the Internet through a designated firewall and restrict the downloading of certain files. Encryption: Encryption may be needed to protect sensitive information in transit, such as electronic mail messages, a file being downloaded, or information in storage (for example, databases).

EXAMINATION COVERAGE
[Need for specialized IT examiners is unknown in this early stage of market development.] Examination coverage for technology risk controls is assigned for each lender MFA regulates. In general, information technology (IT) examiners review technology risk controls at those institutions that host their own web sites or that otherwise have complex operations and activities or difficult or non-routine situations.

Safety and soundness (S&S) examiners review technology risk controls at the remainder. This remainder actually represents the great majority of lenders. Most serviced lenders will have their technology risk controls evaluated at a regular examination by an examiner, but examiners may also examine other lenders, including some with in-house data centers or mixed environments.

The Head of Monitoring and Enforcement will determine when to assign IT examiners by considering the following factors:
- Recent or pending systems conversions.
- Recent or pending mergers and acquisitions.
- Volume and nature of in-house IT operations.
- Existence of novel or complex applications, systems, networks, or equipment.
- Volume and nature of servicing or software from non-examined entities.
- Problems and concerns at previous examinations.

These factors do not automatically require the presence of an IT examiner, but are indications that may warrant further consideration of such. Similarly, the preceding list does not illustrate the universe of situations that may require the involvement of IT examiners. You should consult with the IT Department on technology concerns that arise during planning, scoping, or conducting an examination. Such consultation helps ensure proper evaluation and consistent regulatory treatment. The access and speed capabilities can magnify risk in an electronic environment.

This is particularly true if risk management control programs are ineffective or if a system is linked to an institution's central operations or databases. In other words, an institution can be exposed to significant risk even if activity volume is nominal. Consult with your IT Manager if you have any questions about technology risk exposure. Expanded investigation and analysis may be necessary for some situations, especially significant internal control weaknesses. The examiner completing this program, the examiner in charge (EIC), the IT Manager, and other appropriate staff should determine what additional procedures are needed, who should perform them, and whether to do them at the current examination or at a future safety and soundness or IT examination.

Examiners should review technology risk controls at all lenders that are not examined by IT examiners. Technology may have a positive or negative effect on customer service and operating efficiencies, depending on what technologies are employed and how. The availability or unavailability of data and its completeness and accuracy affect decisions in every area of operations. The board of directors and management cannot delegate responsibility to service providers, software vendors, or in-house technology staff, but must ensure that adequate controls exist throughout the organization.

The review of technology risk controls is not a stand-alone task completed by just one examiner. Throughout the examination, all examiners assess the quality and reasonableness of data provided by the institution. For example, examiners evaluating asset quality depend on accurate and complete records of originations, delinquencies, and concentrations for just a few examples. Instances of data that appears questionable or inconsistent and instances of weak controls should be pursued and adverse findings should be relayed to the EIC and the examiner. In addition, examiners should be sensitive to how the adequacy of the institution's management of information technology can impact our evaluation of each of the CAMELS areas. Listed below are examples of various aspects of information technology and how they impact the CAMELS components.

Capital and Earnings: Information technology may have a positive or negative impact on earnings and capital. The outcome is influenced by several factors.

- Appropriate use of technology can help lenders improve profitability and ultimately build added capital. On the other hand, adverse impacts could take place if technology acquisitions that are not well coordinated fail to achieve business plan requirements.
- Successful information systems conversions result in meeting tangible and intangible benefits. Poorly executed systems conversions can create large quantities of unposted accounting entries. The resources and time needed to research unposted items increase expenses, and delays in clearing the entries may result in increased charge-offs and dissatisfied customers.
- Using outside vendors may reduce the lender's capital investments, but may also unnecessarily increase annual expenses and reduce control and flexibility over processing. Long duration contracts with vendors pose risks to a lender's future

earnings and overall performance if the contract process is not closely tied to the corporate business planning.
- Appropriate processing controls are needed to ensure proper reporting of the Prudential Report and various securities filings.

Asset Quality: Institutions use information technology extensively for processing new loan applications, servicing large pools of loans, and monitoring loan portfolios in a competitive marketplace. Other aspects of automation include the real estate appraisals, loan approval processes, and secondary mortgage activities. Areas involving technology risks may include:
- Decision support software such as credit scoring used to enhance the credit granting process.
- Internet-based delivery channels.

Management: CEOs and boards of directors are increasing their involvement in information technology decisions. Technology touches every aspect of the institution's operations, and impacts earnings, capital, liquidity, and asset quality;
- Risk management processes, for example, vendor management; information security; contingency planning; project management, may be less robust in small institutions.
- Quality of management information systems.
- Other lender activities such as general ledger reconciliation, system balancing, and clearing of suspense items. These depend on or affect information systems operations. This includes an institution's internal controls.

Liquidity and Sensitivity: Information technology serves a significant role in cash management. Disruptions could impact customers, cause operating losses, cause an increase in borrowings to offset any cash shortfalls, and place a heavy burden on existing staff to correct the problems. Technology risks are inherent in all of the following:
- Paper-based cash collections, including check processing, lock-box arrangements, and clearing house activities.
- Management decision-support software used to determine lender's asset liability mix and balance sheet structure.
- Internet-based delivery channels introduce new technology environments with different kinds of risks.

The review of technology risk controls is not confined entirely to Safety and Soundness or Information Technology examinations. Information technology also supports records and activities reviewed during Compliance examinations. For example, consumer disclosure documents disclosing Annual Percentage Rates and Finance charges commonly are prepared by electronic loan documentation programs are often automated. Incorrect programming or data entry could result in improper disclosures or untimely action. Again, consult with your IT Manager if you have questions about technology risks in these specialty areas.

Finally, where aspects of a lender's information technology environment are provided or managed by a holding company or other affiliate, you may need to coordinate the review of some controls with another regulator. Nonetheless, while you should avoid duplication of regulatory oversight, the lender itself must maintain appropriate internal technology risk controls, which you should assess when completing this program.

EXAMINATION PROGRAM

MFA examinations are <u>risk-based</u> and provide for a comprehensive approach to information technology risks. You use a top-down methodology by determining the information technology environments and risks, evaluating management oversight and control activities, and assessing significant unmitigated risks.

The risk-based examination approach relies on audit work and results that match regulatory needs (for example, audit scope, objectives, and evidence and timing of work). One key criterion is whether or not there is evidence of independent testing and reporting on management policies and operating procedures. If there is no audit to rely on, you will need to perform adequate testing to support conclusions. “Audit” here refers to the type of work being performed, not the job title of the person doing the work. While internal or external (independent) auditors may complete this work, in many situations, other employees may also perform audit work.

Examination Comments and Rating

You should generally incorporate examination findings and conclusions about Technology Risk Controls into the Management section of the safety and soundness report.

At a minimum, the report should include a brief description of the institution’s use of information technology and an overall conclusion as to the adequacy of controls. You should describe significant adverse findings in sufficient detail to identify specific conditions that warrant corrective action by the institution. Carry forward a summary of such findings to the Examination Conclusions and Comments page.

The strength or weakness of Technology Risk Controls is one of several factors you consider in assigning a rating to the Management component of CAMELS. You should consider all of the following:

- Specific issues in relation to the volume and trends in transactions, amounts, and customers.
- Apparent risk to the institution’s financial and informational assets, including customer data regardless of the volume and trends in activity.
- Anticipated growth in volume, whether amounts, transactions, or customers.
- Anticipated expansion of products, services, or platforms.

Generally, if you identify serious deficiencies with the controls, the management rating should reflect such findings.

SECTION: External Audit 350

INTRODUCTION

Accurate financial reporting is essential to an institution's safety and soundness. The board of directors and the audit committee are responsible for ensuring that their institution operates in a safe and sound manner. To achieve this goal and meet safety and soundness guidelines, the board of directors should ensure that their institution maintains effective internal controls.

Management is responsible for effectively managing the institution's risks and making sound business decisions. They should also ensure that the financial statements fairly report the mortgage lender's financial condition, results of operations, and cash flows, and that the institution prepares its financial statements in accordance with accounting principles. Lenders must provide accurate and timely Prudential Reports. These reports serve an important role in risk-focused supervision programs, by contributing to pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength. The MFA encourages all institutions to have an external audit. Some institutions must have an audit of the institution's financial statements by an independent public accountant (external auditor), or the MFA may require an audit of an institution's financial statements by an external auditor under certain circumstances. All audits of real estate lenders, regardless of size, must comply with the requirements outlined for management, the board of directors, and the external audit.

External Audit of Real Estate Lenders

Real estate lenders must comply with the provisions of MFA Regulations and should file the required reports with the MFA in accordance with the provisions of this regulation.

Management should:

- Prepare a statement declaring its responsibility for the annual financial statements.
- Establish and maintain an adequate internal control and procedures for financial reporting.
- As of the end of the fiscal year, assess the effectiveness of the internal control and procedures for financial reporting.
- Assess the effectiveness of the internal control and procedures for compliance with laws and regulations relating to loans to insiders and dividend restrictions.

Board of Directors should:

- Establish an audit committee consisting of outside directors who are independent of management. In no circumstances may an audit committee consist of less than a majority of outside directors. Exceptions to the independent membership requirement should be rare.
- Determine the duties of the audit committee that should, at a minimum, include reviewing the audit reports with the external auditor.

External Auditor should:

- Attest to whether management's assertion about the effectiveness of the internal control over financial reporting is fairly stated.
- Participate in a peer review program.

In addition, MFA requires the following reports:

- A management report on internal controls (management internal control report).
- An external auditor's attestation report on management's assessment of the effectiveness of internal control over financial reporting.

Information That Must Be Available to External Auditors
Mortgage lenders that engage the services of an external auditor to audit the mortgage lender should provide copies of the following reports:

- The most recent report of condition, that is, the MFA Prudential Report.
- The mortgage lender's most recent Report of Examination (ROE).

In addition, real estate lenders must provide the external auditor the following information:

- A copy of any supervisory agreement or memorandum of understanding or written agreement between MFA and the mortgage lender that is in effect during the period covered by the audit.
- A report of any formal action taken by MFA during such period, or any civil money penalty assessed with respect to the mortgage lender or any mortgage lender-affiliated party.

Changes in Auditors
MFA requires the board of directors to provide a notice of termination or engagement of the external auditor. In addition, the external auditor must provide the notice of termination to MFA. MFA may request that the institution send notice to the appropriate supervisory office.

Work Paper Reviews
MFA will coordinate the review with the institution's supervisory agency. For additional information on work paper reviews, see the discussion under Regulatory Concerns in this Manual Section.

Peer Review Reports
In certain cases and at its discretion, MFA may require an audit firm enroll in a peer review program, and that each firm files a copy of its peer review report with MFA. In a peer review program, one accounting firm basically examines another firm's quality control for accounting and auditing practices on selected engagements and functional areas. This review encompasses the organizational structure of the policies adopted and the procedures established by a firm to provide it with reasonable assurance that it complies with professional standards. MFA obtains copies of the peer review reports and maintains an updated database that it periodically distributes to accountants' professional organization. If any firm has significant deficiencies noted in its peer review report, MFA staff will the Head of Monitoring and Enforcement for further action.

Audit of Real Estate Lender Holding Companies
MFA requires a mortgage lender holding company to obtain an audit of the financial statements by an external auditor. The holding company should comply with reporting requirements in its annual report.

Modification or Waiver

MFA may grant a real estate lender holding company's request for a modification or waiver of the external audit requirement under any of the following circumstances:

- The real estate lender holding company engages in very limited activities other than control of subsidiary real estate lender(s) and it submits the subsidiary real estate lender's separate external audited financial statements.
- The accounting basis of the holding company makes consolidated financial statements or an external audit impractical.
- The external audit would represent an unusual and unreasonable regulatory burden. The real estate lender holding company must make a written request for a waiver to MFA. The request must describe the circumstances that the real estate lender holding company believes warrant the proposed modification or waiver.

Audit of Real Estate Lenders that Receive a non-satisfactory Composite CAMELS Rating

MFA requires real estate lenders, without regard to size, that receive a composite CAMELS rating of less than satisfactory, as of its most recent safety and soundness examination, to obtain an audit of its financial statements by an external auditor. MFA may request additional audit procedures or standards relevant to the lender's condition.

Required Reports

In addition to the audited financial statements, the real estate lender must submit:

- Any audit-related reports including, but not limited to, internal control reports from the external auditor that contain conclusions and recommendations related to the audit.
- Any other MFA-requested supplemental information, or schedules. MFA accepts the audited consolidated financial statements of the real estate lender holding company in lieu of separate audited financial statements of the real estate lender.

Filing Requirements

If MFA requires a real estate lender to obtain an audit, it must forward three copies of the required reports to the MFA within 90 days of the fiscal year-end, or within 15 days of receipt, whichever is earlier.

Waivers

A real estate lender may dispense with an audit if MFA determines that an audit is not the most effective means to address the safety and soundness concerns that caused the composite CAMELS rating of less than satisfactory. The waiver provision only applies to MFA required audits. It does not apply to audits required by public securities filing or similar requirements. The real estate lender must make a written request for a waiver to the MFA. The written request must include:

- The basis for the composite CAMELS rating of less than satisfactory, and the specific reasons why the real estate lender believes an audit would not address the source of the safety and soundness concerns in the most effective manner; and
- As an alternative, specify procedures and describe how they will address the source of the safety and soundness concerns identified by the examination; or
- Indicate the reasons why they consider an alternative to an audit as unnecessary. MFA will respond to a timely request for an audit waiver from the real estate lender.

Safety and Soundness Considerations for Granting Waiver Requests MFA may grant a real estate lender's request for a waiver of the external audit requirement if the CAMELS rating of less than satisfactory is due to safety and soundness concerns that an external audit would not effectively address. Safety and soundness concerns may include areas of supervisory judgment. Often the mortgage lender cannot reduce these areas to objective criteria that can be audited effectively. Safety and soundness concerns may represent areas in which you have specialized knowledge and expertise; or the concerns may represent areas normally not included in the scope of an external audit. Under such circumstances, you may consider requesting specific procedures to address these areas. You may also rely on your judgment about other procedures that will specifically address your supervisory concerns. Examples of these areas include the following circumstances

- Adequacy of capital levels.
- Deficient credit underwriting policies and loan documentation that management is correcting.
- Low level of earnings or poor quality of earnings whose source the examiners investigated in a recent examination and management is correcting.
- Liquidity, interest rate risk, and other safety and soundness or compliance matters.

While recognizing the limits of an external audit, there are circumstances when pervasive safety and soundness concerns warrant an external audit. These include, but are not limited to the following concerns:

- Identified weakness in the internal audit function or the internal control structure and procedures for financial reporting.
- Lack of confidence in the board of directors or management with regard to integrity, ethical values, competence, operating philosophy, and overall corporate governance exercised by the board.
- Questionable transactions with affiliates.

Case-by-Case Safety and Soundness Required Audit

MFA may require at any time, for any safety and soundness reasons identified by the Director, an independent audit of the financial statements of, or the application of procedures agreed-upon by MFA to, a real estate lender, real estate lender holding company, or affiliate by an external auditor.

Audit of De Novo Real Estate Lenders

MFA generally requires an external audit as a condition of approval for de novo real estate lenders. The conditions of approval will describe the reporting and filing requirements.

Notification by MFA of Audit Requirement

When MFA requires an entity to obtain an external audit for reasons other than its CAMELS rating or size, MFA's Head of Monitoring and Enforcement will notify, in writing, the real estate lender or mortgage lender holding company.

MFA-REQUIRED AGREED-UPON PROCEDURES

MFA may require a real estate lender, mortgage lender holding company, or affiliates to obtain the services of an external auditor to perform agreed-upon procedures to address certain aspects of an entity's operations, operations at outside servicers, adherence to specified laws, regulations, policies and accounting principles, or other specific concerns. MFA may require an entity to obtain specified procedures, under any of the following conditions:

- When the examination process will not address supervisory concerns for the specified element, account, items of the financial statements, outside servicer, or other matters.
- When the specified procedures could supplement the examination process.
- When a full external audit is not the most effective means to address the specified element, account, items of the financial statements or other matters of supervisory concern.

- When identified or suspected insider abuses exist.
- When there is identified or suspected defalcation.
- When there is identified or suspected criminal activity.
- When objective criteria exist for reasonably measuring compliance with specified laws, regulations, and policies.

Notification by the MFA
MFA will notify the entity in writing, when we require it to engage the services of a qualified external auditor to perform agreed-upon procedures.

Required Procedures and Reports Once you determine that agreed-upon procedures are an effective means to address the safety and soundness concerns, identify the specific elements,\ accounts, items of the financial statements, or other matters that the external auditor and the institution must address. MFA generally requires the external auditor to perform the procedures. The external auditor must report in accordance with auditing standards for attestation engagements. MFA may also provide such procedures directly, or develop procedures in consultation with the external auditor.

Filing Requirements
If MFA requires an entity to obtain agreed-upon procedures, the institution must forward three copies of the specified procedures report to the MFA within 30 days of receipt of the report, or 30 days from the date of the procedures, whichever is less.

Auditor Requirements for Required Audit or Required Agreed-Upon Procedures
The external auditor or other qualified person who performs the audit or the agreed-upon procedures must meet the following minimum requirements:

- Be registered or licensed to practice as a public accountant, and maintain good standing, under the laws of Egypt.
- Agree in the engagement letter to provide copies to MFA of any work papers, policies, and procedures relating to services performed.
- Comply with the accountants' Code of Professional Conduct, and meet any Securities Commission independence requirements.
- Receive, or be enrolled in, a peer review. The MFA accepts the following peer review guidelines:
- The external peer review should be generally consistent with accounting standards.
- An organization independent of the auditor or firm being reviewed should conduct there view.
- The organization should conduct a review at least as frequently as is consistent with accounting standards.
- The external peer review should include, if available, at least one audit of a financial institution or consolidated financial institution holding company. (The external auditor should make the peer review report available to the MFA upon request).
- The auditor or firm under review should take corrective action required under any qualified peer review report on a timely basis.

AUDIT OF FINANCIAL STATEMENTS BY AN EXTERNAL AUDITOR (AUDIT)

Objective of Financial Accounting
The fundamental objective of financial accounting is to provide reliable financial information about economic resources and obligations of a business enterprise.

Objective of an Audit
Similar to the objective of financial accounting, the fundamental objective of an audit conducted in accordance with auditing standards is to determine whether the financial statements fairly present, in all material respects, the financial position, results of operations, and cash flows of the institution in accordance with accounting principles. The audit should provide reasonable assurance that the financial statements are free of material misstatements, whether caused by error or fraud. Informative disclosures in the financial statements must follow accounting principles, or the report must state otherwise.

Audit Standards
External auditors should follow the accountants' Code of Professional Ethics. It requires that auditors perform external audits according to auditing standards. Auditing standards, as distinct from accounting standards, are concerned not only with the auditor's professional qualifications, but also the judgment the auditor exercises in the performance of an audit and with the quality of the audit procedures. There are three categories of auditing standards

- General standards.
- Fieldwork standards.
- Reporting standards.

The general standards require that the person, or persons, who performs the audit meet the\ following professional qualifications:

- Possess adequate technical training and proficiency.
- Maintain independence in mental attitude.
- Exercise due professional care in the performance of the audit and the preparation of the report.

Fieldwork standards include the following requirements:

- Adequately planned work.
- Properly supervised assistants, if any.
- Proper study and evaluation of existing internal controls to determine audit scope, audit procedures, and the extent of testing.
- Sufficient evidence to formulate an opinion on the financial statements under audit. Reporting standards require that the external auditor state whether the institution presents its financial statements in accordance with accounting principles.

Limitations of Audits and Audited Financial Statements
Although auditing standards require the use of due care and professional skepticism, a properly designed and executed audit does not guarantee that the audit will detect all misstatements of amounts or omissions of disclosures in the financial statements. Moreover, an external audit is not designed or executed for regulatory purposes, and thus, does not guarantee that the auditor addressed MFA safety and soundness considerations.

You should be cognizant of these and other limits inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the mortgage lender reports transactions and balances in accordance with accounting principles. It does not mean that the transactions make business sense, that the mortgage lender manages associated risks in a safe and sound manner, or that the mortgage lender can recover balances upon disposition or liquidation.

- The auditor attempts to understand financial reporting internal controls sufficient enough to plan the audit, and determine the nature, timing, and extent of tests to perform. This does not mean that the external auditor extensively reviews controls over all areas. The external auditor may use various levels of testing depending on the risk of a specific area.
- The auditor's report states that the financial statements present fairly the financial position. This means that, given evidence and current environment, the mortgage lender can recover reported assets in the normal course of business. It does not mean that underwriting standards, operating strategy, loan monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes.
- financial statements in accordance with accounting principles offer only limited disclosures of risks and uncertainties, and other safety and soundness factors on which an institution's viability depends.

REGULATORY CONCERNS

The following documents are part of the supervisory process for monitoring real estate lenders:

- Audited financial statements along with the external auditor's report.
- External auditor's attestation report on internal control report over financial reporting, if applicable.
- External auditor's management letter.

When MFA requires an external audit, the audit must be completed on a timely basis. MFA is responsible for determining that each mortgage lender files a required audit report on a timely basis. MFA personnel should date stamp the required audit report upon receipt. For required external audits, MFA policy requires real estate lenders to submit copies of the audit report, attestation report on internal control over financial reporting, and any other audit-related reports to MFA.

MFA must maintain one complete set in the supervisory files (supervisory file copy) attached to the completed Audit-Related Report Checklist found in Appendix A of this Manual Section. You should receive another set (examination file copy) with a copy of the appropriate checklists. For all types of audits, required or otherwise, supervisory staff should consider maintaining a tracking system of external audits by real estate lenders, which would include the name of the auditor, and various other information. When MFA requires an audit examination, examination managers are responsible for the review and timely follow-up of the various audit reports and correspondence. They should review audit reports, financial statements, reports on internal control and other audit-related reports within 90 days of receipt. Examination managers should add any items of supervisory interest to the supervisory concerns, objectives, and strategies section of the regulatory profile. Based on this review, the examination manager should take the following steps:

- Set out the timing and nature of any required follow-up as indicated on the checklist.
- Update the activity agenda section of the regulatory profile to reflect any planned actions resulting from the review.
- Consult the Head of Monitoring and Enforcement when the follow-up includes issues about accounting principles, auditing standards, or enforcement matters. MFA will generally reject, as unsatisfactory, a report of audit disclaiming an opinion on the audited financial statement, unless the reason for the disclaimer is beyond the control of the mortgage lender.

MFA is also responsible for requesting external auditing program reports from institutions not required by regulation or otherwise to have an external auditing program.

Audit Requirements
Reports from voluntary external audits and external auditing programs should receive the same level and type of review as those submitted pursuant to MFA requirements.

Independence of External Auditor
The audit committee should hire and terminate the external auditor. To maintain independence from management, the external auditor ideally reports to the outside directors of the board. You should question the independence and objectivity of the external auditor when the auditor appears to be reporting to management, appears to be an advocate for management, or generally appears to be working more for management than the board of directors.

Instances in which you should question independence include but are not limited to the following examples:

- Management approves the external auditor's presentations to the board
- Management prevents the external auditor from meeting with the board unless management was present
- The board of directors appears to lack the sophistication to understand or appropriately discuss audit or accounting issues with the external auditor
- The auditing staff does not have unrestricted access to the board or audit committee without management knowledge or approval. Under these circumstances, you may decide to test the independence of the auditor through reviews of loan listings, contracts, stockholder listings, and other appropriate measures.

Review of External Audit Work Papers
Purpose and Benefits
The purpose of reviewing external audit work papers is to gain insight into the scope of the external auditor's work and assessment of the financial condition of the institution. To assess the financial condition of the institution, the external auditor performs procedures that evaluate the reliability of financial statement assertions based on auditing standards. A review of the external audit work papers and conversations with the external auditor should provide you insight into the following areas:

- The complexity of an institution's transactions.
- The extent of an institution's transactions that are assumption driven.
- The scope, extent, and depth of the external auditor's external audit work.
- The material weaknesses and reportable conditions regarding an institution's internal control and financial reporting practices.
- The accuracy and completeness of Prudential Report information.
- The reliability of the institution's assertions made in Prudential Reports.

A review of the external audit work papers should assist you in the following activities:

- Performing financial analyses of the institution.
- Identifying areas of concern or accounting complexity. For example, the audit work papers may document management's reasons for an aggressive accounting practice. After there view, you should understand management's rationale, and assess whether a less aggressive accounting practice is more appropriate from a safety and soundness standpoint.

- Detecting trends and information not otherwise revealed in the monitoring process.
- Determining the scope of the examination:
- You may reduce the scope of the examination in certain areas based on the extent, scope, and findings of the external audit work.
- You may expand the examination scope in certain high-risk areas based on the external audit work.
- You may expand the scope in certain areas based on the external auditor's findings that disclose matters of supervisory concern.
- Evaluating the institution's internal control over financial reporting. If a mortgage lender has serious internal control weaknesses or deficiencies, you should discuss the full extent of such problems with the external auditor to determine whether you should expand the scope of the examination.
- Identifying areas where external audit work can supplement examination procedures.
- Identifying external audit work that provides insight into certain financial statement assertions, or that is sufficient to enable you to limit certain examination procedures. For example, the external audit work papers may document management's methodology for assessing the appropriate level of allowance for loan and lease losses or valuation estimates, including the assumptions and methodologies used to value servicing and residual assets.

The external audit work papers should document the specific audit procedures performed to test and analyze those estimates. After the review, you should understand management's approach and any exposure areas. If the findings are acceptable for safety and soundness purposes, you may use the information to plan and supplement the examination procedures in this area. Other benefits realized from external audit work paper reviews are:

- Discovering policy and procedures, or transactions and balances, subject to additional examination procedures.
- Developing an understanding of the external auditor's risk assessment process.
- Developing an understanding of management's support for certain transactions and balances.
- Improving examination focus. You may find that you can concentrate on high-risk areas and de-emphasize areas that have been adequately covered by the audit. There are certain situations that may necessitate requesting the external audit work papers for review.

Situations that might trigger an external audit work paper review include the following examples:

- The institution holds assets and liabilities subject to significant management judgment regarding valuation. Examples include the following assets and liabilities:
    - High-risk loans.
    - Repossessed assets.
    - Debt securities with significant credit loss concerns.
    - Servicing assets, if material.
    - Residual interests from securitizations, in which the carrying value is not readily determined by market quotes.
    - Significant potential losses from litigation.
    - Other off-balance sheet activities.
- New or outstanding securitization activities including private-label securitizations and other complex transactions.
- Material loan amounts serviced by others.
- Significant balances or changes in Other Assets or Other Liabilities.
- Significant business plan changes that affect organizational goals, including new or growing business lines.

- Recent acquisition or disposition transactions, including purchase business combinations.
- Institutions with significant goodwill and other intangible assets.
- Problematic computer processing that reinforces the need for general ledger account reconcilement.
- Large number of adjusting journal entries and/or significant balance sheet changes that would affect general ledger account reconciliation.
- Reported earnings or other financial measures substantially better than peer group.
- Institutions engaging in aggressive income recognition.
- Strained relationship between management and/or the board of directors and the external audit firm.
- Significant changes in the external audit program including recent unexplained or sudden change in external audit firm.
- Recent unexplained delays in issuance of audited financial statements.
- Issues regarding independence, objectivity, or competence of the external auditor.
- Accounting or internal audit staff that is inadequate in relation to the size, nature, complexity, and scope of activities of the institution.
- Recent or significant turnover in accounting or internal audit staff.
- Significant transactions with owners (parent company or stockholders), affiliates, Special Purpose Entities, or other related parties.
- Significant changes in Due To/Due From accounts.
- History of late Prudential Report filings or amendments.
- Significant safety and soundness concerns.
- Large unexplained reserves, suspense accounts, or large tax reserves. If external audit work papers exist for lower-risk areas, such as confirming loans, and they appear accurate and reliable, you may use them to avoid duplicating efforts to gain the same or similar information.

However, when you use external audit work papers in lieu of performing the actual work
yourself, you are placing reliance on a work product not necessarily designed for regulatory purposes. In high-risk areas where the external audit work appears reliable, the work papers may be used to design and supplement examination procedures accordingly.

Obtaining External Audit Work Papers

MFA policy requires that the auditor agree in the engagement letter to provide access to and copies of any work papers, policies and procedures related to services performed.

If possible, the EIC should evaluate the need to review external audit work papers prior to the beginning of the exam. If the institution is known to have activities that trigger a review of external audit work papers, the EIC should make arrangements for the work papers to be available as soon as possible. This will facilitate using the results to tailor the scope of the examination review. The request for access to the audit work papers should be in writing and addressed to the external auditor.

Auditors are generally cooperative, as they are interested in assessing the effect of examination concerns on the financial statements. The review of audit work papers and the discussion of significant items and complex transactions with the external auditors can help you assess whether the financial reporting is safe and sound. The auditor may request that you “acknowledge” certain representations and conditions set forth in a letter from the auditing firm before allowing you access to or releasing to you copies of the work papers. It is not unreasonable for the auditor to request that you acknowledge receipt of documents. This is a common business practice and their proof of compliance with your request.

MFA policy allows you to sign a document only to acknowledge receipt of an accounting firm's letter and any copies of work papers, policies, and procedures delivered with such letter. However, any attempt by an auditor to impose conditions, agreements, or understandings on you or MFA is contrary to the auditor's agreement in the engagement letter. Therefore, do not sign any document that implies that MFA has agreed to any conditions in the letter. Notify the Head of Monitoring and Enforcement if any external auditor seeks to avoid inclusion of the required agreement in the engagement letter, or to evade, or impose conditions, on the obligation to provide MFA access to or copies of work papers, policies, and procedures relating to services performed. We provide a sample copy of a letter to request work papers in Appendix D and an acknowledgement letter in Appendix E.

In limited circumstances, a subpoena may be necessary to gain access to the external audit work papers. In these cases, the examination staff should contact the Head of Monitoring and Enforcement and arrange for the subpoena.

Policy for Audit Work Paper Review
MFA has authority to review audit work papers for each financial institution that has been assigned, or expects to be assigned, a CAMELS rating of less than satisfactory.

Communications with Auditors
When conducting an audit of the financial statements of a real estate lender, the external auditor can consider, in accordance with auditing standards, the regulatory authorities as a source of competent evidential matter. Accordingly, the external auditor may review communications from, and make inquiries of, the regulatory authorities. We encourage real estate lenders and their auditors to confer with MFA when they consider it appropriate. Such contacts may include meetings with you to assist in planning audits, or auditors may attend examination planning, interim, and exit conferences with mortgage lender management and examiners. They may also attend other meetings between management or the board of directors (or a committee thereof) and examination personnel when you consider it \ appropriate. You should provide mortgage lenders with advance notice of the starting and completion dates of examinations so management can coordinate the audit fieldwork with the examination. Management should inform auditors in advance of scheduled examinations and meetings. When requested by the mortgage lender and the auditor, the examination manager may communicate examination findings prior to the completion of the examination. We encourage the examination manager to comply with such requests. This fosters better communications and improves the quality of financial reports. We also encourage you to communicate with auditors in the field after notifying the Head of Monitoring and Enforcement.

You should communicate to the auditor all supervisory concerns and information except those involving confidential enforcement actions, such as imminent conservator ships or receiverships. As a general guideline, you should communicate interim examination findings whenever the following occurs:

- The examination process results in substantiated findings that significantly affect the financial information reported by the mortgage lender.
- The mortgage lender is about to report quarterly or annual financial information to the MFA or other outside parties, such as shareholders or the general public.

Obviously, under such circumstances, prompt communication is important. Material examination adjustments made shortly after a mortgage lender issues a financial statement can cause significant public disclosure and securities problems. MFA should make examination work papers available to external auditors upon request. If you have not issued the ROE, stamp any copies of work papers provided to the external auditor as "DRAFT." To access work papers, the external auditor must make the request in writing to the examination manager. The examination manager may decline requests for good cause but such denials should be unusual. A reasonable denial would include the following situations:

- Specific work papers requested contain confidential litigation matters such as criminal referrals.
- Litigation against the auditor is pending or contemplated. Finally, to obtain access to work papers, the auditor must sign a statement of consent to the Prohibition of Disclosure or Release notice.

Prohibition of Disclosure or Release

The report of examination, regulatory correspondence, and examination work papers are the property of MFA. MFA makes documents available to the independent audit firm for its confidential use relating to its audit of the mortgage lender engaging the audit firm. Neither the audit firm nor any of its employees may disclose or make these documents, or any portion of them, public in any manner. If an external auditor receives a subpoena or any legal process calling for the production of any MFA documents held by the auditor, the auditor must notify MFA immediately. You should advise MFA counsel and, if necessary, the court of the above prohibition and refer them to MFA regulations.

REFERENCES

SECTION: Internal Audit 355

INTRODUCTION

Appraising the effectiveness of an institution's internal audit function is integral to evaluating an institution's maintenance and effectiveness of internal control, and the integrity of its financial records. Each institution should have an internal audit function that is appropriate to its size and nature, and scope of its activities. All large lenders and those with complex operations should have an internal audit function. Regardless of size, lenders should consider the need for an internal audit function. A strong internal audit function should provide the following elements within the internal audit program:

- Adequate monitoring of the institution's internal control system.
- Independence and objectivity.
- Qualified personnel.
- Adequate testing and review of information systems.
- Adequate documentation of tests and findings of any corrective actions.
- Verification and review of management's actions to address material weaknesses.
- Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

This Section of the Manual describes the objectives of, and the work performed by, internal auditors and offers guidelines for regulatory staff in evaluating their work. You should use it in conjunction with Manual Section 340, Internal Control.

INTERNAL AUDIT FUNCTION

Use of an internal audit function for control and monitoring purposes is an important management function. The internal audit function includes:

n independent, objective assurance and consulting activity designed to add value and improve on an organization's operations. It helps an organization accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The practice of professional internal auditing goes beyond examining accounting controls, records, and financial statements, and reports. A real estate lender's internal audit program should consist of the policies and procedures that govern its internal audit functions, including risk-based audit programs and outsourced internal audit work, if applicable. While smaller mortgage lenders' audit programs may not be as formal as those found in larger more complex real estate lenders, all institutions' internal audit program should incorporate the following:

- An audit charter or mission statement that sets forth the audit department's purpose, objectives, organization, authority, and responsibilities. The charter should include a discussion about the scope of the audit committee responsibilities and how it carries out those responsibilities. The audit committee or board should periodically assess the internal audit function, and take appropriate action to ensure its ongoing reliability and effectiveness.
- An audit plan that addresses goals, schedules, staffing budget, reporting, and, if applicable, financial budgets.
- A policies and procedures manual for audit work programs and, if applicable, risk-based auditing or risk assessments and outsourcing of internal audit work.

- A program for training audit staff, including orientation and in-house and external training opportunities.
- A quality assurance program, performed by internal or external parties, to evaluate the operations of the internal audit department.

This may include ongoing reviews of the performance of the internal audit activity, or periodic reviews performed through self-assessment, or by other persons within the organization with knowledge of internal auditing practices. A qualified, independent reviewer or review team outside the organization may also conduct external assessments. Internal auditors should evaluate the efficiency and adequacy of the internal audit system, and test the continuing effectiveness and maintenance of controls. An adequate internal audit function should also incorporate the following:

- Procedures to determine the reliability of information produced within the institution and the effectiveness of internal policies and procedures. For example, internal auditors often help formulate and revise policies and procedures to plan and implement safeguards and controls, including ensuring appropriate evidence and audit trails.
- Recommendations to assist management in attaining the most efficient administration of institution operations. Internal auditors also evaluate the following:
    - Compliance with laws and regulations.
    - Effectiveness of administrative controls and procedures.
    - Efficiency of operations (also called operational auditing).
- Information to enable management to fulfilling its responsibilities under statutes, regulations, and lender policies.
- Procedures to ascertaining the adequacy of controls to minimize risk of losses. One procedure is for internal auditors to appraise the soundness and adequacy of accounting, operating, and administrative controls.

The appraisal process ensures that the mortgage lender records transactions promptly and accurately and properly safeguards assets. For example, a critical internal audit responsibility/ procedure is to determine the adequacy of valuation allowances by reviewing the system and procedures for internal asset review and credit quality classifications.

INDEPENDENCE OF INTERNAL AUDITORS

Internal auditors must maintain independence within the organization. The higher the level the auditor reports to within the organization, the greater the likelihood of achieving effective independence. The institution's policies should give the auditor the authority necessary to perform the job. That authority should include free access to any records necessary for the proper conduct of the audit. Ideally, the internal auditor should report directly to the lender board of directors or to an audit committee comprising non-employee members of the board of directors. Reporting at this level should allow the auditor the greatest access to all levels of the institution, and assure prompt and independently objective consideration of audit results. It also enables the auditor to assist the directors in fulfilling their responsibilities.

The board of directors or its audit committee should regularly receive a report of all audit activity. This report should include the status of all audits on the internal audit schedule, and summaries of all audits completed during the period including audit conclusions. In addition, this report should provide the resolution status of previous internal audit findings and recommendations. If the internal auditor does not report to the board or its audit committee, the reporting line should be to an individual with no financial or operational responsibilities. Inadequate independence of internal auditors is cause for critical MFA examination report comments. Instances in which an internal auditor reports to management may warrant further consideration and assurance that independence of the internal auditor is not compromised.

Internal auditors' responsibilities and qualifications may vary, depending on the size of the institution and complexity of operations. The internal audit function is generally a full-time job of an individual or group, but may be a part-time job in smaller institutions. The institution may also outsource some or all of its internal audit work.

Large institutions often designate a chief auditor to supervise the work of an internal audit staff. In small institutions, the responsibility for internal audit may rest with officers or other employees designated as part-time auditors. Small institutions with few employees and less
complex operations may not have an internal auditor on staff. Nevertheless, the institution can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The person given this task should not also be responsible for managing or operating those controls.

COMPETENCE OF INTERNAL AUDITORS

An internal audit manager, whether working alone or with staff, should possess the following qualifications:

- Academic or other credentials comparable with those of other institution officers with major responsibilities in the organization.
- Commitment to a program of continuing education and professional development.
- Audit experience, and organizational and technical skills commensurate with the responsibilities including proficiency in applying internal audit standards, procedures, and techniques.
- Strong oral and written communication skills.
- Ability to properly supervise each audit and provide suitable instructions to help meet audit objectives.

To understand fully the flow of data and the underlying operating procedures, the internal audit function manager must have proper education, training, and understanding of key areas of operations. College courses, various industry sponsored courses, and significant prior work experience in various departments of an institution may provide adequate education. Certification as an internal auditor or a public accountant may serve as further evidence of having the appropriate credentials.

The internal audit function manager must maintain a program of continuing education. The audit staff should also possess certain minimum qualifications and skills commensurate with the complexity of the institution's operations. Any member of the audit staff in a supervisory position should possess adequate knowledge of audit objectives and an understanding of the audit procedures performed by the staff. The final measures of internal auditors' competence and performance are the quality of the work performed, and the ability to communicate the results of that work. The adequacy of the audit program, the quality and completeness of internal audit work papers, and the clarity and comprehensiveness of internal audit reports reflect evidence of an auditor's competence and performance.

THE AUDIT PLAN AND PROGRAMS

The overall audit plan, which consists of various departmental and functional audit programs, must attain the audit committee or the board of director's desired objectives. The audit committee or board should approve the audit plan at least annually. In assessing the adequacy of the annual audit plan and completed audit programs, evaluate the following areas:

- The audit plan's scope, frequency, and depth including any internal rating system as it relates to the institution's size, the nature and extent of its activities, and the institution's risk profile.
- Board of directors' or audit committee minutes, or summaries thereof. Determine whether the audit committee or board of directors formally approves the internal audit function's objectives, the audit program and schedule, and monitors the activities of the internal audit department to follow the approved programs and schedules. The audit committee or the board should approve any significant changes to the program or schedule.
- Management's records supporting any assertions concerning the effectiveness of internal controls over financial reporting and compliance with designated laws and regulations. Management should set its standards for measuring the adequacy and effectiveness of internal controls over financial reporting based on risk analyses or assessments, control assessments, audit report findings, and other various resources including established standards.
- Content of the individual audit programs.
- Documentation of the work performed.
- Conclusions reached and reports issued.
- Procedures for follow-up to ensure the mortgage lender take corrective action.

A characteristic of a good internal audit plan is a proactive approach. It should have an early warning system to detect and evaluate risks, determine scope, frequency, and depth of audit procedures needed, and adjust the audit plan accordingly. In assessing risk, the auditor should consider the following factors:

- The nature and relative size of the specific operation and related assets and liabilities, including off-balance sheet transactions.
- The existence of appropriate policies and internal control standards.
- The effectiveness of operating procedures and internal controls.
- The potential materiality of errors or irregularities associated with the specific operation. Audit programs are an integral part of the audit work papers, and serve as the primary evidence of the audit procedures performed. Before developing or revising the audit program, the internal auditor should have a thorough understanding of the operations of the department or function.

The auditor should prepare or revise a written audit program for each area of an institution's operations before beginning the audit work. Each program should contain a clear, concise description of the internal control objectives, degree of risk if internal controls fail, and the procedures to follow in testing such controls. An individual audit program may encompass several departments/functions of an institution, a single department, or specific operations within a department. The effectiveness of the overall audit plan depends on a variety of factors. To plan effectively, the auditor must consider the factors described above, along with many of those outlined.

Manual for Supervision Section 060, Examination Strategy, Scoping, and Management.

Most audit programs should address the following audit procedures:

- Surprise audits where appropriate.
- Maintenance of control over records selected for audit.

- Review and evaluation of the institution’s policies and procedures and the system of internal controls.
- Reviews of laws, regulations, and rulings.
- Sample selection methods and results.
- Proof of reconciling detail to related control records.
- Verification of selected transactions and balances through examination of supporting documentation, direct confirmation and appropriate follow-up of exceptions, and physical inspection. The internal audit work papers must document the work performed by the auditor.

Work papers should contain completed audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached. Upon completion of the procedures outlined in audit programs, the internal auditor should be able to reach conclusions that will satisfy the audit objectives. The internal auditor must effectively interpret these conclusions documented in the work papers. Audit report findings must be consistent with the documented conclusions. Reports should include, when appropriate, recommendations for remedial action. The overall audit plan must also provide for follow-up procedures to ensure that the mortgage lender takes corrective action.

The internal auditor must communicate all findings and recommendations in a clear, concise manner, pinpointing problems and suggesting solutions, and submit reports as soon as practicable. Auditors should route reports to those officials who have both the responsibility and authority to implement suggested changes. If full audit reports do not go to the board of directors, the auditor should prepare summary reports for the board’s review. Prompt and effective management response to the auditor’s recommendations is the final measure of the effectiveness of the audit program. The auditor should inform the audit committee or board of management’s responses to audit findings and recommendations.

Information Systems and Technology Audit Review

The institution’s internal audit program should have qualified personnel review, test, and evaluate the information systems and technology environment. The internal audit program should provide audit coverage of significant information systems and technology risk exposures. This would include systems development projects and computer production activities involving on-premise computing (for example, on stand-alone and networked microcomputers), in-house computer centers, and third-party vendors (for example, service bureaus). The scope of the internal audit program should also address information system and technology-related threats from outside sources (for example, unauthorized access to the institution’s or their service provider’s on-line operation).

Management Assertions

To assist management in determining strategies related to management’s reporting on both the effectiveness of internal control over financial reporting and compliance with designated laws and regulations, the internal auditor may:

- Test the effect of key controls identified as a basis for management’s assertions.
- Perform agreed-upon procedures to test compliance with laws and regulations.
- Establish a system to monitor the internal control system and identify changes needed in the control environment.

Management may use the internal auditor's work to facilitate its assertion that the internal control over financial reporting is effective. The internal auditor's procedures must be sufficient for management to rely on them for such assertions. The external auditor performs examination procedures to attest to management's assertion that the internal control over financial reporting is functioning effectively. The external auditor may consider the work done by the internal auditor as part of the auditing procedures.

REGULATORY CONCERNS

Your review and evaluation of the internal audit function is key in determining the scope of the examination. You should separately determine the adequacy and effectiveness of the audit program for each area of examination interest.

The internal auditor's work may provide useful information in setting the scope of the examination. You should judge the independence and competence of the internal auditor before addressing the overall adequacy and effectiveness of audit programs, and the work performed. If, for example, you conclude that the internal auditor possesses neither the appropriate independence nor the competence, you cannot rely upon the work for scoping purposes.

To test the adequacy of the internal audit work, follow the Internal Audit Program Level I and II procedures. Level I procedures describe the use of the Internal Audit Questionnaire. Under Level II procedures, you may review work papers that document and test procedures performed by internal auditors. In some cases, such a review may be sufficient to substantiate conclusions about the quality and reliability of the internal audit function. The Internal Auditor Questionnaire from the pre-examination package should provide pertinent information. Findings from the internal audit work paper reviews will also help you determine whether further verification procedures and testing are necessary under Level III procedures.

After reviewing work papers and testing procedures, report the following weaknesses in internal audit-related management and internal controls to the Head of Monitoring and Enforcement:

- Absence of or inadequacy of an internal audit function in a large institution or an institution with complex operations.
- An inadequate internal audit plan.
- Instances in which the internal auditor does not have full access to records or otherwise lacks independence.
- Lack of internal auditor competence and/or expertise.
- Instances in which the internal auditor reports to operational officers rather than the board of directors or audit committee of outside directors.
- Audit committees not properly established or non-functioning, such that they are unable to initiate corrective action.

REFERENCES

SECTION: Fraud and Insider Abuse 360

INTRODUCTION

Historically, fraud and insider abuse have significantly contributed to many lender failures in developed mortgage markets, and have caused substantial losses at many others. MFA will develop and use a uniform interagency Suspicious Activity Report (SAR) form [proposed]. This form MFA-regulated mortgage lenders use to report suspected violations of criminal law and suspicious transactions related to money laundering offenses and bank secrecy violations. In addition, MFA will develop regulations that require regulated financial institutions and service corporations to file SARs. MFA and lenders must co-operate with the various criminal investigative and enforcement agencies.

FRAUD, INSIDER ABUSE, AND CRIMINAL MISCONDUCT

Fraud is the intentional misrepresentation of a material fact(s), or a deception, to secure unfair or unlawful gain at the expense of another. Either insiders or outsiders, or both acting in concert, can perpetrate fraud on financial institutions. Every year, lenders lose a significant amount of money due to insider abuse and criminal misconduct. The term insider abuse refers to a wide range of activities by officers, directors, employees, major shareholders, agents, and other controlling persons in financial institutions. The perpetrators intend to benefit themselves or their related interests. Their actions include, but are not limited to, the following activities:

- Unsound lending practices, such as inadequate collateral and poor loan documentation.
- Excessive concentrations of credit to certain industries or groups of borrowers.
- Unsound or excessive loans to insiders or their related interests or business associates.
- Violations of civil statutes or regulations, such as legal lending limits or loans to one borrower.
- Violations of criminal statutes, such as fraud, misapplication of lender funds, or embezzlement.

In addition to criminal misconduct, insider abuse includes other actions or practices that may harm or weaken an institution, but that do not violate criminal statutes. While every criminal violation by an insider constitutes insider abuse, not all insider abuse constitutes criminal misconduct. In most problem financial institutions where regulators find insider abuse, they also find a variety of unsafe and unsound lending practices and mismanagement that may involve criminal acts.

While a thin line often separates a criminal act from an abusive act, MFA has the responsibility and the authority to act against all insider abuse, whether criminal or not. Many of the largest cases of financial institution fraud involved insiders. If the insider is in a key position, the amount of loss can be significant enough to cause the institution to fail. Often, these individuals perform criminal acts using subordinates who do not question their instructions. In some instances, however, the subordinates may be astute enough to know that what the insiders instructed them to do is questionable or wrong and may freely discuss the situation if the regulators simply inquire. During formal and informal discussions with employees, you should listen carefully and be attuned to signals of possible illegal activity by others within the institution. Often, discovering fraud is a matter of talking with the right person who knows what is occurring. Inside abusers often start with small transactions, and engage in increasingly larger transactions as their confidence level rises. Because of this, the early detection of insider abuse is an essential element in limiting risks to the insurance fund. Generally you should bring up fraud as part of another discussion.

Once you have established some rapport, you should first ask, as appropriate to the person you are interviewing, general questions, and then more specific questions:

- What kind of history does the mortgage lender have with fraud in general, including defalcations and employee thefts?
- During the examination, what specific areas should we examine to ensure that there are no major fraud problems?
- Has anyone else ever asked you to do something that you thought was illegal or unethical?
- If someone wanted to commit fraud against the mortgage lender, what would be the easiest way to do it?
- Is the mortgage lender in any kind of financial trouble that would motivate someone to commit fraud?
- Is anyone in any personal financial difficulty that you are aware of?
- Have you ever committed fraud against the company?

Criminal Statutes

MFA counsel should compile a list of citations and text from criminal statutes which can be violated by directors, officers, and employees of mortgage lenders. Though MFA examining professionals are not law enforcement officers, often suspected criminal activity can be disclosed during the examination process. This listing of statutes will be an effective resource for experienced examiners who will be alert for such violations during on-site examinations and off-site monitoring.

CONFLICTS OF INTEREST

There remains a continuing need for regulatory personnel to scrutinize all conflict of interest transactions. You should, accordingly, comment on and request appropriate corrective action on any actual or apparent conflict of interest situation that adversely affects the institution, even though a regulation may not specifically address the conflict. You should also comment on and request appropriate corrective action whenever people involved in a conflict situation participate in or exercise an undue influence over the approval of the transactions.

IMPORTANCE OF INTERNAL CONTROLS

Real estate lenders facing increased competition often consider implementing new strategies including cutting costs, offering different products, and pursuing other activities that have higher yields. While MFA recognizes that mortgage lenders must adapt to changing business conditions, it is critically important that management maintain strong internal controls. The following are some examples of unsafe, unsound, and sometimes fraudulent activities that have caused real estate lenders to suffer significant financial losses due to breakdowns in internal controls:

- Unauthorized loans and falsified loan records, including the hiding of delinquencies on insider loans.
- Unauthorized withdrawals from a correspondent account. Inadequate internal controls also contribute to losses associated with a shift from traditional activities to higher risk commercial and consumer lending.

In addition, in face of increasing competition and shrinking margins many mortgage lenders desire to cut costs, particularly in areas not directly tied to income. Mortgage lenders must direct expense control to areas that do not compromise critical policies and procedures governing internal controls.

Internal Control System When determining the effectiveness of a mortgage lender's internal control system, you must be particularly alert to the following situations:

- Management does not implement effective procedures to correct internal control deficiencies noted in reports prepared by the internal auditors or the independent accountants.
- Management scales back or suspends the internal audit function.
- The internal auditor has dual, operational responsibilities that compromise the internal audit function.
- The internal auditor reports to management instead of directly to the board of directors or an audit committee.
- The mortgage lender's independent audit firm does not have financial institution audit experience. A similar problem may exist when a nationally recognized accounting firm assigns auditors to a real estate lender audit who are not familiar with financial institution procedures and practices.
- The mortgage lender discontinues the annual independent accountant's audit.
- The mortgage lender does not have proper controls in high-risk lending areas (this could be the result of poor policies, frequent exceptions to policy, or understaffing).
- The mortgage lender engages in new lending activities with inadequate or unqualified staff.
- The mortgage lender often deviates from board approved policies without exception documentation.
- The mortgage lender fails to effectively segregate duties and responsibilities among employees.
- The mortgage lender fails to provide adequate reports to the board of directors.

Internal Control System Critical Components
Five critical components of a good internal control framework:

- Control environment
- Risk assessment
- Control activities
- Accounting, information, and communication systems
- Self-assessment.

Internal control can be defined as a process to achieve the following objectives:

- Effectiveness and efficiency of operations including safeguarding assets.
- Reliability of financial reporting.
- Compliance with applicable regulations.

MFA urges real estate lender directors and management to review these and other recognized standards and compare them to their mortgage lender's internal control systems. Good internal control processes are only effective if properly understood and strictly followed. The board of directors must establish internal control systems policy and properly monitor implementation of the policy. Management must properly implement internal control systems according to board policy. In addition, internal and external auditors should vigorously check the appropriateness and effectiveness of real estate lenders' internal controls. See Manual Section 340, Internal Control.

Access to Real estate lender Directors, Employees, Agents, and Books and Records

MFA regulations [proposed] entitle you as examiner to prompt and unrestricted access to real estate lender directors, employees, agents, books, and records. In some instances, mortgage lender management attempted to delay or limit your access to information with the intent to conceal fraud, derogatory information, or insider abuse. Such obstruction, however, more often occurs due to a lack of understanding by mortgage lender personnel. In either case, you can usually promptly resolve access problems by reviewing the appropriate statutory requirements with mortgage lender management. You must recognize obstruction and consider it a red flag indicating potentially serious problems, and take steps to prevent it.

Red Flags of Examination Obstruction Recognizing and refusing to tolerate obstruction is critical to preparing an accurate report of examination. It is important that you promptly notify your EIC or Head of Monitoring and Enforcement of a mortgage lender's attempt to obstruct your examination. If you try to ignore it, the evasion generally gets worse, as do the problems concealed by the obstruction. Appendix B of this Manual section consists of a number of examination obstruction questions and answers.

Examples of Obstruction

- Delaying Tactics. Real estate lenders sometimes do not provide requested information within a reasonable time. For example, the mortgage lender may tell you that:
    - The only staff member who knows the location of the records is unavailable right now – and continues to be unavailable.
    - A mortgage lender employee urgently needs a particular computer with the necessary records for other purposes.
    - The records are off site and there will be a delay in obtaining them. Your response should be polite but firm; under Regulations such unreasonable delays are impermissible.
- Screening Tactics. Mortgage lenders may try to prescreen the documents you need to review requiring that you request documents or staff in advance. The mortgage lender's intent may be to review or sanitize requested documents before you see them.
- Alteration of Records. Mortgage lender employees may attempt to alter records before your review to prevent you from discovering significant losses, fraud, or insider abuse. The employees may remove key documents from files, destroy records, or create required records (known as file stuffing).
- Removal of Records. In some cases, management has removed important documents from mortgage lender offices and hid them off site from examiners. You can only discover this conduct when you remain alert to the fact that obstruction may be occurring, and persistently follow up on employee comments and cross references to missing documents in other files. If you suspect that this has occurred, you should notify your EIC or Head of Monitoring and Enforcement of your concerns.
- Withholding Information based on Assertions of Privilege. Mortgage lenders, their attorneys, or their accountants may attempt to prevent you from accessing documents based on assertions of privilege or confidentiality. Because rulings on privilege claims can turn on specific facts, you should consult with MFA counsel whenever a mortgage lender raises privilege claims. Generally, mortgage lenders cannot properly use these assertions to bar you from attending executive board of director sessions or reviewing minutes of its meetings, including draft minutes. These assertions also may not prevent you from reviewing records of the mortgage lender's operations, such as documents relating to loans that may be the subject of ongoing litigation between the mortgage lender and third parties. The documents

may be in the offices of the mortgage lender's litigation counsel. You are entitled to review such documents wherever they are.

- Attacks on your credibility. Mortgage lenders sometimes attempt to neutralize negative examination findings by attacking the credibility of individual examiners. Your best defense to this tactic is prevention. Use good judgment, comply with MFA policy, and make it a practice to have another examiner present during important or potentially hostile meetings with mortgage lender employees.

Stopping Examination Obstruction

You must promptly stop examination obstruction. We have found repeatedly that obstruction is a red flag for a variety of more serious problems. You cannot always identify and address these serious problems, however, until the mortgage lender stops the obstruction. Whenever you meet any of the types of obstruction noted above, you should immediately discuss the problem with senior management and seek a quick resolution of what could be a simple misunderstanding. You should explain to senior management the statutory basis for gaining access to all records. If you do not obtain access or if the mortgage lender does not resolve the situation, you should inform your EIC or Head of Monitoring and Enforcement. They will work with you and MFA counsel to address the problem.

Any continued obstruction will involve other attorneys of the General Counsel's office as appropriate. The following are several tools available for a prompt and complete remedy. The right response depends on the type and seriousness of the obstruction you meet and the Chief Counsel's suggestions as to the best way to proceed.

- Reviewing with the mortgage lender's board of directors the applicable statutes that compel prompt and complete access of records and politely insisting on compliance.
- Delivering a supervisory letter instructing the mortgage lender to promptly comply with examiner requests for information or face formal enforcement action.
- Issuing a temporary cease and desist order requiring that inaccurate or incomplete records be restored immediately to a complete and accurate state.
- In extreme cases, or where MFA has exhausted other remedies, appointing a conservator or receiver based on the mortgage lender's concealment of records and obstruction of the examination.
- Where appropriate, or in conjunction with the remedies listed above, filing a suspicious activity report to the Ministry of Justice. Such filings may be for obstructing an examination, making false entries to defraud the mortgage lender or deceive regulators, or concealing assets from a mortgage lender's conservator, receiver, or liquidating agent.

DETECTING FRAUD AND INSIDER ABUSE

Because perpetrators do not always carefully plan and discreetly carry out fraud, if you are alert to certain warning signs you may be able to detect it. It is essential, however, that you are knowledgeable of the warning signs and are alert to circumstances where fraud may exist, either by insiders or outsiders. Once you suspect fraud you should thoroughly investigate the circumstances surrounding a suspected activity.

The primary problem that you face in detecting fraud is the limited time and resources available to conduct an examination. Certainly, if you are aware of it and it is material, you should devote the time necessary to determine the appropriate action. However, when you only mildly suspect it, such as with a hunch, it is difficult to justify expanding the examination scope. To assist you in assessing an institution's risk of fraud, this section attaches a Fraud Risk Evaluation Form (Appendix A) and includes the following subsection: Red Flags of Fraud and Insider Abuse. When you consider the risk of fraud to be high you may expand your examination scope in the appropriate areas.

You must be alert to situations that may be conducive to fraud and insider abuse. If a situation exists where an officer or employee is able to control a sizable transaction from beginning to completion, you should notify the board of directors. The board should immediately correct the situation. You should not think of internal control weaknesses, poor loan documentation, improper internal audit reporting relationships, etc., only as technical violations, but also as potential opportunities for large frauds. Such weaknesses should receive appropriate treatment in the report of examination and should result in effective supervisory action.

Red Flags of Fraud and Insider Abuse
Experience has taught regulators in developed financial markets that certain common elements are often present in cases of fraud and insider abuse. The following listings are warning signs of possible fraud and insider abuse:

General
- Dominant officer with control over the institution or a critical operational area.
- Internal audit restrictions or unusual reporting relationships (the internal auditor not reporting directly to the board or audit committee).
- Lack of written or inadequately written policies.
- Lack of adherence to written policies.
- Unusual or lavish fixed assets (for example, aircraft or art work).
- Management attempts to unduly influence examination or audit findings.
- Material internal control deficiencies.
- Frequent changes of auditors.
- High internal audit department turnover.
- Alteration of records.
- Withholding of records.
- Delaying tactics in providing documents or records.
- Large transactions with small out-of-town banks.
- Ownership or control vested in a small group.
- Difficulty in determining who is in control.
- Overly complex organizational structure, managerial lines of authority, or contractual arrangements without apparent business purpose.
- Inaccurate, inadequate, or incomplete board reports.
- Discontinuation of key internal reports.
- No vacation taken by employee or officer.

Management Level
- Routinely contests exam findings by filing appeals, complaining to ministers or other influential persons, or directly or indirectly contacting agency officials.
- Routinely accuses you of being unfair, acting overzealously, or making errors.
- Fails to provide actual documents – only provides copies.
- Hires ex-agency officials when faced with enforcement actions.
- High turnover of officials.
- Motivation to engage in fraudulent financial reporting – significant portion of management's compensation is contingent upon aggressive targeted financial achievements, stock prices, or earnings.
- Use of aggressive accounting practices or tax-motivated behavior.
- High degree of competition in the community accompanied by declining margins of profit or customer demand.

Exam Level

- Inability to generate cash flows from operations.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties.
- Unusually rapid growth in comparison to other institutions.
- High vulnerability to interest rate changes.
- Inadequate monitoring of significant controls.
- Lack of timely and appropriate documentation for transactions.
- Significant unexplained items on reconciliations.
- Falsified documents.
- Weak loan administration and out of balance loan accounts.
- Repeated regulatory violations including significant Prudential Report violations year after year.
- Significant related party transactions not in the ordinary course of business.
- Significant bank accounts in tax haven jurisdictions.
- Weak internal controls and risk management such as, inadequate overall internal control design, inadequate procedures to assess and apply accounting principles, absence of controls for certain transaction activities, evidence that a system fails to provide accurate output, or evidence of design flaws, among others.
- Known criminal referrals.

Red Flags of Lending Abuse

- Poorly documented loans and appraisals.
- Lack of an acceptable past due or watch list.
- Lack of, or unsigned, borrower financial statements.
- Questionable loan disbursement transactions.
- Loan funds disbursed to a third party.
- Corporate loans with no endorsements or guarantors.
- Large pay-down of problem loans prior to an audit or examination.
- Refinancing of debt in a different department.
- Loans secured by flipped collateral.
- Nominee loans (not in name of real borrower).
- Loans of unusual size or with unusual interest rates or terms.
- Loans with unusual, questionable, or no collateral.
- Loan review restrictions.
- Questionable, out-of-territory loans.
- A considerable number or amount of insider loans.
- Construction draws with no or inadequate inspection reports.
- Construction inspections conducted by unauthorized or inappropriate persons.
- Market study on proposed project not on file.
- Loan approvals granted to uncreditworthy employees.
- Lack of independence between the approval and disbursement functions.
- Frequent sales of collateral (land flips) indicating related party transactions.
- Predatory lending practices.

Red Flags of Appraisal Abuse

- No appraisal or property evaluation in file.
- One appraisal in file, but appraisers billed institution for more than one.
- Unusual appraisal fees (high or low).
- No history of property or prior sales records.
- Market data located away from subject property.
- Unsupported or unrealistic assumptions relating to capitalization rates, zoning change, utility availability, absorption, or rent level.
- Valued for highest and best use, which is different from current use.

- Appraisal method using retail value of one unit in condo complex multiplied by the number of units equals collateral value.
- Use of superlatives in appraisals.
- Appraisals performed or dated after loan.
- Close relationship between appraiser, lender and/or borrower.

Suspicious Activity Reports (SAR)

Filing Requirements

MFA regulation sets out Suspicious Activity Reports and Other Reports and Statements, requires real estate lenders and their service corporations to report suspicious activities. They are to file SARs with the appropriate law enforcement agencies with copies to MFA. The regulation requires a filing after the discovery of a known or suspected criminal violation that involves any of the following persons or transaction:

- Any officer, director, employee, agent, or other institution-affiliated person.
- Transaction(s) aggregating [above a minimal threshold] in funds or other assets, when there is a factual basis for identifying a suspect.
- Transaction(s) aggregating [above a minimal threshold] even though a suspect is unidentified.
- Transaction(s) aggregating [above a minimal threshold] that involve potential money laundering, or violations of bank secrecy. If a violation requires immediate attention, such as when it is ongoing, a mortgage lender or service corporation must by telephone immediately notify an appropriate law enforcement authority and MFA. They must also file a timely SAR.

Examiner and Reporting Requirements

Real estate lenders and their service corporations have the primary responsibility to file SARs. You must, however, complete and file a SAR when the required filing institution has either failed to do so or has not properly completed or filed it. When necessary, you should seek filing guidance from your supervisors or MFA counsel.

REFERENCES

SECTION: Enforcement Actions 370

INTRODUCTION

The Mortgage Finance Authority (MFA) uses its statutory authorities to take prompt and vigorous enforcement action when warranted to ensure compliance with laws and regulations and the safety and soundness of real estate lenders. These policies and procedures only provide guidance. They are not intended, do not, and may not be relied upon to create rights, substantive or procedural, enforceable at law or in any administrative proceeding.

Proper use of MFA's formal enforcement powers and informal supervisory responses is critical in helping MFA meet its functional responsibilities:

- Ensuring the safety and soundness of the lender industry.
- Ensuring that all mortgage lenders and their holding companies comply with laws and regulations.
- Maintaining the soundness of the insurance funds.

MFA uses its enforcement powers primarily to halt unlawful acts or practices and to require corrective action. MFA may take enforcement action against real estate lenders, holding companies, operating subsidiaries, other affiliates, or institution affiliated parties (IAP) to ensure the safety and soundness of real estate lenders and the lender industry in general. Institution-affiliated party means: . Any director, officer, employee, or controlling stockholder (other than a holding company) of, or agent for, a financial institution.

- Any other person who filed or MFA requires to file a change-in-control notice with MFA.
- Any shareholder (other than a holding company), consultant, joint venture partner, or any other person as determined by MFA (by regulation or case-by-case) who participates in the conduct of the affairs of a financial institution.
- Any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in any:
  - violation of any law or regulation,
  - breach of fiduciary duty, or
  - unsafe or unsound practice,

The enforcement policies in this Manual section apply to all the parties listed in the paragraph above as well as all examination types.

MFA uses formal and informal enforcement tools to carry out its supervisory and enforcement responsibilities; to address violations of laws and regulations, conditions imposed in writing and written agreements with the agency; and to address unsafe and unsound practices. These tools are the focus of this Manual section.

SUPERVISORY POLICIES

Selecting the Appropriate Tool

Choosing the appropriate supervisory response involves the careful balancing of factors and the exercise of discretion. Below we list the general considerations for determining whether to use a formal enforcement action or an informal supervisory response:

- The extent of actual or potential damage, harm, or loss to the real estate lender because of the action or inaction.
- Whether the mortgage lender or an IAP has repeated the illegal action or unsafe or unsound practice.
- The likelihood that the conduct may occur again.
- The mortgage lender’s record for taking remedial or corrective action in the past.
- The capability, cooperation, integrity, and commitment of the mortgage lender’s management, which caused or is likely to cause more than a minimal financial loss to, or have a significant adverse effect on, the mortgage lender, board of directors, and ownership to correct identified problems.
- The extent to which the identified problems were preventable and not solely the result of external factors.
- The effect of the illegal, unsafe, or unsound conduct on other financial institutions, or the public.
- The examination rating of the mortgage lender.
- Whether the mortgage lender’s condition is improving or deteriorating.
- Whether another government agency’s or private party’s litigation or actions will achieve objectives.
- The presence of unique circumstances.
- The supervisory goal MFA wants to achieve. The last factor, the supervisory goal, is especially important.

MFA considers the following items before determining whether a mortgage lender’s problems are serious enough to warrant a formal enforcement action or whether an informal action, such as a board of directors’ resolution, supervisory meeting, or correspondence can adequately address the mortgage lender’s problems:

- An analysis of the facts.
- An assessment of the seriousness of the problem.
- The mortgage lender’s supervisory history.
- The quality of management involved.
- The results of any meeting with the board of directors.
- An evaluation of whether management will take appropriate corrective action.
- An assessment of the potential harm to the mortgage lender if the mortgage lender does not take corrective action.

Policy on Enforcement Actions

When to Take Formal Enforcement Action

For serious problems or deficiencies, formal enforcement action may be the appropriate initial action. There is a strong presumption that MFA will take prompt formal enforcement action against any mortgage lender with serious problems regardless of examination ratings or capital levels. Examples of when MFA will consider taking formal enforcement action include, but are not limited to, one or more of the following situations:

- The mortgage lender’s records, systems, controls, policies, or internal audit program exhibit significant problems or weaknesses.
- There is serious insider abuse.
- There are substantial violations of law or regulations.
- There is material noncompliance despite prior commitments to take corrective actions. (If the mortgage lender does not comply with an informal enforcement action within a reasonable time, absent strong justification, a formal action is strongly indicated.)
- The board does not take corrective action.
- Informal actions are insufficient.

- The mortgage lender does not maintain satisfactory books and records or provide MFA or other regulatory authorities with prompt and complete access to books and records.

Unsatisfactory Rated Mortgage lenders
There is a strong presumption that real estate lenders with a composite rating of unsatisfactory for the latest safety and soundness, compliance, or information technology examination, or unsatisfactory rating for the latest holding company examination warrant formal enforcement action. Because unsatisfactory rated mortgage lender is more likely to fail, a formal MFA corrective action is presumed necessary. For unsatisfactory mortgage lenders that are currently subject to informal enforcement actions, MFA will consider imposing a formal enforcement action if the most recent examination reaffirms or reclassifies the mortgage lender's composite rating.

3-Rated Mortgage lenders
There is a presumption that real estate lenders with an unsatisfactory composite rating for the latest safety and soundness, compliance, or information technology examination warrant formal enforcement action under any of the following circumstances:

- Management is weak.
- There is uncertainty as to whether management and the board have the ability or willingness to take appropriate corrective measures.
- Conditions are rapidly deteriorating.
  unsatisfactory rating continues for two consecutive examinations following the lender entering into the informal enforcement action, unless the lender complies with the informal enforcement action and no new grounds exist for taking a formal action.

MFA may consider issuing an informal enforcement action for unsatisfactory mortgage lender with strong management and a generally positive assessment if circumstances suggest that remedial measures are immediately forthcoming. The capability, cooperation, integrity, and commitment of management, board, and owners are important considerations in choosing the appropriate actions.

Holding Companies
There is a strong presumption that holding company enterprises with an unsatisfactory rating warrant formal enforcement action. Other factors that might influence MFA's decision to take enforcement action against a holding company and its subsidiaries include:

- Information or referrals from another financial regulator
- Significance of the problems or weaknesses.
- The potential threat that holding company problems might pose a reputation risk for the real estate lender.
- Severity of the effect the holding company enterprise is having on the real estate lender
- Whether the holding company is in compliance with prior commitments to take corrective action.
- Substantial violations of law.

Consulting with Central Bank and Other Authorities
Communications with other regulators is essential to ensure a smooth resolution of a problem mortgage lender. Other regulator may include the Central Bank if the mortgage lender's parent is a bank, and may include other regulators with authority over certain types of service corporations, subsidiaries, and affiliates. Consultation

with such regulatory supervisors should occur in parallel with examinations, supervisory efforts, and enforcement actions.

In coordinating these consultations, be aware of existing information sharing agreements and laws that may govern information sharing between regulators.

TYPES OF ENFORCEMENT ACTIONS

This Section discusses the specific types of enforcement actions, formal and informal, that MFA may take the regulatory considerations in deciding whether and what type of enforcement action to take, and the procedures for investigating and initiating enforcement actions. MFA generally attempts to obtain consent to the issuance of an enforcement action from a mortgage lender's board of directors. Although rare, MFA may not seek consent, for example, in an instance where an immediate cessation to an activity is necessary to halt harm to a mortgage lender.

Informal Enforcement Actions When a mortgage lender's overall condition is sound, but it is necessary to obtain written commitments from a mortgage lender's board of directors or management to ensure that they will correct the identified problems and weaknesses, MFA may use informal enforcement actions. MFA commonly uses informal actions for problems in the following types of mortgage lenders:

- Well- or adequately-capitalized mortgage lenders.
- Mortgage lenders with a satisfactory composite rating.
- Mortgage lenders with a strong management.

Informal actions put the board and management on notice that MFA has identified problems in case a formal action may be necessary later. Informal actions are not enforceable in and of\ themselves. If the mortgage lender violates or refuses to comply, MFA cannot enforce compliance in court or assess civil money penalties for noncompliance but the MFA may take more severe enforcement actions if the institution fails to comply. The effectiveness of the informal tools depends in part on the willingness and ability of the mortgage lender to correct deficiencies that MFA notes.

MFA has a number of informal enforcement tools available to address unsafe or unsound practices or violations of laws and regulations. Those informal enforcement actions include, but are not limited to, the following actions:

- Meetings with management
- Meetings with the board of directors
- Board of directors' resolutions. (A document designed to address one or more specific concerns identified by MFA and adopted by the mortgage lender's board of directors).
- Supervisory letters and directives. (A supervisory letter is a letter signed by the board of directors or management reflecting specific written commitments to take corrective action in response to problems or concerns identified by MFA in its supervision of the mortgage lender).
- Special examinations.
- Requests for voluntary management changes or reorganizations.
- Notice of deficiency and request for safety and soundness compliance plan.
- Individual Minimum Capital Requirement.

(IMCR) Directives. MFA may establish an IMCR for a real estate lender that varies from the requirement that would otherwise apply to the mortgage lender. MFA may establish such IMC requirements for a real estate lender, as it deems necessary on a case-by-case basis. Minimum capital levels higher than those normally required may be appropriate for mortgage lenders:

- Needing special supervisory attention.
- Exhibiting a high degree of exposure to interest rate risk, credit risk, and other risks due to nontraditional activities.
- Experiencing poor liquidity or cash flow problems due to weak credit quality, operational losses, and other factors.

Mortgage lenders have the opportunity to respond in writing to MFA notification of imposition of an IMCR. Failure to satisfy an IMCR may constitute grounds for issuance of a capital directive to the mortgage lender, or other formal enforcement action. If informal tools do not resolve the problem, MFA will use formal enforcement tools. A mortgage lender's unwillingness to comply with an appropriate informal remedy is a significant factor in determining whether a formal enforcement response is appropriate.

Formal Enforcement Actions

A formal enforcement action is both written and enforceable. Formal actions are appropriate when a mortgage lender has significant problems, especially when there is a threat of harm to the mortgage lender, borrowers, or the public. MFA will use formal enforcement actions when informal remedial actions are inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems. Because formal actions are enforceable, MFA can assess civil money penalties against mortgage lenders and individuals for noncompliance with a formal agreement, consent order. Unlike informal actions, formal enforcement actions are public.

We discuss below the formal enforcement actions that MFA may use.

Supervisory Agreements

Supervisory agreements are formal written agreements, and MFA uses them only with mortgage lenders or their holding companies that are subject to MFA's continuing supervision and jurisdiction, not with individuals or other entities. MFA may use supervisory agreements to require mortgage lenders or holding companies to cease any statutory or regulatory violation or unsafe or unsound practice. The agreements may also require affirmative corrective action to address any existing violations, management or operational deficiencies, or other unsound practices. Violations of supervisory agreements, unlike violations of other types of formal enforcement actions, are not enforceable in court.

However, a violation of a supervisory agreement may form the basis for the possible assessment of CMPs, and R&P actions. To ensure that supervisory agreements, if violated, will properly form the basis for other enforcement actions, each supervisory agreement should state that "the Agreement is a 'written agreement' for the purposes of [cite regulatory or legal basis]."

Cease-and-Desist Orders

A C&D order normally requires a halt to illegal, unsafe, or unsound activities. MFA may issue a C&D order in response to violations of banking, securities, or other laws by institutions or individuals, or if it believes that an unsafe and unsound practice or violation is about to occur. MFA will issue a C&D order if one of the following factors is present:

- An unsafe or unsound practice.
- A violation of law, rule, or regulation.

- A violation of any condition imposed in writing in connection with the granting of an application, or any written agreement with MFA.

MFA can issue a C&D order by consent or following a formal administrative hearing. MFA can issue a C&D order against a real estate lender, its service corporation or subsidiary, an IAP, a holding company, a holding company subsidiary, or service providers. If an entity or individual fails to comply with a final order, the MFA may seek enforcement of the order through the court with proper jurisdiction. Violations of an order may form the basis for possible civil money penalties and for removal and prohibition actions. A party subject to the C&D may apply for modification or termination of the order.

Temporary Cease-and-Desist Orders
MFA uses temporary C&D orders to address situations requiring immediate action. To issue a temporary order, MFA first issues a notice of charges, which also initiates a proceeding to obtain a permanent C&D order. In the notice of charges, MFA states that it has determined that there is a violation, an unsafe or unsound practice, or a threatened violation or practice that is likely to result in one or more of the following conditions:

- Insolvency or significant dissipation of assets or earnings.
- Weakening of the mortgage lender's condition.
- Prejudice to the interests of customers before the completion of the C&D proceeding. A temporary C&D order may require affirmative action to prevent insolvency, dissipation of assets, a weakened condition, or prejudice. For example, MFA may use a temporary C&D order to require that a mortgage lender restore its books and records to a complete and accurate state under the following conditions:
- A mortgage lender's books and records are so incomplete or inaccurate that MFA is unable, through the normal supervisory process, to determine the financial condition of the mortgage lender.
- A mortgage lender's books and records are so incomplete or inaccurate that MFA cannot determine the details or purpose of a transaction that may have a material effect on the mortgage lender's financial condition.

MFA may also use a temporary C&D to order cessation of any activity pending the completion of the C&D proceeding. For example, MFA may issue a temporary C&D to freeze assets pending the outcome of litigation or to require immediate change in management. MFA can also require cessation of activities causing incomplete or inaccurate books or records.

A temporary C&D order terminates automatically when MFA dismisses the charges in the notice initiating the C&D proceeding or when a permanent C&D against the same party becomes effective.

Orders of Removal and Prohibition
MFA can remove an IAP from office and prohibit a person or entity from further participation in an mortgage lender's affairs, if all of the following circumstances occur:

- The IAP directly or indirectly engaged in any of the following practices:
  - Violated a law, or regulation, or final C&D.
  - Violated any condition imposed in writing by the appropriate regulator in connection with the grant of any application or other request by the mortgage lending institution.
  - Violated any written agreement between the lending institution and the MFA.

- Engaged or participated in any unsafe or unsound practice with respect to any financial institution or business institution.
- Committed or engaged in any act, omission, or practice that constitutes a breach of fiduciary duty.

- As a result of the violation, unsafe or unsound practice, or breach of fiduciary duty described above, any of the following occurred:
  - The financial institution suffered or will probably suffer financial loss or other damage.
  - The IAP received financial gain or other benefit from the violation, practice, or breach.

- The violation, unsafe or unsound practice, or breach of fiduciary duty:
  - Involves personal dishonesty.
  - Demonstrates a willful or continuing disregard for the safety or soundness of the financial institution or business institution.

An R&P order has industry wide effect and permanently bars an individual from holding office in, being employed by, or participating in any manner in the conduct of the affairs of any mortgage lending institution, and from working for any depository institution regulatory agency. Removed or prohibited individuals may apply for modification or termination of the R&P order. Anyone convicted of a criminal offense involving dishonesty or breach of trust, or who has agreed to enter into a pre-trial diversion or similar program in connection with such a prosecution, is automatically subject to an industry-wide prohibition by operation of law.

Temporary Suspensions

MFA may issue an order temporarily suspending an individual from a position in conjunction with a notice of intention to remove or prohibit the individual from acting in the position. By statute, MFA can issue a temporary suspension only if the suspension is necessary to protect the interests of the real estate lending institution. The suspension remains in effect pending the removal or prohibition proceeding initiated by the notice, unless a relevant court stays the suspension. MFA staff must adequately document violations or unsound practices underlying the temporary suspension. MFA may use the documentation when presenting its action to a reviewing court. Appropriate documentation may include the following materials:

- Examination reports.
- Other materials documenting violations or personal gain to the individual.
- Periodic reports to MFA showing a decline in a mortgage lender's financial condition.

MFA has authority to temporarily suspend or remove an individual charged with committing or participating in a crime involving dishonesty or breach of trust, which is punishable by a term of imprisonment, if the individual's continued service poses a threat to the interests of the mortgage lender's customers or threatens to impair public confidence in the mortgage lender. In such cases, the temporarily suspended or prohibited individual may request an opportunity to appear before the agency to show that his or her continued participation does not pose a threat to the interests of customers or threaten to impair public confidence. The suspension or prohibition remains in effect until resolution of the criminal charges or termination of the order of suspension.

Civil Money Penalties

MFA possesses statutory authority under the statutes to assess civil money penalties (CMP) against mortgage lenders, their service corporations or subsidiaries, holding companies, and IAPs. Assessment of a CMP is appropriate for any of the following violations:

- Violations of any laws or regulation.
- Violations of the terms of any final order or temporary order.
- Violations of any condition MFA imposed in writing in connection with the granting of any application or other request by the mortgage lender.
- Violations of any written agreement between the mortgage lender and MFA.
- Breaches of fiduciary duty.
- Failure to maintain adequate records.
- Failure to file, or filing late or inaccurate MFA-required reports.
- Unsafe or unsound practices.

When assessing a CMP, MFA should consider the following factors:

- Financial resources and good faith of the person, mortgage lender, or company.
- Whether the person, mortgage lender, or company will make financial resources available.
- The gravity of the violation.
- The history of previous violations.
- Any such other matters as justice may require.

Prompt Corrective Action

Prompt Corrective Action (PCA) is triggered by a mortgage lender's capital category. Depending on a mortgage lender's PCA capital category, certain restrictions and actions are automatically imposed by operation of law. Other PCA actions are discretionary. Capital Plans In addition to mandatory and discretionary operating restrictions, MFA requires all mortgage lenders with a rating below adequately capitalized to submit a timely capital restoration plan (Capital Plan) after receiving notice or being deemed to have notice of becoming undercapitalized. MFA regulations provide the timing, content, and approval standards for Capital Plans.

The Capital Plan must explain in detail the proposed strategy for becoming, at a minimum, adequately capitalized, and for accomplishing the mortgage lender's overall objectives. MFA must consider various factors in determining whether to approve the plan. These factors include, but are not limited to, the following criteria:

- How the mortgage lender will comply with restrictions and requirements.
- The mortgage lender's proposal to become adequately capitalized.
- The mortgage lender's activities.
- Whether the mortgage lender's assumptions are realistic.
- Likelihood of success.
- Risk exposure.

Each controlling company of an undercapitalized mortgage lender must guarantee that the mortgage lender will comply with the Capital Plan until adequately capitalized (on average) during four consecutive quarters, and provide adequate assurances of performance.

If MFA approves the Capital Plan submitted by the mortgage lender, it becomes the basis for a PCA Directive along with any mandatory or discretionary operating restrictions applicable to the mortgage lender. If MFA determines that the mortgage lender's Capital Plan is not acceptable or if the mortgage lender fails to file one, MFA issues a PCA Directive. The PCA Directive becomes the basis for curtailing certain activities, and mandating the steps necessary to either increase capital to acceptable levels, or otherwise move the mortgage lender toward resolution.

Prompt Corrective Action (PCA) Directives MFA requires that the agencies take prompt enforcement against undercapitalized institutions. Under PCA standards, an institution is in one of five capital categories: well capitalized; adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized. Mandatory, discretionary, and presumed restrictions and sanctions apply for institutions in the three undercapitalized categories. A PCA directive establishes a capital-based supervisory scheme that requires MFA to place increasingly stringent restrictions on mortgage lenders as regulatory capital levels decline. PCA mandates the imposition of certain restrictions once a mortgage lender falls below the well-capitalized category. Most of the restrictions are limited to mortgage lenders at the undercapitalized level or below. The following two restrictions, however, pertain to all adequately capitalized mortgage lenders:

- No mortgage lender can make a capital distribution if it results in undercapitalization; and for mortgage lenders at the undercapitalized level and below, there may be additional mandatory operating restrictions that apply. These restrictions may include the following actions:
- Restricting asset growth.
- Restricting capital distributions and certain management fees.
- Limiting the ability to make acquisitions, branch, or enter new lines of business.
- Requiring compliance with a capital restoration plan submitted by the mortgage lender.
- Monitoring by MFA. (This may include more frequent field visits by MFA or written quarterly reports from the board of directors on adherence to the PCA restrictions). In addition to the mandatory restrictions, the PCA regulations provide MFA with authority to apply a wide range of discretionary remedies.

MFA should impose the following discretionary restrictions when conditions warrant:

- Require recapitalization.
- Restrict transactions with affiliates.
- Restrict interest rates paid.
- Restrict asset growth more stringently than required by statute.
- Restrict activities (for example, banning certain types of lending).
- Improve management (for example, mandating the election of a new board of directors, dismissing current directors and members of senior management, or requiring the hiring of certain qualified employees subject to MFA approval).
- Require prior approval for capital distributions by a holding company.
- Require divestiture.
- Restrict executive or senior officer compensation.
- Take any other action necessary to resolve the problems of the mortgage lender at the least possible long term loss to the insurance fund.

The above provisions apply to mortgage lenders that fail to submit and implement capital plans. In addition to the PCA remedies available for undercapitalized real estate lenders, the statutory framework allows the MFA to reclassify a mortgage lender's PCA category if it operates in an unsafe and unsound condition.

Once the MFA has implemented a reclassification, a mortgage lender can petition the MFA for a PCA category upgrade if it successfully rectifies the unsafe and unsound conditions.

Orders Enforcing Safety and Soundness Standards

MFA also has authority to issue a Safety and Soundness Order against a real estate lender. The process begins with MFA issuing a notification to the mortgage lender of its failure to meet the safety and soundness standards, and requesting that the mortgage lender submit a compliance plan. Generally, this tool addresses unsafe and unsound conduct that is not reflected in capital levels.

These notices of deficiencies may also address specific problems in well- or adequately capitalized mortgage lenders. MFA generally only uses Part 570 safety and soundness notices of deficiency when the following conditions are present:

- The problems or weaknesses are narrow in scope and correctable.
- MFA is confident of the board and management's commitment and ability to correct problems or weaknesses.

If the mortgage lender fails to submit a compliance plan, or fails to comply with an approved compliance plan, MFA may issue a Safety and Soundness Order. The mortgage lender has the right to respond in writing to the proposed issuance of an order. There are serious consequences for a mortgage lender's failure to comply with a Safety and Soundness Order. MFA can impose CMPs or seek enforcement through judicial or administrative proceedings.

POST-ENFORCEMENT ACTIONS

Checking for Compliance with Outstanding Agreements and Orders

The recurrence of a problem previously addressed by an informal method of supervision, such as a supervisory directive, raises a presumption that MFA will pursue a C&D action or assess a CMP. That is, a material violation of an informal enforcement action should cause MFA to consider a C&D action or a CMP assessment, unless there are substantial mitigating factors. A significant violation of a formal enforcement order raises a presumption that MFA will take a more severe formal enforcement action (for instance, CMPs against the board or management if the mortgage lender has failed to comply with a C&D order). During every examination, regardless of the type of examination, examiners will expressly check for compliance with each outstanding directive, agreement, or order. Examiners must document compliance or noncompliance in the Report of Examination (ROE).

The terms of the directive, agreement, or order will dictate the scope of the inquiry. For example, an agreement requiring a mortgage lender to develop and adopt effective, written lending procedures necessitates that examiners review the procedures for clarity, effectiveness, and proof that the board of directors adopted them. An agreement that the mortgage lender must comply fully with new loan procedures requires a review of a sample of loans for compliance with those procedures. This review should be in addition to the normal loan review for compliance with applicable regulations and safety and soundness standards.

Documentation

Throughout this Manual Section we mention the importance of thorough documentation that is required for taking supervisory and enforcement action. In the event a mortgage lender violates a final order that MFA may have to enforce by bringing court action, MFA will rely on examiners' determination of the source of noncompliance (or other conduct), which may be due to the mortgage lender's administrative oversight, lack of knowledge or skill, or willful disregard. Discussions with management should be summarized in a written report. This report should also include management's oral explanations of why such violations occurred and MFA's opinion as to the necessity of further enforcement action. In all cases, MFA should obtain clear documentary evidence of the violations or conduct to provide evidence if MFA issues an order.

Termination or Modification of Enforcement Actions

Generally, MFA does not terminate an enforcement action until the mortgage lender has complied with all the articles in the enforcement action document. MFA must explain, in writing, a decision to terminate or modify an enforcement action. An MFA examination documenting compliance with the enforcement action is usually a prerequisite to removal of the action unless MFA can obtain the appropriate documentation to support such modification or termination without an MFA examination. In limited instances, MFA will permit a modification or termination of an enforcement action without an MFA examination if deemed appropriate.

METHODS OF GATHERING INFORMATION

Regular and Special Examinations

Generally, MFA will undertake informal means of obtaining information before requesting a formal examination with subpoena power. MFA will seek out and use reliable information from real estate lenders and their affiliates, employees, and agents. Because of MFA's authority to examine the records of any real estate lender and that mortgage lender's affiliates, MFA does not need to issue subpoenas to compel the production of the records of the mortgage lender or their affiliates.

MFA should have prompt and complete access to all mortgage lender personnel and agents, and to all mortgage lender documents. Examiners should notify MFA Counsel immediately if the mortgage lender or its personnel refuse to supply mortgage lender records or otherwise obstructs the progress of an MFA examination.

Informal requests to interview persons outside of the mortgage lender or to review records of a borrower or other entity that is not a real estate lender or its affiliate may also be informative.

In instances where a parent is regulated by the Central Bank or another regulator, MFA will work cooperatively with the primary regulator of the entity to request information and reports. In limited circumstances, if the regulator is unable or unwilling to obtain the information, MFA can request the information directly from the entity. MFA may also obtain information from publicly available sources of information, such as land record offices or corporation regulators.

REFERENCES

SECTION: Transactions with Affiliates and Insiders 380

INTRODUCTION

A lender's affiliate relationships and transactions can significantly affect the operations and overall financial condition of a real estate lender. Your review of a lender's and its subsidiaries' transactions with its affiliates is a critical component of the lender and holding company examinations.

However, the affiliate transaction rules are complex and, at times, confusing. This section will give you a basic understanding of the rules related to affiliate transactions. You should carefully review these transactions to identify any potential risks they pose to the real estate lender.

Mortgage lenders may pursue opportunities to enhance operational results among affiliated entities and to leverage expertise and resources throughout their overall organizational structure. Such relationships can present unique challenges for regulators, for example, in identifying the flow of funds among entities and assessing internal controls for oversight of lender/affiliate arrangements.

Transactions with affiliates (TWA) can result in risk that is difficult to detect. In many cases, it is appropriate and beneficial for a lender to engage in business transactions with its affiliates and insiders. MFA, however, may prohibit transactions by regulation or, when contrary to the lender's best interests, based on safety and soundness grounds and even abuse. Accordingly, you must distinguish appropriate transactions from abusive or potentially abusive transactions, or transactions that are otherwise inconsistent with safe and sound operations.

The lender's affiliate transactions should meet the following criteria:

- Not be abusive or detrimental to the mortgage lender. (You should be alert to any transaction that subjects the mortgage lender to unreasonable pressure from management or an affiliate.)
- Be based on safe and sound practices.
- Comply with applicable statutory and regulatory standards. Such standards set forth how much and on what terms a lender may lend to its own insiders (directors, executive officers, principal shareholders and related interests) and insiders of an affiliate.

This Section should help you evaluate the following areas:

- Acceptability of transactions with affiliates.
- Permissibility of transactions with insiders.

TRANSACTIONS WITH AFFILIATES

Affiliate transactions occur when a mortgage lender or its subsidiary engages in a transaction with its holding company, any subsidiary of the holding company, or any other entity or person considered an affiliate. You may find evidence of such transactions at any lender, but the volume of affiliate transactions is usually greater in a holding company structure since intercom any transactions are often an integral part of a company's operations.

Due to the potential risk from these transactions, lenders are subject to the following regulatory standards:

- Individual and aggregate percentage of capital ceilings on the amount of affiliate transactions.
- Arms-length dealings requirement.
- Prohibition of acquisitions of low-quality assets from affiliates.
- Collateralization requirements for affiliate credit transactions.
- Prohibition of certain activities.
- Transaction exemption provision.

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SECTION: Financial Records and Reports 410

Good decisions begin with good information. Complete and accurate records and reports are essential for a real estate lender's board of directors and officers to make informed decisions and to clearly understand and support transactions. Also, a mortgage lender must establish policies, procedures, and controls to ensure that management properly maintains financial reports and records.

Inaccurate, incomplete, or unreliable information jeopardizes the safety and soundness of a mortgage lender because unidentified or undisclosed problems could prevent or delay necessary corrective action and undermine the mortgage lender's viability.

The Mortgage Finance Authority (MFA), in its role as regulator, must have reliable data to assess and monitor a real estate lender's financial condition and activities. Your review of a mortgage lender's books and records, internal reports, and reports to external auditors and regulatory officials should include an assessment of the accuracy and adequacy of that information. Your review allows MFA to rely on the mortgage lender's records throughout the examination, supervision, and monitoring processes.

RISK-FOCUSED REVIEW

You should direct the focus of your review to assessing the accuracy and adequacy of a mortgage lender's records and reports. Accuracy is essential to properly evaluate and monitor a mortgage lender's financial condition. This involves obtaining satisfactory explanations of all material variances, trends, or other items and assessing the reasonableness of financial records. You must also evaluate a mortgage lender's policies and procedures for relevance and sufficiency. You should not spend an inordinate amount of time verifying a minor account if it has a small balance and does not consist of large, offsetting transactions. If you discover minor errors or omissions, you should report it to management. You should be alert, however, if a minor account problem appears to be systemic.

Regulatory Requirements

All real estate lenders and their affiliates must maintain accurate and complete records of all business transactions. The real estate lender must keep the records in Egypt. Upon request by MFA, these records must be readily accessible immediately for examination and other supervisory purposes at a location acceptable to MFA.

In addition, each real estate lender should establish and maintain an accurate and complete record of all business that it transacts. A mortgage lender must establish and maintain such other records as required by applicable statutes or regulations. The documents, files, and other material or property comprising these records must be available for examination and audit.

Change in Location of Records

Real estate lenders must perform the following actions before they transfer the location of general accounting or control records:

- Obtain a board of directors' resolution authorizing the transfer or maintenance
- Send a certified copy of the resolution to the MFA

Incomplete or Inaccurate Records

Examiners should immediately take enforcement action if a mortgage lender's books and records are incomplete to make an examination impossible or if they do not provide complete and accurate details on all business transactions. The EIC or Head of Monitoring and Enforcement should promptly meet with the mortgage lender's board of directors, discuss the problem, and require prompt corrective action. If the mortgage lender does not correct the deficiency, the EIC or Head of Monitoring and Enforcement should refer the matter to MFA top management for appropriate action.

You should be particularly alert to the presence of incomplete and inaccurate records, as this is often evidence of severely deficient operating standards and a resultant deteriorating financial condition.

Records and Reports

MFA may gather data from real estate lender records, such as:

- General ledger
- Subsidiary ledgers
- Journals
- Vouchers
- Various schedules and reports

Various schedules and reports that will be useful to you in the review process include the following:

- Internal reports that staff submits to management and the board of directors
- Prudential Reports
- External and internal audit reports
- Parent company annual reports
- Securities commission filings

You may also obtain additional information from MFA off-site monitoring activities and work performed by external and internal auditors who attest to the integrity of a mortgage lender's books and records.

Real estate lenders should maintain internal systems and procedures to ensure that reporting reflects appropriate regulatory requirements. Clear, concise, and orderly records should support the compilation of various data. Proper documentation provides not only a logical tie between financial report data and a mortgage lender's records, but also facilitates accurate reporting and verification.

General and Subsidiary Ledgers

Each real estate lender should have a chart of accounts describing the nature and general content of each general ledger account. You should encourage mortgage lenders that do not have such charts to develop one. The chart of accounts will not only aid in your review, but will also provide consistency and continuity in a mortgage lender's accounting department. You should review the individual asset, liability, capital, and income and expense accounts for their history, recent activity, balance, and propriety. You should investigate any extraordinary items or items that are not self-explanatory, and you should review and reconcile any catch-all accounts (that is, other assets, other liabilities, miscellaneous, or suspense accounts). If your review discloses any errors or omissions, you should determine whether they resulted from inadequate policies, deficient procedures, or practices not in accordance with a mortgage lender's policies and procedures.

During your review of the general ledger and subsidiary ledgers, you should determine that the account titles accurately reflect the account contents. A title describing an account may not always represent its content. The determination that an account contains the proper items and has a true balance helps to ensure that all line items are being recorded properly on the prudential report. If reclassifications are necessary, you should advise management accordingly and follow up to see that the mortgage lender has done so correctly.

Prudential reports

MFA requires each real estate lender to file a prudential report with the Financial Reporting Division within 5 working days following the reporting date. MFA uses the prudential report to do the following:

- Collect detailed financial information in a consistent format on all regulated mortgage lenders
- Collect uniform information on industry activities
- Facilitate supervision

The prudential report discloses a mortgage lender's financial condition, the results of its operations, and other supplemental data. MFA uses data from this report as the basis for its Financial Reporting System. This report system in turn produces other reports, such as the Uniform Lender Performance Report and the Report of Examination (ROE) financial pages.

Prudential report Requirements

Real estate lenders must file financial reports that use generally accepted accounting principles. Real estate lenders must complete the financial sections of the prudential report on a consolidated basis. You should review the prudential reports to ensure that mortgage lenders are performing consolidations properly and following prudential report instructions in completing their reports.

MFA uses consolidated maturity and rate information to collect detailed information relating to an institution's interest rate risk.

MFA requires real estate lenders to file prudential reports electronically, and reports are collected, reviewed and analyzed by MFA off-site examiners.

Review of the Prudential Report

You should review the content of the most recent quarterly prudential reports for accuracy. You should also reconcile line items shown on the reports to the general ledger, the subsidiary ledgers, and other appropriate sources, such as loan registers.

MFA revises the instructions periodically and generally revises the forms annually. Both industry and regulatory personnel must have up-to-date instructions for accurate classifications and reconciliation.

If you discover any errors or omissions during the prudential report review, you should determine whether any mortgage lender policies, procedures, or deficient or inadequate practices caused them. You should explain and document in the ROE any significant adjustments, including their causal factors. A significant adjustment results in any one of the following:

- Failure of a capital requirement
- Change in a mortgage lender's prompt corrective action (PCA) category
- Change in a component rating
- A change that is significant for regulatory reporting purposes

Generally, you should not require that a mortgage lender amend a prior period prudential report unless the adjustment is significant. If the adjustments are not significant, you should direct the mortgage lender to show the adjustments on its next prudential report scheduled filing.

Errors or omissions in one schedule usually have repercussions within other schedules. As a result, when you discover and correct an error in one schedule, you must also amend other schedules affected by the error. You must disclose any errors discovered in the prudential reports on the proper page(s) in the ROE, including financial report pages.

The accuracy of prudential reports is extremely important, because MFA uses information contained in the reports to monitor real estate lenders between examinations. If mortgage lenders submit inaccurate data, MFA may not detect changing patterns of behavior or deteriorating trends. When compounded, a distorted picture of the industry condition could result.

Internal Financial Reports to the Board of Directors

Boards of directors have extensive fiduciary responsibilities in guiding the activities of their mortgage lenders. Creditors and investors have the right to expect that a mortgage lender's board of directors and officers use safe, sound, and ethical practices.

You should do the following examination procedures:

- Ascertain whether management presents any financial reports to the board besides the required reports, such as the prudential report
- Review the accuracy and adequacy of additional reports
- Determine whether the submission of inaccurate or inadequate reports is the result of an intentional act by management

At a minimum, financial reports to the board of directors should include the following operational information:

- A summary of significant financial activity
- Documentation detailing loans granted
- Delinquencies
- The status of previously approved ongoing projects (including loan projects)
- The status of any real estate workouts
- Liquidity reports
- Profit and loss statements with yearly and year-to-date comparisons
- Foreclosure status reports
- Classified asset summaries
- Any salient trial balance data

If you discover any material errors or omissions in these reports, you should determine and explain the causal factors in the ROE.

Monitoring Reports

MFA off-site functions monitor real estate lenders' reports on an ongoing basis. Some provide examiners with reports that are generated from information gleaned during the surveillance process. Monitoring reports should be reviewed for any of the following:

- Incipient adverse trends
- Material deviations from one period to another
- Extraordinary developments
- Other matters of concern

You should follow up on all items deemed worthy of further investigation and obtain satisfactory responses from management that explain specific questionable matters.

SECTION: Operations Analysis 430

INTRODUCTION

All phases of the regulatory process, from off-site monitoring between examinations to the final Report of Examination (ROE), involve some form of operational analysis. Operational analysis is the interpretation of financial data through careful and questioning study. An analysis of operations should result in a comprehensive review and evaluation of a real estate lender's past, current, and prospective earnings. To maintain a mortgage lender's viability and to minimize risks to the mortgage lending system, it is essential that you recognize and report problems or potential problems, and that the mortgage lender takes corrective action. This Manual Section provides guidelines for reviewing and evaluating the financial operations of a mortgage lender.

Importance of Earnings

Earnings are essential to a real estate lender's continued viability. A mortgage lender's earnings determine its ability to absorb losses, ensure capital adequacy, and generate a reasonable return. You should evaluate a mortgage lender's operations for stability, trend, level, and quality of earnings. You should also analyze additional factors, such as capital level, credit risk, and interest rate risk, to thoroughly evaluate a mortgage lender's operations.

Examination Process

The review of a real estate lender's operations and financial condition is a continuing process. The pre-examination analysis and scoping process identify existing or potential problem areas requiring attention. A comprehensive on-site analysis substantiates and assesses current and prospective earnings. A well-performed analysis not only provides an understanding of a mortgage lender's operations, but also identifies matters of existing or potential concern. You can use the analysis to facilitate corrective action that will avert problems or prevent existing problems from worsening. When analyzing financial statements, avoid undue precision or spending excessive time on immaterial amounts. Most importantly, you should constantly maintain a sense of the examination objectives. Since earnings reflect a real estate lender's overall financial condition, you must be aware when examining a mortgage lender of the extent of existing or potential problem areas outside the purview of operations analysis. As such, you must maintain a constant flow of communication with individuals working on other examination areas to affect a cohesive and comprehensive review.

Finally, such matters as reporting errors, incomplete information, or deficient accounting procedures may hinder or prevent an accurate evaluation of a real estate lender's operations. A thorough analysis depends on accurate and reliable information and is an extension of reviews of a mortgage lender's financial records and reports (Manual Section 410) and accounting standards.

> Information presented in this Section will enable you to accomplish the following procedures: Establish the scope of the financial analysis aspect of the examination. Section 060, Examination Strategy, Scoping, and Management, provides specific guidance on establishing the scope of the examination
>
> Identify practices that are potentially unsafe and unsound and formulate a regulatory response

- Assess a mortgage lender's operations and strategies
- Identify problem areas disclosed by the financial records
- Obtain satisfactory explanations for all material variances of financial data from prior periods and budgeted amounts

INFORMATION SOURCES

The basic sources of information for performing an analysis of a real estate lender's operations include all the following items:

- Prudential reports (prudential reports) filed with the Mortgage Finance Authority (MFA)
- Financial pages of the previous and current ROE
- Analytical reports generated by MFA off-site monitoring
- Additional monitoring reports developed by MFA, if any
- Independent and internal audit reports
- Other internal reports to the board of directors, including budget, business plan, earnings reports such as yield and cost analysis, and investment committee reports
- Board minutes

Off-Site Monitoring

The primary purpose of off-site monitoring is to identify adverse changes in the financial condition and performance of real estate lenders that may occur between regularly scheduled on-site examinations. MFA is establishing uniform financial monitoring guidelines to ensure greater consistency in risk assessment and risk detection. These guidelines define the frequency of monitoring, the scope and content of monitoring reviews, and the format for communicating monitoring results.

MFA may use off-site monitoring to accomplish the following other objectives:

- Identify regulatory trends or problems that warrant immediate attention
- Identify institutions that need to be examined ahead of schedule
- Identify specific areas within institutions that should be given close scrutiny during on-site examinations
- Monitor compliance with supervisory directives to correct problems uncovered in prior examinations
- Monitor adherence to conditions of approval and business plans
- Monitor compliance with statutory and regulatory limits
- Modify an institution's examination rating
- Assemble data, information, and analysis to support on-site examinations

MFA is responsible for monitoring real estate lenders on a quarterly basis and has discretion in determining the priority of monitoring reviews. Priorities may be based on various factors, such as the severity of deterioration in the financial condition or performance of the institution as evidenced by breach of any regulatory limit or Prompt Corrective Action trigger, high-profile status, CAMELS rating, asset size, or the occurrence of a significant event such as a proposed merger or acquisition. Monitoring of real estate lenders with high-risk profiles will be more extensive and more frequent than that of non-high-risk mortgage lenders. High-risk mortgage lenders include those that fail their minimum capital requirements or have a higher overall risk profile based on such factors as asset quality, higher risk asset composition, earnings and operations, liquidity, interest rate risk, or capital. For non-high-risk mortgage lenders, it may be sufficient to limit the review to compliance and summary monitoring reports on a quarterly basis.

For a high-profile mortgage lender, supervisory staff should incorporate in the mortgage lender's regulatory profile a summary discussion of the monitoring findings and any resultant corrective action recommended or taken. Supervisory staff should document in the regulatory profile any significant actions, including the identification of material concerns and recommendations for action. This documentation should provide an understanding of a mortgage lender's operations and performance and should identify matters of existing or potential concern. Supervisory staff should, when appropriate, reference all violations of law, regulation, policy or supervisory directives

For any mortgage lender, you should notify appropriate MFA staff of any problems or risks identified through monitoring. The department must maintain written documentation of the results of off-site monitoring. MFA must initiate corrective action when appropriate. Such action may range from a telephone call or letter to the mortgage lender, a meeting with management, recommendation for an examination, or, in the case of serious problems, formal enforcement action.

COMPONENTS OF EARNINGS

To obtain a complete and accurate understanding of a real estate lender's operations, it is essential to understand its operating strategy and the components of earnings. MFA identifies the mortgage lender's strategy in the regulatory profile, or you can identify it by determining revenue and funding sources. Earnings components include such items as interest income and expense, non-interest income and expense, and core income. The paragraphs below describe each of these components in greater detail.

Interest Income

Interest income consists of interest earned on loans, investment securities and deposits. Interest income is the most important income component of core income for mortgage lenders. Mortgage loan servicing fees and other fees and charges are the most important income component of core income for mortgage lenders that emphasize mortgage banking.

Interest Expense

Interest expense is the interest that the mortgage lender pays on debt, including subordinated debt, collateralized securities, and other borrowed money.

Net Interest Income

Net interest income (NII) represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. NII is a key component of earnings for most real estate lenders engaged in portfolio lending.

Net Interest Margin

Net interest margin (NIM) represents net interest income divided by average assets. NIM is a key performance/profitability ratio. Prudent management of NIM includes the following:

- Planning and implementing sound growth strategies that include effective cash flow analysis
- Maintaining minimum acceptable levels of non-interest-earning and/or non-performing assets
- Maintaining adequate and reasonable capital levels
- Managing interest rate risk to minimize NIM volatility due to changes in market interest rates
- Maximizing low cost funding sources

Balancing investment yield and risk (credit risk, interest rate risk, liquidity risk, etc.)
Managing the mix of interest-earning assets and interest-bearing liabilities

Interest-Earning Assets

Interest-earning assets (IEAs) consist of investment securities, deposits in other institutions, mortgage-backed securities, mortgage loans, and non-mortgage loans, less non-IEA components. Non-IEA components include intangible assets (such as goodwill), non-accrual loans, real estate owned, and real estate held for investment.

Interest-Costing Liabilities

Interest-costing liabilities (ICLs) consist of debt, subordinated debentures, loans from parent,
mortgage collateralized securities, other borrowings, any non-ICL components deducted from these categories, and the combined total. The level of equity capital influences the level of ICL. High capital levels will lower ICL as a percentage of total assets.

Net Interest Position

A net interest position (NIP) is the same as a net IEA position (IEAs less ICLs). A shrinking NIP indicates a weakening balance sheet, and a greater reliance on products and investment margins for continued profitability. A NIP that is negative may indicate that interest-costing liabilities are financing non-interest-earning assets, which may be a serious weakness.

Net Interest Spread

Net interest spread is the weighted interest yield on average earning assets less the weighted interest rate paid on average interest paying liabilities.

Non-interest Income

Non-interest income includes loan origination fees, loan servicing fees, late fees, hedging gains and service corporation profits. This item may also contain nonrecurring sources of income such as gains on the sale of assets, income from REO operations and other income sources of earnings that are generally unpredictable and unstable.

Non-interest Expense

The major component of non-interest expense is salaries and compensation. This category also includes rent, depreciation, utilities, marketing, assessments, and professional fees. Controlling costs is a critical management function. A reduction in non-interest expenses will increase core earnings, net income and market value.

Provision for Loan Losses

Weak or deteriorating credit quality can result in the need for higher provision expenses, which can adversely affect the mortgage lender’s earnings. See Manual Section 261, Adequacy of Valuation Allowances, for examination procedures on evaluating the adequacy of the mortgage lender’s valuation allowances.

Core Income

Core income means only spread income and other sources of recurring and reasonably predictable income. MFA defines core income to be net interest margin plus fees earned from loan servicing and other sources, minus general and administrative expenses. While serving as a useful analytical tool, it is important to realize that even core income can be misleading. For example, if spread income stems from an interest rate risk gamble, or if fee income comes from nonrecurring sources, core income will not be sustainable. It is therefore important to know what percentage of core income consists of interest income. In addition, high-risk loan programs may generate consistently high loan losses. You should consider this when evaluating core income. See Quality of Earnings Section in this Manual.

COMPREHENSIVE INCOME

Comprehensive income measures all changes in equity that result from recognized transactions and other economic events not related to transactions with owners in their capacity as owners. Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes, for example, the following amounts, net of income taxes:

- Unrealized gains and losses on available-for sale debt and equity securities
- Gains and losses related to qualifying cash flow hedges under accounting principles pertaining to derivative instruments and hedging activities
- Minimum pension liability adjustments
- Foreign currency translation adjustments

A real estate lender should report the total of accumulated other comprehensive income as a
separate component of equity capital.

RETURN ON ASSETS AND EQUITY

Return on Assets

Return on assets is net income divided by average assets. Traditionally, return on assets is the primary measure of a mortgage lender's profitability. You should review the level, trend, and peer comparison of this ratio since it is a critical determinant of long-term viability.

Return on Equity

Return on equity is net income divided by average equity. Investors and capital markets use
the return on equity ratio to determine investment options. Average equity refers to the
average of total equity capital:

- Perpetual preferred stock
- Common stock
- Retained earnings
- Unrealized gains (losses) on available-for-sale securities
- Other equity capital components according to accounting principles

EARNINGS ANALYSIS

To make a thorough analysis of earnings you should begin with a review of a mortgage lender's earnings strategies and its strategic business plans. You should evaluate earnings performance relative to measures appropriate for the dominant type of business the mortgage lender engages in such as traditional lender activities, mortgage lending, securitizations, or other activity. Your earnings analysis should not only provide an assessment of why earnings are weak or strong, stable or variable, but also give reasons for the earnings performance relative to the mortgage lender's business strategy and economic environment. For example, if earnings are poor because of lower gain on sale from mortgage banking activities, do not attribute poor earnings to high general and administrative expenses. Most successful mortgage banking operations generally require higher general and administrative expenses.

Four Key Aspects of Earnings

You should perform an aggregate evaluation of the components of earnings in relation to four key aspects of earnings: stability, trend, level, and quality. We further discuss these four aspects below.

Stability of Earnings

The stability of earnings relates to the quality, composition, and constancy of income and expense flows relative to internal factors such as credit risks, interest rate risks, or accounting practices, and external factors such as general economic or competitive forces. A real estate lender's income stability depends on proper management of its sources of income and expense and the influence of internal and external factors on those sources. Recurring income sources, such as net interest on loans or investment portfolios, are usually preferable to nonrecurring income sources, such as income derived from the sale of assets. Relying too heavily on nonrecurring sources of income could severely affect a mortgage lender's future viability. See Quality of Earnings Section in this Manual.

Trend of Earnings

Trend is the general direction of the real estate lender's earnings relative to previous time periods. Evaluating previous time periods should encourage you to identify and investigate both an mortgage lender's adverse and positive earnings trends.

Level of Earnings

The level of earnings is the measure of earnings relative to internal factors such as capital position, credit risk, and interest rate risk. You should perform a comparison to peer groups to determine material variances. In doing so, you may use the standard peer groups based solely on asset size or the more refined peer groups based on operational and geographical characteristics. You must review additional areas to ensure a comprehensive analysis, since many risks may materially affect earnings. You should therefore review the findings relating to risk analysis that the Asset Quality Section of this manual discusses.

Quality of Earnings

Your examination of a real estate lender's earnings should include a review of the quality of earnings. The quality of reported earnings, also referred to as accounting quality, may be defined as how well a company's financial statements accurately depict business activities. Management is responsible for reporting earnings that are consistent with economic substance. Accounting principles allow management the flexibility and latitude to effectively communicate the financial position and results of a company's operations. Accordingly, management may implement certain reporting strategies, make certain accrual, deferral, or allocation decisions, or exercise other managerial discretion when reporting earnings. Management should not manipulate earnings or misuse accruals or underlying assumptions of a transaction such that it misreports income, and thus capital, and causes users of the financial statements to change or alter judgments or decisions about the condition of the company.

Accordingly, it is not only important to look at the components of earnings, but also at the techniques and strategies management may be using to report earnings. The strategies management uses should fall within acceptable limits of accounting principles, and not mask the economic condition of the company. When evaluating the quality of a mortgage lender's earnings, you should also identify key areas of operating performance that affect profitability. For example, if a key area of operation is in securitization transactions, a mortgage lender may show impressive profitability by reporting nonrecurring gains and revenues such as gains on sales of securitizations or other asset transfers. It is also possible for lenders to report impressive profitability ratios and high volumes of income by assuming unacceptable levels of risk. For example, to boost earnings in the short-term, management may seek higher rates on riskier loans and other investments to offset the increased credit risk associated with those assets. However, over the long-term, these assets may not be of a quality to assure either continued debt servicing or principal repayment. Eventually, earnings or capital may suffer when management must recognize the losses in these higher-risk assets.

Aside from any recourse implications that may arise, properly reflecting the quality of earnings is less likely a problem in a generic sale of whole loans than in a securitization or other type of asset sale.

Mortgage lenders may also have various sources of recurring and nonrecurring fee income including late fees from loan accounts and nonrefundable rate lock fees. You should review fees that you consider significant to the statement of operations.

Securitization Transactions

Properly reflecting earnings from securitization transactions or those from mortgage servicing assets may be more difficult because relatively minor changes in the economic environment can significantly affect reporting. In addition to economic influences, financial reporting of securitizations is based on complex accounting standards. A mortgage lender initially measures and records assets retained in connection with a sale or securitization, based on the relative fair values. That is, the mortgage lender allocates the previous carrying amount between the sold assets and the retained interests based on their relative fair values. The reported gain is the difference between the net proceeds from the sale and the allocated carrying value of the assets sold. This methodology is often called “gain-on-sale” accounting. While much of the focus on gain-on-sale accounting has been on sub-prime securitizations, prime securitizations may also take advantage of gain-on-sale accounting. Because of the subjectivity underlying most assumptions used to determine fair values, management can allocate higher carrying amounts to retained interests. The higher the carrying amount allocated to retained interests, the lower the carrying amount allocated to the sold assets. The lower carrying amount of the assets to be sold results in a higher recorded gain on the assets sold. Thus, reported gains may not be truly reflective of the mortgage lender’s operating performance, or they may be non-cash, temporary, or of a nature that the mortgage lender may never realize them in the future.

The following management actions may affect the assigned fair value of the assets, and thus affect the quality of reported earnings:

Management uses optimistic assumptions to calculate asset values. Since allocating a higher carrying amount to retained interests may result in a larger up front gain on the assets sold, management may use optimistic assumptions that over estimate the value of retained interests.

The following factors affect estimates underlying valuations and the ability to measure cash flows reliably:

- Prepayment rates
- Credit loss rates
- Discount rates (required rate of return)
- Lack of a reliable market

Management assumes a credit loss rate that is too low or inconsistent with existing market conditions. As a result, credit losses may be high if management fails to timely reassess assumptions. Even if the assumed credit loss rate is consistent with existing market conditions, unanticipated losses may still occur if there is an economic downturn. In the event of a recession or a dramatic economic downturn, losses may increase significantly.

Management assumes a prepayment speed that is too slow for assets such as mortgage servicing assets or other retained interests. For example, a fall in longer-term interest rates will cause an acceleration of payments. If prepayments are faster than expected, then future cash flows may disappear and the value of the servicing asset or retained interest will decline. Even sub-prime mortgages, once believed largely insulated from prepayment risk, have become more prepayment sensitive as alternatives for sub-prime borrowers increase.

Goodwill

Institutions may find it challenging to keep abreast of new accounting standards that affect reported earnings, as well as to appropriately and timely implement complex standards into their financial reporting systems. Institutions should no longer amortize goodwill, but must measure the goodwill, if any, for impairment, and make adjustments accordingly. This treatment may create volatility in reported income because impairment losses are likely to occur irregularly and in varying amounts. You should review a mortgage lender's goodwill, if any, and determine how the mortgage lender measures and adjusts its goodwill for impairment. You should ensure that the mortgage lender no longer amortizes goodwill.

Regulatory Concerns

In summary, incentives to report higher earnings, the nature of assumptions used in certain transactions, like securitizations, and improper reporting in general may affect reported earnings. Examiners should be alert to the regulatory concerns cited throughout this section, and to the following additional regulatory concerns as well:

Management may use gains to further leverage the balance sheet. You should consider the quality of capital supporting asset growth to the extent that management based gains on optimistic assumptions or that the value of the retained interest is highly sensitive to accelerating prepayments or declining asset quality.

Management compensation or dividend payouts may be excessive, and dependent on earnings. Mortgage lenders often tie compensation and dividends to reported profits. To the extent that reported profits are overstated, these payouts can dissipate assets and capital.

Management may ignore credit quality. The incentive for profits can override attention to quality of earnings. The potentially significant profit that management can generate by gain-on-sale accounting creates a strong incentive to produce originations, often with little attention to credit quality.

Later impairment assessments may erase reported gains. Management may have to reverse, in later periods, some or all of the up front gains recorded in a securitization or other transfer of assets because of impairment assessments. For income purposes, management should reflect certain adversely classified and nonperforming assets, especially those where the mortgage lender does not anticipate future interest payments, on a non-accrual basis. If management does not place these assets on a non-accrual status, they may overstate earnings.

Improper treatment of losses may overstate capital. Management should not create allowances for losses on retained interests. Management should record losses by adjusting the recorded investment in the retained interests. Management should not record such losses in the General Reserve.

ANALYTICAL TECHNIQUES

Operations analysis involves a review of financial data on a period-to-period basis to substantiate the reasonableness of financial performance without requiring a systematic review of transactions. (This does not preclude a review of transactions, if appropriate.) Through understanding the components of operations analysis you will be able to apply various analytical techniques to assess a mortgage lender's financial condition. You may use mortgage lender and peer group ratios to identify discrepancies. You must be aware of the following weaknesses inherent in the approaches employed in the operations analysis:

- More than one component of the financial data being analyzed cause apparent variances.
- Operations analysis is historical — the financial data that you analyze describes the mortgage lender at a prior point in time.
- Operations analysis may not answer all questions, but it may raise additional ones. For example, a common ratio used to evaluate the efficiency of a mortgage lender's operations is the level of operating expenses expressed as a percentage of operating income. Using this ratio, you may conclude that operating expenses are higher than the peer group and that they have been increasing during the periods under review. The real concern, however, is not that a variance exists, but why it exists.

Interrelationships

Operations analysis requires an awareness of the interrelationships of the data used. For example, an increase in the operating expense to operating income ratio may be due to an increase in actual operating expenses. Also, a decline in revenues that was the result of shrinking assets without a corresponding decline in the fixed operating expenses of the company may cause the variance. Examination procedures that investigate operating expenses would not explain why the variance occurred if the ratio increased due to a decline in revenues. By understanding the interrelationships of the data, you will be able to focus your analysis to answer the questions raised by the variance.

Basic Approaches

All financial analytical techniques are combinations or adaptations of four basic approaches used to evaluate a real estate lender's operations. We discuss the fundamental considerations of each of the following four approaches below:

- Structural
- Trend
- Ratio
- Comparative

Structural Analysis

Structural analysis is a static analysis, where you view the components of a financial statement in relation to the whole financial statement as of a specific date. This technique can provide insight regarding the relative size of a particular line item in comparison to the other components of the financial statement. You can also use structural analysis to determine whether a particular line item is increasing or decreasing in relation to the other components. For example, total assets on a statement of condition and gross revenues on a statement of operations are base figures representing 100 percent. The financial statement presents each line item as a percentage of these base figures.

Trend Analysis
Trend analysis is the technique of comparing ratios or financial statement line items over several periods of time. You should make the comparison by using both the amount variance and the percentage variance methods. The amount variance method involves calculating the difference in the line item between the various periods. The percentage change in the line item for the periods is the basis for the percentage variance method.

It is important to use both methods. The percentage variance may not readily disclose large amount changes in line items if the base is also large. The amount variance method may not disclose large percentage changes in line items. For example, a line item variance could be under 5 percent but still require investigation if the amount of the change is LE 5 million. Conversely, a LE 20,000 change in a line item may not seem to be material. If it represents a 35 percent change from a prior period, however, it may also warrant investigation.

Components of Trend Analysis
We discuss below the three primary components to performing a good trend analysis.

Number of Accounting Periods: The use of three or more accounting periods provides an understanding of what will likely be normal changes in the data. By comparing variances in the data over several accounting periods, patterns of change emerge that you can use to identify any unusual changes in current periods. Another benefit is that you can identify a change that may warrant investigation. The accounting periods reviewed may include annual, quarterly, or monthly data depending on the purpose of the review. Quarterly or annual data in some instances can mask a month-to-month cash flow problem that a mortgage lender is experiencing. You must use mortgage lender records to review monthly figures.
Sound Judgment: It is necessary to use sound judgment in assessing the materiality of a variance. You must use professional skepticism when evaluating the change, but must also remember that business is dynamic and change is inevitable. You should pursue only those variances that are not reasonable or are of sufficient magnitude to justify additional examination procedures. You must evaluate such variances in relation to the overall financial position of the mortgage lender. A number of factors may account for variances including cyclical and seasonal factors, changes in accounting practices, and changes in operating strategies. You should identify and explain positive or adverse trends, so that your findings support the overall evaluation.

Volume-to-Rate Variance Analysis: Volume-to-rate variance analysis identifies how much of a change in an income statement line item is due to a change in volume and how much is due to a change in rate. This analysis is especially beneficial in evaluating changes in revenues and expenses associated with interest-bearing assets and interest-costing liabilities. Further, this technique allows you to identify offsetting variances that may otherwise go undetected. For example, although significant changes are occurring, a substantial decline in rate that results in little change in the financial statement line item may offset a large increase in volume. Through this analysis, you can narrow the scope of the examination to focus on the cause of the change in the data.

Ratio Analysis
Ratio analysis is the method of comparing a figure or group of figures in a set of financial statements to another figure or group of figures within the same financial statements. The assumption that there are meaningful relationships between different asset, liability, net worth, income, and expense accounts is the basis for ratio analysis. Financial analysts have developed numerous standardized ratios for analyzing financial statements.

Although it is beyond the scope of this Manual to provide a listing of all the ratios that you may use to analyze financial statements, the more commonly used ratios include:

Current assets divided by current liabilities
Net income divided by average assets
Operating expenses divided by average assets

You can find these ratios in nearly all intermediate accounting or financial analysis texts. In addition, there are several ratios specific to analysis of financial institutions. Most traditional lending institutions strive to maintain a relatively stable spread between asset yields and liability costs. Net interest income is a function of interest-earning asset (IEA) yields, interest-costing liability (ICL) costs, and the IEA/ ICL relationship. When IEA/ICL exceeds 100 percent, the excess of earning assets bolsters net interest income and somewhat mitigates the effect of interest rate volatility on earnings. As the IEA/ICL ratio falls below 100 percent, net interest income obviously becomes impaired and becomes less likely to cover operating expenses.

In general, the net interest margin (NIM) will be greater than the spread if IEA exceeds ICL and less than the spread if ICL exceeds IEA. The difference between the yield on earning assets and the cost of funds provides the net interest spread. You should compare ratios with historical (trend analysis) and peer group standards (comparative analysis) to identify unusual items.

Comparative or Peer Group Analysis
Comparative analysis is the method of comparing the components of a financial statement with those of a real estate lender of a similar size or other similar characteristics. You may also use ratio analysis to compare ratios from one firm with that of industry standards or peer group ratios. You should not rely upon peer group information in isolation, but in conjunction with other pertinent evaluation factors. Peer group or other comparative industry data should not be the sole, or even primary, basis for component ratings.

FUTURE OPERATING RESULTS

After you review the stability of operating results and identify historic trends of the primary revenues, you can estimate and evaluate an mortgage lender's probable future operating results.
A key tool in making this evaluation is the budget prepared by management. You should obtain a copy of the budget including projected revenues, expenses, and underlying assumptions.

An evaluation of the budget should include all the following comparisons:

Projections with prior period results.
Projections with actual results for the same period.
Projected return on assets and return on equity with prior period results.

Projected yields for major earning assets with prior period yields.
Projected operating expenses as a percentage of assets and revenues with prior period data.
Projected goals and assumptions with trends in market conditions.

Although comparing the operating budget with prior period data is necessary, the key to evaluating the budget is to understand the validity of the underlying assumptions and the probability of projected goals. Prior data does not provide meaningful information if the entire focus of the mortgage lender is changing. For example, if a portfolio lender begins mortgage-banking operations, the crucial evaluation of the budget would not come from comparison with prior period data. Instead, the focus would be on the reasonableness of projected loan originations and sales compared with current market conditions. Controlling business risks is one of the primary responsibilities of management. A mortgage lender's balance sheet and operating statement reflect the types of risk assumed by the mortgage lender and how well management controls those risks. By analyzing the balance sheet and operating results, and identifying trends in the financial data, you can make a determination whether management's policies benefit or adversely affect a mortgage lender.

PROFITABILITY ASSESSMENT

A mortgage lender may assess its own profitability in many ways and at different levels. A lender may evaluate its profitability as a whole or the particular profitability of branches, products, or types of customers. In whatever way a mortgage lender assesses its profitability; accurate information is the basis for good decisions. A mortgage lender's information requirements depend largely on its size and complexity of its operations. While you should encourage management to develop improved systems and information, mortgage lenders must be reasonable in their expectations.

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements summarize the financial position and results of operations for two or more affiliated companies. Mortgage lenders prepare and present such statements without regard to the separate legal status of either company. The purpose of consolidated financial statements is to present a parent company and its subsidiaries as if they were a single company. Such statements do not include gain or loss on transactions among the companies in the group. Further, consolidation is usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

Real estate lenders should prepare consolidated financial statements for all subsidiaries in which a mortgage lender has a controlling financial interest through direct or indirect ownership of a majority voting interest. As a general rule, direct or indirect ownership by one company of over 50 percent of the outstanding voting shares of another company is a condition that suggests consolidation. In order for the parent and its subsidiaries to be presented as one entity, the institution must consolidate their separate trial balances into one trial balance and eliminate inter-company balances and transactions. The institution must make eliminating entries on consolidating worksheets, but neither the parent nor the subsidiaries are to record them in their general ledgers.

You should review the consolidating entries of intercompany accounts. Typical consolidations include the following eliminating entries:
Intercompany payables against intercompany receivables

- Intercompany profit and losses on sales of assets that the parent or subsidiary have not subsequently resold to third parties
- Investment accounts of first-tier subordinate organizations against the capital accounts of lower-tier subsidiaries
- Intercompany revenues against intercompany expenses. See Appendix C, Reconciliation of Intercompany Accounts

Materiality

MFA defines materiality as an assessment of relative size and importance. You can analyze the materiality of intercompany transactions by:

- Identifying intercompany transactions that frequently occur. Such transactions include:
  - The parent's investment in capital of the subordinate organization
  - Long-term loans from the parent to the subordinate organization
  - Short-term accounts receivable (or payable) between the parent and the subordinate organization pertaining to normal operations
- Assessing activity in intercompany accounts. This involves reviewing general ledger account histories of selected accounts for following items:
  - Numerous transactions.
  - Correcting entries (original entries posted to the wrong accounts).
  - Large amount entries lacking a clear explanation of their purpose.
- Identifying source documents for review if you deem further analysis of specific transactions necessary. Such documents include:
  - Cash receipts records (cash receipts journals and bank deposit slips)
  - Cash disbursement records (cash disbursement journals and checks issued)
  - Journal vouchers for non-cash transactions

REFERENCES

SECTION: Present Value Analysis 440

INTRODUCTION

Effective management decision making means making the best possible choices from the available investment alternatives consistent with the amount of funds available for reinvestment. To make the best choices consistently, however, a basis for analysis must exist that can provide a common denominator for various investment alternatives. Each alternative will have a different contract rate, maturity, minimum amount requirement, and method of payback.

One idea that both management and regulators use in the lender industry is "present value analysis," based on the time value of money. In this Section we specifically provide information about present value analysis. Through a detailed set of problems, the Section provides assistance in performing present value analysis computations to arrive at conclusions regarding sound institutional investments.

A word of caution is in order. Many business transactions involve considerations other than those governed by present value theory and its applications. Consequently, there will be instances where other considerations will temper management's and regulators' positions. The primary objectives of this Section are:

- To understand and apply the concept of present value analysis in management decision making within the framework of the regulatory process.
- To evaluate the true effect of actual business transactions and decisions on the overall financial condition of a lender institution.
- To ensure that real estate lenders adjust financial statements to reflect present value where necessary.

EXAMINATION CONSIDERATIONS

Financial intermediaries, including mortgage lenders, attempt to channel funds effectively and efficiently from debt sources to worthwhile borrowers. Institutions buy and sell financial claims. Financial assets and financial liabilities, however, have a time value. Bond issues and other debt will be based on rates and terms in that market, that is, what investors expect as return, in amount and timing. Conversely, institutions lend present funds to borrowers in exchange for a promise of future interest and principal repayment. Real estate lenders evaluate such financial transactions based on present value analysis. Institutions sell interests in previously originated mortgages; you must be able to understand the underlying valuation mechanics. In addition, real estate owned financing requires present value application knowledge. The following guidelines show the user how to compute the future value, present value, and prospective rate of return of various investment opportunities. Simply stated, the worth of one currency unit tomorrow is different from the worth of one currency unit today.

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SECTION: Funds Management 510

INTRODUCTION

Funds management encompasses both the treasury management and asset/ liability management functions. The goal of funds management is to achieve a mortgage lender's targeted risk and return objectives through the effective management of the mortgage lender's resources. Funds management is the management of a mortgage lender's balance sheet mix and pricing of assets and liabilities.

Funds management encompasses the coordination and integration of a broad range of functions, policies, and decisions that influence the mortgage lender's net interest earnings, net interest margin, and net portfolio value, including the following:

- Asset and liability composition
- Loan pricing
- Funds transfer pricing policies
- Capital structure and capital financing
- Asset securitizations
- Hedging activities

An effective funds management process should increase the likelihood that a mortgage lender will achieve its financial objectives. Successful funds management programs typically have four elements:

- Management that understands how to structure the balance sheet and price loans and other products to achieve risk and return objectives.
- A clearly defined funds management process that includes sound policies, procedures, and controls.
- Effective information systems that provide the information needed to make sound funds management decisions.
- An effective performance measurement system. The sophistication of a mortgage lender's funds management process and systems should be appropriate to the size and complexity of the mortgage lender.

In assessing a mortgage lender's funds management, you should:

- Review the policies, procedure, and controls governing the funds management process
- Determine whether the policies, procedures, and controls are sufficient given the size and complexity of the mortgage lender
- Determine whether the mortgage lender's information/ analytical systems are adequate given the size and complexity of the mortgage lender
- Review the reports to the board that summarize major decisions and transactions
- Determine compliance with policies, procedures, and controls governing funds management

SETTING FINANCIAL GOALS: THE RISK/RETURN PROFILE

The Risk/Return Tradeoff

The board of directors and senior management should define the mortgage lender's overall financial objectives with clearly defined risk and return measures.
A mortgage lender usually states its overall financial objectives regarding return with accounting-based earnings and profitability measures or with economic or market value-based performance measures. In specifying these goals, a number of specific measurement gauges may be appropriate, either individually or in combination.

The most common accounting-based measures are:

- Return on assets
- Return on equity
- Net Interest Margin

The economic/market value-based measures that mortgage lenders commonly use are:

- Net portfolio value
- Market value capitalization
- Total return

Mortgage lenders sometimes seek to achieve short-term earnings and profitability targets by accepting greater risk and in the process compromise long-term earnings and market value objectives.

THE FUNDS MANAGEMENT DECISION-MAKING PROCESS

You should review the funds management policies and procedures.

- Are the policy limits reasonable given the mortgage lender's financial condition?
- Is management complying with the board approved policies?
- Are periodic reports to the board adequate?

An integrated, funds management process is important. A piecemeal approach to funds management, or a structure in which one or more of the financial functions are autonomous, will complicate the attainment of a common overall risk/return profile. The funds management process in small mortgage lenders may be informal, while in larger mortgage lenders the process may be very formal.

FUNDS MANAGEMENT FUNCTIONS

Presented below are the functions of the typical funds management process:

- Determine financial objectives and set policy for each of the financial functions
- Provide periodic reports to the board concerning funds management
- Periodically review the funds management policies with the board
- Oversee funding activities
- Coordinate asset and liability product pricing
- Evaluate proposed strategies and transactions through sound methodology, including simulation and scenario analysis
- Oversee investment portfolio management activities
- Monitor the economic and interest-rate environment, including local economic conditions, prepayment trends, and volatility
- Identify instruments that the board of directors authorized for use to manage the mortgage lender's risk exposures
- Oversee funding and capital financing activities, including debt and equity issuance, and dividend policies

PROCEDURES AND CONTROLS

If the funds management process is not functioning properly, then you should focus on the related operating procedures and internal controls. Typically, in a large mortgage lender, extensive documented procedures are necessary to accommodate a large volume of data flow from numerous functional areas to the manager responsible for funds management. In smaller mortgage lenders such complex procedures are not necessary.

Internal Procedures
Mortgage lenders should document and follow procedures that allow for the smooth and timely flow of data to the funds management function. Flow charts documenting the physical flow of data to and from all departments are usually very informative. Other procedures may be necessary to accommodate the funds management function at certain mortgage lenders.

Internal Control
In small mortgage lenders, the lack of adequate internal controls may be more of a concern because one individual will often perform multiple functions. For example, the Chief Financial Officer (CFO) may direct funds management, but may also execute transactions, oversee the disbursement of cash, and authorize the related accounting entries. Mortgage lenders should segregate these duties to the extent possible to ensure adequate internal control.

You should verify that internal controls are adequate in the following areas:

- Transaction authorizations – both internal (officers authorized to transact business) and external (approved dealers)
- Position and transaction limits, regulatory requirements or limits, and other guidelines

REFERENCES

SECTION: Liquidity Management 530

INTRODUCTION

Liquidity management is the ability to meet financial obligations at a reasonable cost in a timely manner. The essence of liquidity is having cash when you need it. Each mortgage lender must maintain sufficient liquidity to ensure safe and sound operations.

Liquidity can be thought of as a reservoir of funds that management can readily access to meet funding requirements and business opportunities.

Primary sources of liquidity include:

- Liquidity assets (surplus cash and assets that can be quickly converted into cash)
- Liquidity liabilities and unused borrowing capacity (a mortgage lender's capacity to access the markets for wholesale funds)

Liquidity risk is the risk of not having sufficient funds to meet financial commitments when due. As mortgage lenders have become more dependent on wholesale funding to meet liquidity needs, liquidity risk has become largely synonymous with funding risk, that is, the risk of being unable to maintain or acquire funds at a reasonable price when needed. Mortgage lender-specific problems or systemic disturbances can trigger liquidity problems.

Mortgage lender-specific liquidity problems are usually the result of other problems within a mortgage lender:

- Poor asset quality
- Excessive interest rate risk
- Inadequate capital
- Operational problems
- Inadequate cash flow planning

Systemic liquidity problems may result from a major financial debacle, a crisis, or other catastrophic event.

Liquidity management involves balancing the trade-off between profitability and the risk of illiquidity. Although a high degree of liquidity may be a positive sign since it indicates a capacity to meet obligations and take advantage of business opportunities, too much liquidity in the form of cash and low-earning assets or expensive borrowings can reduce profitability. The key is to find the right balance between liquidity and profitability. That balance will change over time as economic and business conditions change. Finding the right balance depends in part on management's ability to estimate and manage future cash flows. To manage liquidity, effective managers typically employ the following analytical techniques:

- Maturity gap analysis
- Cash flow forecasting
- Scenario planning

Effective liquidity management, however, starts with the development of written policies and procedures, and the establishment of minimum acceptable levels of liquidity. These policies should clearly define a mortgage lender's strategy for managing liquidity, delineate areas of management responsibility, and establish a process for measuring, monitoring, and managing liquidity. Each mortgage lender should also have contingency plans for dealing with unanticipated cash flow disruptions or cash flow needs.

This Section provides an overview of the liquidity management process. It includes a brief description of the various sources of liquidity, a basic explanation of the various techniques for measuring liquidity and estimating future cash flow needs, and a guide for assessing the quality of risk management practices. The Section concludes with a list of early warning signals of potential liquidity problems.

SOURCES OF LIQUIDITY

Liquidity Assets

Real estate lenders often meet liquidity needs through the sale of liquid assets and the planned runoff of loans and investments. While in theory any asset can serve as a source of liquidity, mortgage lenders must consider the length of time it takes to dispose of an asset and the price at which it can be sold. Unencumbered assets that a mortgage lender can sell or borrow against with relative ease without appreciable loss are ideal sources of liquidity.

Liquid assets would generally include deposits with other financial institutions, money market instruments, and short-term, investment-grade securities. In addition, mortgage lenders may consider as liquid assets other securities and loans that can easily be sold or are about to mature. Because of the time dimension of liquidity, an asset may be a source of liquidity if it matures or can be sold within the time horizon of the need for funds. But as a general rule, assets with shorter maturities or those with a higher quality are more liquid.

Cash and Deposits with Other Institutions

While cash is the essence of liquidity, the cash balances reported on a mortgage lender's balance sheet are not necessarily available to meet a liquidity shortfall. While a minimum level of operating cash balances is needed for day-to-day transactions (for paying operating expenses), other cash balances may be in the form of checks or drafts in the process of collection, and are unavailable.

Typically only excess cash balances – balances over and above those needed for daily operations and scheduled payments – are considered to be a source of liquidity. However, generally mortgage lenders do not hold large excess cash balances that are non-earning assets.

Money Market Instruments and Securities

As a practical matter, most mortgage lenders view their portfolios of money market instruments and investment securities as a primary source of liquidity. Accounting principles require institutions to designate investment securities as available-for-sale, trading, or held-to-maturity.

Securities designated as available-for-sale or trading must be carried on the balance sheet at fair value. Securities designated as held-to-maturity are carried at amortized cost. Manual for Supervision Section 540 discusses accounting for securities.

In general, mortgage lenders may not sell securities in the held-to-maturity portfolio before maturity without "tainting" the entire portfolio – an event that would cause the entire portfolio of held-to-maturity securities to be reported at fair value. Moreover, management should carefully consider its liquidity needs before designating securities as either available-for-sale, trading, or held-to-maturity. While the designation of a security as available-for-sale, trading, or held-to-maturity has certain consequences for accounting purposes, it has no bearing on whether the security is liquid in an economic sense. Whether an investment is liquid depends on how easily the holder can sell it in the market. Securities with tight bid-ask spreads are more liquid than those with wide bid-ask spreads.

Securitizations
[Principles presented in this section are pending development of secondary market for Egyptian mortgage loans.] With adequate planning and certain efficiencies, securitizations can create a more liquid balance sheet as well as leverage origination capacity. However, peculiarities related to certain transactions as well as excessive reliance on securitizations as a single funding vehicle may increase liquidity risk. For example, a concentration or over-reliance on securitizations as a funding source may increase liquidity risk if there are disruptions in the market.

Management should consider securitization's implications on its day-to-day liquidity management and on its contingency planning. Management should analyze the potential effect of securitizations on liquidity from an individual transaction perspective and on an aggregate basis. Mortgage lenders should make the following determinations when contemplating a securitization transaction:

- The volume of securities scheduled to amortize during any particular period
- The plans for meeting future funding requirements (including when such requirements may arise)
- The existence of early amortization or increased collateralization triggers
- The alternatives available for obtaining substantial amounts of liquidity quickly
- Operational concerns associated with reissuing securities

Management should factor the maturity and potential funding needs of the receivables into short-term and long-term liquidity planning. Exposure may also increase if a mortgage lender minimizes securitization costs by structuring transactions at maturities offering the lowest cost, without regard to maturity concentrations or potential long-term funding requirements.

Correlating maturities of incidental securitized transactions with overall planned balance sheet growth may somewhat mitigate this risk. Mortgage lenders that originate assets for securitizations may depend heavily on securitization markets to absorb its asset-backed security issues. If the mortgage lender allocates only enough capital to support a "flow" of assets to the securitization market, it may experience funding difficulties if circumstances in the markets or at a specific institution were to force the mortgage lender to hold assets on its books.

Mortgage lenders should have adequate monitoring systems in place so that management is aware well in advance of a potential problem.

Mortgage Loans
As noted above, many real estate lenders view mortgage loans and other receivables that can easily be sold or are about to mature as liquid assets. In addition, mortgage lenders with active loan securitization programs generally treat loans that they are about to sell as liquid assets. Because of the time dimension of liquidity, mortgage lenders may consider an asset that matures or can be easily sold at a fair price within the time horizon of the need for funds as a liquid asset.

Pledged Assets
In assessing liquidity, it is important to know which assets have been pledged to secure borrowings or for other purposes. Pledged assets are not liquid. In addition, it is important to determine which assets are currently unpledged, eligible, and available as collateral to secure borrowings.

Liquidity Liabilities
As an alternative to liquid assets to satisfy liquidity needs, these needs may be met through liability sources such as wholesale borrowings. A real estate lender's ability to borrow in the markets is generally a function of its size, reputation, creditworthiness, and capital levels. Access to money markets also depends on prevailing market conditions.

Retail and Wholesale Deposits
Though deposits play a critical role in ongoing successful operations of banks and other financial intermediaries, mortgage lenders regulated by the Mortgage Financing Authority (MFA) are not authorized to take citizen's deposits and will not have access to such funds.

Wholesale Funding
Borrowing sources that a mortgage lender can access immediately, at a reasonable cost, and with a high degree of certainty are ideal sources of liquidity. Wholesale borrowings frequently have attractive features, and can, if properly assessed and prudently managed, facilitate the management of interest rate and liquidity risks. The initial cost of the borrowing is often low when compared to other liabilities with similar maturities. If the instrument contains embedded options, however, borrowing costs may increase under certain circumstances, and must be properly evaluated and managed.

Management should take the following actions if engaging in wholesale borrowings:

- Review borrowing concentrations. Determine whether an amount of borrowings from a single source poses an undue risk
- Review borrowing contracts
    - Determine if there are any embedded options or other features that may affect the interest rate or pose liquidity risk
    - Review collateral agreements for fees, maintenance requirements, and triggers for increases in collateral
- Review stress tests
    - Determine how to identify and monitor the risks of the various terms of each contract, including penalties and option features
    - Perform tests before entering into any agreement and periodically thereafter
    - Ensure that the stress test results depict the potential impact of contractual triggers and external events (such as interest rate changes that may result in the exercise of embedded options or the termination of the contract) on the mortgage lender, as well as on its overall earnings and liquidity position
- Review the use of complex borrowings on the mortgage lender's interest rate exposure
- Ensure that there are management processes in place to control liquidity and interest rate risks, and that they also have in place contingent funding plans

- Fully inform the board of directors, or the asset/ liability management committee about the risks of wholesale borrowing agreements prior to engaging in the transactions, as well as on an ongoing basis
- Ensure that the instruments are consistent with the mortgage lender's portfolio objectives and level of sophistication of its risk management practices. Only mortgage lenders with technical knowledge and risk management systems sufficient to adequately identify, monitor, and control the risks of complex wholesale borrowings should use this type of funding

Wholesale fund providers are professionals who manage most wholesale funds, and operate under established investment criteria. They may be associated with large commercial and industrial corporations, other financial institutions, governmental units, or wealthy individuals. Because their responsibility is to preserve their clients' principal, they are sensitive to changes in the credit quality of the institutions where they invest, as well as to changes in interest rates.

A mortgage lender can use a variety of instruments to tap the wholesale funding markets. A brief description of some of these instruments is provided below. Depending on the side of a transaction that a mortgage lender takes, some of these instruments may be either a source of asset liquidity or a source of liability liquidity.

Securities Sold Under Repurchase Agreements Securities are a means of financing inventories of securities. Under repurchase agreements, securities are temporarily "loaned out," for periods ranging from overnight to one year in return for borrowed funds. The vast majority mature in three months or less. A standard repurchase agreement involves the acquisition of funds through the sale of securities with a simultaneous commitment to repurchase the securities on a specified date at a specified price. The repurchase agreement rate is the interest rate that the borrower pays the lender (investor) for the use of funds.

Lines of Credit
An unused portion of a line of credit with another financial institution or a bank can be an important source of liquidity, particularly if it represents a binding legal commitment to borrow without major restrictions on its use and the borrowing rate is reasonable.

MEASURING LIQUIDITY
The purpose of liquidity analysis is to measure a mortgage lender's current liquidity position and its ability to meet future funding needs. An analysis of a mortgage lender's *current liquidity position* generally involves a review of key balance sheet ratios, while the analysis of a mortgage lender's ability to meet *future funding needs* involves an analysis of projected cash inflows and outflows.

Financial Ratio Analysis
The measurement of liquidity is an inexact and highly subjective process. This is largely due to the high degree of cash flow uncertainty associated with assets, liabilities, and off-balance-sheet contracts. In practice, analysts use a variety of financial ratios to measure the current liquidity position of an institution. Some ratios that measure liquidity include the following:

- Liquid assets to total assets
- Volatile liabilities to total assets
- Liquid assets to short-term liabilities
- Net liquid assets to total assets
- Unpledged eligible collateral to total assets
- Net unused borrowing capacity to total assets

- Unpledged collateral to net unused borrowing capacity

A key issue is defining liquid assets and short-term liabilities. Definitions vary depending on the objective or purpose of the analysis and data limitations. The time horizon of the analysis is particularly important in defining what is and what is not liquid. As a rule, liquid asset definitions include shorter-term assets that are readily saleable and assets that mature over the near-term. Some analysts define liquid assets to include the sum of cash, deposits with other mortgage lenders, investment securities, and mortgage pool securities.

The basic model for measuring current liquidity relates liquid assets to short-term liabilities. The difference between liquid assets and short-term liabilities represents the net liquidity position. (Liquid assets less short-term liabilities equals net liquidity position).

A mortgage lender can improve its liquidity position in a number of different ways. For example, it can take the following actions:

- Increase holdings of high-quality liquid assets
- Shorten the maturities of assets
- Lengthen the maturities of liabilities
- Diversify funding sources by maturity, geographic region, and by creditor
- Make loans that it can easily sell or securitize. Successful liquidity management requires accurate measurement and control of the daily inflow and outflow of funds. Advance knowledge of liquidity shortfalls makes it possible to explore alternative ways to deal with them. Two useful techniques for monitoring cash flows are liquidity gap analysis and liquidity forecasting

Liquidity Gap Analysis
A liquidity gap schedule provides an analytical framework for measuring future funding needs by comparing the amount of assets and liabilities maturing over specific time intervals. Table 1 below presents a sample liquidity gap schedule.

Table 1. Liquidity Gap Schedule

	Less than 10 days	Over 10 days but less than 3 months	Over 3 months but less 6 months	Over 6 months but less than one year	1 to 5 years	Over 5 years and capital	Total
Assets	10	10	10	5	65	0	100
Liabilities & Equity	50	30	15	0	0	5	100
Net outflow (assets minus liabilities)	(40)	(20)	(5)	5	65	(5)	0
Cumulative net outflow	(40)	(60)	(65)	(60)	5	0	0

In the liquidity gap schedule, assets and liabilities are slotted into different time intervals according to their remaining time to maturity. As a rule, the assets and liabilities are slotted according to their *effective* maturities rather than their *contractual* maturities. In this example, more liabilities than assets mature in the earlier time intervals, indicating that the mortgage lender is borrowing short and lending long, which is typical of most real estate lenders. Negative gapping at the shorter end of the schedule (that is, borrowing short and lending long) increases the risk that the mortgage lender will not be able to rollover maturing liabilities as they come due. While such a position is not favorable to liquidity, it tends to enhance profitability over the long-term – provided the mortgage lender keeps the gaps within manageable bounds and the shape of the yield curve is not inverted.

One shortcoming of the liquidity gap schedule is that it does not capture projected balance sheet changes such as future loan and borrowing growth. While it is important to understand the liquidity of a mortgage lender's existing balance sheet, it is also important to forecast the growth of key balance sheet components.

Liquidity/Cash Flow Forecasting
Cash flow forecasting is a critical element in managing liquidity. The objective of cash flow forecasting is to project cash inflows and outflows over future periods. A common practice is to project net funds deficits for short-term (next 5-10 days) and long-term planning intervals (3-6 months, 6-12 months). By projecting cash flows for short- and long-term planning periods, management can significantly reduce the risk that sizable net funds deficits go unnoticed and unattended.

A sample forecast is presented in Table 2.

Table 2. Cash Flow Forecast

	Forecast 0-30 days	Forecast 31 –60 days	Forecast 61-90 days	Forecast 91-365 days
Cash Inflows: **Parent borrowing**	1,000	1,200	1,500	20,000
Maturing loans and investments	600	1,200	1,800	9,000
Loan sales	0	0	0	0
Other	200	100	200	1,500
Total inflows	1,800	2,500	3,500	30,500
Cash Outflows: **Maturing parent debt**	800	900	1,000	3,500
Maturing other debt	0	0	0	1,000
New Loans	900	1,500	1,600	15,000
Other	200	0	0	1,000
Total Outflows	1,900	2,400	2,600	20,500
Net Surplus (deficit)	(100)	100	900	10,000
Cumulative net surplus (deficit)	(100)	0	900	10,900

LIQUIDITY MANAGEMENT
Each mortgage lender should have a written strategy for the day-to-day management of liquidity. The liquidity strategy should define the mortgage lender's general approach to managing liquidity, including various quantitative and qualitative targets. The liquidity strategy should cover specific policies on the composition of assets and liabilities, the use of wholesale funding, and strategies for addressing temporary and longer-term liquidity disruptions. The sophistication of a mortgage lender's policies, procedures, and information systems for managing liquidity should be related to the following items:

- Size and complexity of the mortgage lender
- The mortgage lender's dependence on wholesale funding
- Variability of the mortgage lender's cash flows
- Financial condition of the mortgage lender. Mortgage lenders with deteriorating financial condition and/or declining exam ratings should increase attention to liquidity management and contingency planning

Board and Senior Management Oversight
Effective oversight is an integral part of an effective liquidity management program. The board and senior management should understand their oversight responsibilities.

Board of Directors
The board of directors should establish the mortgage lender's tolerance for liquidity risk, set liquid requirements, and approve significant policies related to liquidity management. The board should also ensure senior management takes the necessary steps to monitor and control liquidity risk.

The board should understand the nature and level of the mortgage lender's liquidity risk, and management should inform the board regularly of the liquidity position of the mortgage lender.

Senior Management
Senior management should establish policies, procedures, and guidelines for managing and monitoring liquidity to ensure adequate liquidity at all times. Policies should include internal controls. In addition, senior management should review the mortgage lender's liquidity position on a regular basis and monitor internal and external factors and events that could have a bearing on the mortgage lender's liquidity. Senior management should also prepare contingency funding plans. Senior management should review periodically the mortgage lender's liquidity strategies, policies, and procedures.

Policies and Procedures
A real estate lender should have clearly defined policies and procedures for managing liquidity. The board of directors has ultimate responsibility for the adequacy of policies and procedures; senior management has responsibility for their design and implementation. Polices and procedures should include the following:

- *Delineated lines of responsibility*. Identification of individuals or committees responsible for managing and monitoring liquidity risk.
- *An overall liquidity strategy*. The liquidity strategy should define the general approach the real estate lender will follow in managing liquidity, including various quantitative and qualitative targets. The liquidity strategy should cover specific policies on the composition of assets and liabilities, including policies on investment in illiquid securities and the use of wholesale funding. There should also be a written strategy for addressing temporary and long-term liquidity disruptions.
- *A process for measuring and monitoring liquidity*. Although mortgage lenders can use a number of procedures for measuring and monitoring liquidity, the most effective procedures involve pro-forma cash flow projections. These range from simple calculations to complex models for projecting cash inflows and outflows over different planning periods (time bands) to identify cash shortfalls and surpluses in future periods. While liquidity measures based on balance sheet ratios are useful in measuring a mortgage lender's current liquidity position and in monitoring trends in liquidity, management should focus its attention on forward looking, pro-forma measures of liquidity.
- *Quantitative guidelines and limits to ensure adequate liquidity*. Guidelines and limits will vary depending on the nature of a mortgage lender's operations and circumstances. Mortgage lenders could set guidelines, for example, on the size of cash flow mismatches over specified time horizons. Because of the subjective nature of the numbers in pro-forma cash flow projections, mortgage lenders may find it impractical to establish precise risk limits or precise rules for addressing cash flow mismatches projected to occur in future periods.

Nevertheless, a mortgage lender should make an effort to define its tolerance for cash flow mismatches and should establish strategies for addressing them. Mortgage lenders can also tie limits to balance sheet ratios. Examples include the following ratios:

Maximum projected cash flow shortfall tolerated for specified time (for example, one week ahead, one month ahead, one quarter ahead) as a percentage of liquid assets and unused borrowing facilities
Minimum ratio of liquid assets to total assets

Maximum overnight borrowings to total assets
Maximum ratio of total wholesale borrowings to total assets
Maximum ratio of pledged assets to total assets
Maximum ratio of loans to borrowings
Maximum ratio of managed assets to total assets if the mortgage lender securitizes assets

Internal control procedures to ensure adherence to policies and procedures that address the integrity of the liquidity risk management process. An effective system of internal control should promote effective operations, reliable financial and regulatory reporting, and compliance with relevant laws and institutional policies. Internal control systems should provide appropriate approval processes, limits, and ensure regular and independent evaluation and review of the liquidity risk management process. Such reviews should address any significant changes in the nature of the instruments acquired, limits, and controls since the last review. Internal control should include the following activities:

Procedures for approvals of exceptions to policies, limits, and authorizations. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies.
A schedule for the periodic review of the liquidity policies and procedures. Periodic reviews of the liquidity management process and related procedures should address any significant changes in liquidity risk limits, liquidity strategy, information systems, and internal controls since the last review.
Contingency Planning. Management should assess its responses to liquidity events in the context of their implications for a mortgage lender's short-term, intermediate-term, and long-term liquidity profile. Contingency Plans are further discussed in this manual section.

Management Information Systems

Each real estate lender should have adequate information systems for measuring, monitoring, and controlling liquidity risk:

- A management information system should provide timely information on the mortgage lender's current and prospective liquidity position.
- Management should be able to project its liquidity position and liquidity requirements over various time horizons and scenarios.
- Management should clearly define assumptions used in projections so it can evaluate the appropriateness and validity of the projections.
- The information system should provide the data needed by management to determine compliance with the mortgage lender's liquidity policies, procedures, and limits.

Measuring and Monitoring Liquidity

Each mortgage lender should have a process for measuring and monitoring its existing liquidity position as well as its net funding requirements. Liquidity measurement involves forecasting cash inflows and outflows over various time horizons to identify potential cash imbalances. A cash flow forecast is a useful device to compare cash inflows and outflows on a daily basis and over future periods. Management should take steps to address projected net funding deficits in a timely manner.

Management and other staff responsible for managing overall liquidity should be aware of any information, such as a pending decline in earnings, an impending legal action, or a downgrade by a rating agency that could have an adverse impact on perceptions about the financial condition of the mortgage lender.

Management should also consider conducting scenario analysis in estimating liquidity requirements. In conducting an analysis of liquidity, management should consider the following scenarios:

- Range of possible future scenarios, such as optimistic, pessimistic, and most likely. In estimating normal funding needs, some mortgage lenders use historical data and account for seasonal and other effects believed to determine loan demand and other cash flows. Alternatively, some mortgage lenders rely on judgmental business projections, or undertake a customer-by-customer assessment for larger customers and apply historical relationships to the remainder.
- Cash flow timing differences and the related assumptions among scenarios. For example, in a general market crisis, the capacity to sell assets may deteriorate significantly.
- The potential for unanticipated cash outflows and reduced cash inflows associated with embedded options in various assets, liabilities, and off-balance-sheet contacts. Potential cash outflows include loan commitments; calls on loans sold with recourse and financial guarantees; payments on swap contracts and other financial derivatives; margin calls; early termination agreements; and so forth.

Contingency Planning

Each mortgage lender should have a contingency plan for handling unanticipated stressful scenarios that could result in a significant erosion of mortgage lender-specific or general-market liquidity. Management should update the plan on a regular basis. A contingency plan should accomplish the following:

- Consistently planned use of liquidity sources with the mortgage lender's stated purposes and objectives of its liquidity program
- Identify and assess the adequacy of financial resources (source of funds) for contingent needs. The plan should identify all back-up facilities (equity lines of credit), the conditions related to their use, and the circumstances where the mortgage lender might use them. Periodically, management should test all sources of its contingency funding with the goal of ensuring that there are no unexpected impediments or complications in case the mortgage lender needs to use its contingency lines. Management should understand the various conditions, such as notice periods, that could affect access to back-up funding sources
- Define responsibilities and decision-making authority so that all personnel understand their role during a problem situation
- Identify the sequence that the mortgage lender will mobilize and commit key sources of funds for contingent needs. The degree of uncertainty as to the magnitude and timing of availability of resources may call for different priorities in different situations
- Address implementation issues such as procedures by which resources are committed for emergency use or released from one use and transferred to another
- Identify other actions necessary in the event of an unexpected contingency
- Assess the potential for funding erosion (magnitude and rate of outflow) by source of funds under different scenarios
- Assess the potential liquidity risk posed by other activities such as asset sales and securitization programs

A fundamental principle in designing contingency plans for liquidity purposes is to ensure adequate diversification in the potential sources of funds. Such diversification should not only focus on the number of potential funds providers but on the underlying stability, availability, and flexibility of funds sources in the context of the type of potential liquidity event.

Managing Access to Funding Sources

Real estate lenders should carefully manage their access to available sources of funding and understand their funding options:

- A mortgage lender should build and maintain relationships with a broad range of creditors and other funding sources. A mortgage lender should understand how much funding might be available from various sources under normal and adverse circumstances
- Senior management should be aware of the composition, characteristics, and diversification of its funding sources
- Management should consider developing or expanding markets for asset sales or exploring arrangements for borrowing against assets

Liquidity Support Between Affiliates

A mortgage lender within a holding company structure should be able to rely on liquidity support from other affiliates within the company. Transfers can usually be made quickly and easily, and typically include granting or repaying debt, or selling or participating in loans or other assets. Limitations on transactions with affiliates is an additional consideration.

Liquidity Risk of the Holding Company

The funding structure of a holding company may expose it to more liquidity risk than its subsidiary insured institution. Typically, it has no independent source of revenue, no liquid assets, and a leveraged balance sheet.

In some instances, liquidity may flow from the parent holding company to the subsidiary. Examples include a parent holding company placing excess cash in its subsidiaries or participating in certain loans.

A holding company in a liquidity crisis may not look to its subsidiaries for relief, and any upstreaming of value by a subsidiary to its parent holding company is highly regulated by
statues and implementing regulations.

SUPERVISORY CONCERNS

MFA requires real estate lenders to maintain sufficient liquidity to ensure safe and sound operations.

Early Warning Signals

Liquidity problems are often symptomatic of other more fundamental problems at a mortgage lender such as excessive credit risk, excessive interest rate risk, inadequate capital, operational problems, and so forth. Factors that could indicate or precipitate liquidity problems include:

- Over-reliance on wholesale funding
- A significant increase in the level of wholesale funding
- Excessive borrowing concentrations
- A sharp rise in funding costs
- A ratings downgrade by credit rating agency
- A sharp drop in earnings
- An increase in nonperforming assets
- A decline in capital adequacy category
- Management problems

- Adverse publicity

Mortgage Banking and Loan Sale Activities
Mortgage lenders engaged in mortgage banking activities and loan origination and sale activities must ensure that adequate lines of credit are available to meet warehousing needs and that there are adequate forward commitments to sell the loans in the pipeline. The mortgage lender's liquidity planning should consider the effect of recourse and other credit enhancements from loans sold. You should review loan sale and servicing agreements to determine how credit enhancements and recourse obligations affect liquidity.

Troubled Mortgage lenders
There are restrictions on funding sources for troubled and undercapitalized lending institutions.
These restrictions serve to reduce the ability of troubled or undercapitalized mortgage lenders to obtain credit. [Proposed]

REFERENCES

SECTION: Investment Securities 540

INTRODUCTION

Mortgage Finance Authority 2005 Manual for Supervision 540.1

[Pending proposed regulations which will affect many aspects]

Real estate lenders must conduct their investment activities prudently and within the bounds of a clear and well-reasoned investment policy. Mortgage lenders should have diversified portfolios that achieve an appropriate balance between risk and return. In addition, mortgage lenders should establish appropriate risk management systems and controls to monitor and control investment portfolio activity and performance.

This section outlines the following areas:

- Role of the investment portfolio
- Permissible investments
- The investment process
- Investment risks
- Use of investment consultants
- Reporting and accounting for securities
- Collateralized Mortgage Obligation (CMO) issuances

In addition, this section has three appendices that cover the following areas:
Appendix A — Total Return Analysis
Appendix B — Money Market, Fixed-Income Market, and Equity Market Securities
Appendix C — Mortgage-Related Securities

ROLE OF THE INVESTMENT PORTFOLIO

A real estate lender's investment portfolio serves as a source of income and liquidity, as well as a tool for asset/liability management. At many mortgage lenders, the primary influences of loan demand and liquidity needs determine the percentage of assets allocated to the investment portfolio. When loan demand is weak, the mortgage lender deploys excess cash inflows in the investment account, and when loan demand is strong, the mortgage lender draws down the investment account.

Since real estate lenders can change the composition of an investment portfolio with relative
ease, many real estate lenders also use the investment portfolio to adjust their overall interest rate risk exposure. Similarly, some mortgage lenders use the investment portfolio to manage diversification, asset quality, and risk-based capital levels.

PERMISSIBLE INVESTMENTS

MFA regulations outline permissible investments for real estate lenders.

Subject to certain restrictions and limitations, the following types of investments are currently permissible investments for real estate lenders [proposed]:

- Deposits in banks

Treasury bills

See Appendices B, Money Market, Fixed-Income Market, and Equity Market Securities; and C, Mortgage-Related Securities, for information on specific types of investments.

THE INVESTMENT PROCESS

A sound investment program results from clear policies and objectives, and a sound investment process. The real estate lender should begin the investment process by determining its objectives for return requirements and risk tolerance. Management should have a clear understanding of how much return they expect the investment portfolio to generate and how much risk they can tolerate. Management should determine risk and return objectives in the context of the various investment constraints faced by the real estate lender, including those that restrict the list of permissible investments. The mortgage lender's investment objectives and constraints provide the foundation for developing sound investment policies.

Investment Objectives

The real estate lender should clearly state portfolio objectives. The objectives should focus on the trade-off between risk and return. In formulating risk and return objectives, a mortgage lender should consider the following constraints:

Liquidity
Interest rate risk
Investment horizon
Taxes
Laws and regulations
Other needs

The investment objectives should be internally consistent and supportive of other efforts such as the interest rate risk policy, funds management, capital plan, and profit plan. The investment policy should fit into the mortgage lender's overall direction as described in the business plan.

INVESTMENT RISKS

Investment Risk versus Portfolio Risk

While management should understand the risks associated with individual securities, the decision of whether to buy a security should not rest on the risk of a security alone. Management should evaluate how the addition of the security to the portfolio affects the overall risk and return of the portfolio. The addition of a risky security to a portfolio can either raise or lower portfolio risk depending on the characteristics of the security and the portfolio.

Management should have a clear understanding of how changes in the composition of the investment portfolio affect the risk of the investment portfolio and the overall risk of the real estate lender. In a sense, the investment portfolio is a portfolio within a larger portfolio that includes all the assets, liabilities, and off-balance sheet contracts of the real estate lender. The overall risk of the real estate lender should be the primary consideration of management.

All investments carry some elements of risk. The primary risks associated with investments are:

Market risk (including interest rate risk)
Credit risk
Prepayment risk
Liquidity risk
Operational risk

Market Risk
We define market risk as the potential that the market price of a security will fall due to changes in interest rates, exchange rates, commodity prices, or other market or political conditions. A primary market risk faced by investors in fixed income securities is interest rate risk. Simply put, interest rate risk is the risk that the price of a security will change when interest rates rise or fall. Almost all fixed income securities decline in price when interest rates rise. A real estate lender can control the degree of interest rate risk in its investment portfolio by managing the weighted average maturity of the securities in its portfolio. In general, the longer the weighted average maturity of a portfolio, the greater the interest rate risk. Similarly, a mortgage lender can also control interest rate risk exposure by managing the duration of the portfolio.

Duration is a more precise measure of the interest rate sensitivity of a security or a portfolio of securities than weighted average maturity. Duration is a measure of the average time required to receive all the cash flows (interest and principal) from a security or a portfolio of securities. The higher a portfolio's duration, the greater the losses when interest rates rise. In general, bonds with longer maturities and higher durations carry more risk.

Credit Risk
Credit risk is the risk that an issuer may default (fail to pay) on principal or interest payments.
Real estate lenders can manage the credit risk of an investment portfolio by using the following techniques:

Portfolio diversification — investing in a variety of securities with differing credit risks.
Investment selection — managing the quality of securities in the portfolio

Real estate lenders can assess the overall quality of individual bonds by analyzing the financial condition of the issuer and other related factors. Such factors include the quality of management, competitive conditions in the industry, economic conditions, and so forth.

Many investors rely on credit rating agencies to measure the quality of corporate and municipal bonds. The most widely used bond rating agencies are Standard & Poor's Ratings Services and Moody's Investors Service.

Real estate lenders may only invest in investment grade bonds. Investment grade bonds are those in one of the four highest rating categories by a nationally recognized investment rating service such as Standard & Poor's and Moody's. Real estate lenders, by statute, may not invest in non-investment grade bonds.

The table below shows investment-grade and non-investment-grade ratings of these agencies.

Bond-Quality Ratings

This is not available in Egypt now.

Prepayment Risk
Prepayment risk is the risk that an issuer may repay all or part of the principal on a bond prior to maturity. Prepayment risk is a particular concern with mortgage-backed securities (MBS).

Issuers back MBS by mortgages that borrowers can prepay or refinance. When this occurs, the principal of the MBS is reduced and the issuer returns the cash flows from prepayments to the holders of the MBS. The risk is that the bonds will repay at an inopportune time, such as when interest rates are falling. Periods of falling interest rates usually generate widespread prepayments. If the investor wants to reinvest the proceeds from the prepayments, the prevailing yields on newly issued bonds are generally lower than the investor previously earned on the bond that prepaid.

Liquidity Risk
Liquidity risk is the risk that a security will be difficult to sell at a reasonable price within a reasonable time. On occasion, the liquidity of entire securities markets can seize up due to financial crisis or panic. Certain types of securities, however, such as those of small firms and securities with unusual features, are inherently illiquid. Real estate lenders may not invest in corporate securities that they cannot sell with reasonable promptness at a price that corresponds reasonably to the fair value of the security.

Operational Risk
Operational risk is the risk that deficiencies or failures in personnel, technology, or systems will result in unexpected losses.

Settlement Risk
Settlement is an arrangement between parties for payment or receipt of cash or securities. Settlement risk is the possibility that a counterparty will fail to honor its obligation to deliver cash or securities at settlement, and is a key operational risk in managing investment portfolios.

The careful selection of brokers and dealers can mitigate settlement risk. The selection process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments.

An inquiry into the general reputation of the dealer is also appropriate. This includes review
of information from securities regulators and industry self-regulatory organizations.

Risk Reduction
In general, real estate lenders should limit investments in complex securities with high price sensitivity to transactions and strategies that lower interest rate risk. Any mortgage lender that invests in such securities for a purpose other than that of reducing portfolio risk should do so in accordance with safe and sound practices.

Sound Practices for Market Risk Management
You should assess the overall quality and effectiveness of the real estate lender's risk
management process as it relates to investment activities.

Board and Senior Management Oversight
The board and senior management should understand their oversight responsibilities regarding the management of investment activities. Board oversight need not involve the entire board, but may be carried out by an appropriate subcommittee of the board. In particular, the board, or an appropriate subcommittee of board members, should take the following steps:

Approve broad objectives and strategies and major policies governing investment activities

Provide clear guidance to management regarding the board's tolerance for risk
Ensure that senior management takes steps to measure, monitor, and control risk
Review periodically information that is sufficient in timeliness and detail to allow the board to understand and assess the institution's investment activities
Assess periodically compliance with board-approved policies, procedures, and risk limits
Review policies, procedures, and risk limits at least annually

Senior management should ensure the effective management of the institution's operations, establish and maintain appropriate risk management policies and procedures, and ensure
that resources are available to conduct the institution's activities in a safe and sound manner. In particular, senior management should take the following steps:
Ensure that effective risk management systems are in place and properly maintained
Establish and maintain clear lines of authority and responsibility for managing investment activities
Ensure that competent staff with technical knowledge and experience consistent with the nature and scope of their activities conducts the institution's operations and activities
Provide the board of directors with periodic reports and briefings on the institution's investment activities and risk exposures
Review periodically the institution's investment risk management systems, including related policies, procedures, and risk limits

Adequate Policies and Procedures
Real estate lenders should have written policies and procedures governing investment activities. Such policies and procedures should be consistent with the institution's strategies, financial condition, risk-management systems, and tolerance for risk. An institution's policies and procedures (or documentation issued pursuant to such policies) should do the following:
Identify the staff authorized to conduct investment and derivatives activities, their lines of authority, and their responsibilities
Identify the types of authorized investments and investment instruments
Specify the required type and scope of pre-purchase analysis for various types or classes of investment securities
Define, where appropriate, position limits and other constraints on each type of authorized investment, including constraints on the purpose(s) for which such instruments may be used
Identify dealers, brokers, and counterparties that the board or a board-designated committee authorizes the institution to conduct business with and identify credit exposure limits for each authorized entity
Ensure that contracts are legally enforceable and documented correctly
Establish a code of ethics and standards of professional conduct applicable to personnel involved in investment and derivatives activities
Define procedures and approvals necessary for exceptions to policies, limits, and authorizations

Monitoring and Reporting
Real estate lenders should have accurate, informative, and timely management information

systems, both to inform management and to support compliance with investment policy. The
board of directors and senior management should receive reports for monitoring investment risk on a timely basis.

The board of directors and senior management should monitor investment activities on a regular basis. The types of reports prepared for the board and various levels of management will vary depending on the size and complexity of the mortgage lenders operations.

Record Keeping
Real estate lenders must maintain accurate and complete records of all securities transactions. In particular, mortgage lenders should retain any analyses (including pre- and post-purchase analyses) relating to investment transactions. A mortgage lender should make these records available to you upon request.

Internal Controls
Real estate lenders should have adequate internal controls over investment activities. A
fundamental component of the internal control system involves regular independent reviews and evaluations of the effectiveness of the system. Internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and institutional policies. An effective system of internal control should include the following elements:

- Effective policies, procedures, and risk limits
- An adequate process for measuring and evaluating risk
- Adequate risk monitoring and reporting systems
- A strong control environment
- Continual review of adherence to established policies and procedures.
- Real estate lenders should review their system of internal controls at least annually. Individuals independent of the function being reviewed should conduct the review. Reviewers should report results directly to the board.
- You should consider the following factors when reviewing an institution's internal controls:
- Does the mortgage lender maintain risk exposures at prudent levels?
- Does the mortgage lender employ the risk measures that are appropriate to the nature of the portfolio?
- Does the mortgage lender have board and senior management actively involved in the risk management process?
- Does the mortgage lender document policies, controls, and procedures adequately?
- Do mortgage lender personnel follow the established policies and procedures?
- Does the mortgage lender adequately document the assumptions of the risk measurement system?
- Does the mortgage lender accurately process data?
- Is the risk management staff adequate?
- Has the mortgage lender changed risk limits since the last review?
- Have there been any significant changes to the institution's system of internal controls since the last review?
- Are internal controls adequate?

Analysis and Stress Testing

Management should thoroughly analyze the various risks associated with investment securities before making an investment. In addition, management should periodically review the portfolio.

Evaluation of New Products, Activities, and Financial Instruments
New investment products and activities can entail significant risk. Senior management should evaluate the risks inherent in new products and activities to ensure that they are subject to adequate review procedures and controls. The board, or an appropriate committee, should approve major new initiatives involving new products and activities.
Before authorizing a new initiative, the review committee should review the following items:

- A description of the relevant product, activity, or instrument
- An analysis of the appropriateness of the proposed initiative in relation to the institution's overall financial condition and capital levels
- Descriptions of the procedures to measure, monitor, and control the risks of the proposed product, activity, or instrument

Management should ensure that adequate risk management procedures are in place before undertaking any significant new initiatives.

USE OF INVESTMENT CONSULTANTS

Some real estate lenders use consultants in the investment process. The mortgage lender should limit the role of consultants and brokers to advising management and executing transactions approved by management. The real estate lender should not delegate investment decision-making authority to third parties, including brokers or consultants. Ceding decision-making power to a consultant or broker represents an unsafe and unsound practice.

REPORTING AND ACCOUNTING FOR SECURITIES

MFA regulations [proposed], require mortgage lenders to record and report their financial
condition according to accounting principles. This responsibility includes the obligation to properly account for the real estate lender's securities under accounting principles. Real estate lenders must categorize each security as trading, available-for-sale (AFS), or held-to-maturity. A mortgage lender should determine whether securities are for its trading accounts, AFS, or held-to-maturity at the time it purchases or originates the securities. The real estate lender should not record securities in a suspense account until it determines the appropriate category. Management should periodically reassess its security categorization decisions to ensure they remain appropriate.

Trading Assets

Real estate lenders should classify as trading assets securities that the mortgage lender intends to hold principally for the purpose of selling them in the near term. Trading activity includes active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Real estate lenders must report securities held for trading purposes at fair value; and recognize unrealized gains and losses in current earnings and regulatory capital.

Held-to-Maturity

Held-to-maturity securities are debt securities that the real estate lender has the positive intent and ability to hold to maturity. Mortgage lenders generally report held-to-maturity securities at amortized cost.

Available-for-Sale
Real estate lenders must report securities not categorized as trading or held-to-maturity as available-for-sale. Real estate lenders must report AFS securities at fair value on the balance sheet. Real estate lenders must exclude unrealized gains and losses from earnings and report them in a separate component of equity capital. Section 260, Classification of Assets, states that real estate lenders holding non-investment grade securities must classify these securities as held for sale since they do not have the ability to hold them to maturity.

Changes in Categorization
If a real estate lender judges a decline in fair value of a held-to-maturity or AFS security to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and include the amount of the write-down in earnings. For example, if it is probable that a real estate lender will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment has occurred. Sales from the held-to-maturity portfolio could call the intent to hold to maturity into question and result in tainting the remaining portfolio. The real estate lender may need to redesignate the portfolio as AFS and be subject to mark-to-market adjustments. As a result, real estate lenders normally limit portfolio restructuring activities to AFS portfolios.

Proper Categorization of Securities
The proper categorization of securities ensures that real estate lenders promptly recognize trading gains and losses in earnings and regulatory capital.

SECTION: Borrowed Funds 560

INTRODUCTION

Unlike most other financial intermediaries, real estate lenders under Egyptian law do not take deposits, and therefore rely on borrowings of various types for the funding of their lending operations.

Borrowed funds, liquidity management, and funds management are integrally related. It is recommended that Manual Sections 530, Cash Flow and Liquidity Management, and 510, Funds Management, be reviewed in conjunction with this Section.

BORROWED FUNDS

Generally, lenders pursuing a strategy of moderate growth find borrowing an attractive funding alternative. However, rapid growth based on short-term borrowed funds, without well-established risk management controls, can also contribute to the failure of financial institutions.

The lender's present and anticipated use of borrowed funds should be integrated into the overall goals and objectives of the business plan and its funds management strategy. Borrowing is subject to criticism if precipitated by poorly planned funds management practices. Prudent management of borrowed funds should include:

- The clear identification of the purpose of the borrowing
- Analysis of present and anticipated funding and liquidity needs
- Analysis of the cost of the borrowing (including the desired spreads between the cost of the borrowing and the earnings from the assets funded, and, if issuing securities, the cost of issuance)
- Analysis of the availability of collateral
- Comparative analysis of the costs of various alternative types of borrowings
- Frequent monitoring of the borrowing activity to ensure that it remains appropriate to the lender's overall goals of interest rate risk management, liquidity management, funds management, and near-term and longer-term profitability

Lenders can become active solicitors of funds in the financial markets through transactions such as reverse repurchase agreements and various debt security issuances. Access to the financial markets and the cost of such borrowings is related to the lender's credit reputation, which is primarily based upon the lender's financial condition and adequacy of capital, and on the availability of such financial markets.

Certain costs and risks must be considered. Borrowings through debt issuance have operating costs that should be considered such as issuance expenses and investment banker fees. A more important consideration is that lender borrowings typically are collateralized. The amount that a lender can borrow is related to the market value of the collateral. When interest rates increase, the market value of most financial collateral declines. Consequently, rising interest rates often require a lender to pledge additional collateral or repay some debt. Such rising-rate scenarios can place a considerable strain on the lender's liquidity. In a rising-interest rate environment, the lender's financial condition will also be negatively affected if it has a significant mismatch of short-term borrowings financing long-term assets that are required to be held as collateral for borrowings.

Major Sources of Borrowed Funds

While banks can borrow at the Central Bank, and lenders in other countries also have access to other sources of government funds, Egyptian real estate lenders do not have such access.

Reverse Repurchase Agreement

Reverse repurchase agreements (reverse repos) with investment broker/dealers are commonly used by lenders as a short-term source of funds. Reverse repos are collateralized borrowings wherein the lender "sells" securities to a broker, agreeing to repurchase the same securities at a specified price and date.

Other Sources of Borrowed Funds

Common sources of lender borrowed funds include the following:

Short-term commercial bank loans
Issuance of various other debt securities
Retail reverse repurchase agreements
Loans from a parent or affiliate

Also considered a source of borrowed funds are overdrafts in the institution's transaction accounts in depository institutions, where there is no right of offset against other accounts in the same financial institution, unless the overdraft is in a zero-balance account or an account that is not routinely maintained with sufficient balances to cover checks drawn in the normal course of business.

Borrowed Funds Analysis

Cost and Risk Analysis

Management should analyze and monitor the borrowing composition to determine the effect of the financial costs on the net interest margin and profitability, and to assess the risks associated with these liabilities. The analysis should assist management in determining an acceptable liability mix. The regulator should evaluate the adequacy of management's analysis and its monitoring systems. Cost and risk analysis should include:

- The identification of the overall rate/volume/ mix of borrowings and the periodic evaluation of changes (variance) in interest expense due to changes in rate/ volume/ mix
- An evaluation of the risk/benefit trade-offs of the various sources of funds. (See discussion of risk/benefit trade-offs below.)
- A procedure to estimate the effect of an instantaneous and sustained shift in interest rates of +100, + 200, + 300, + 400 basis points on the net portfolio value of borrowings.
- An analysis of the marginal cost to generate additional funds

Marginal Cost Analysis

When interest rates are changing, average cost and marginal cost of borrowings will differ. Consideration of marginal cost is especially appropriate for monitoring and evaluating the cost of new borrowings. When rates are rising, the true cost of acquiring new borrowings (marginal cost) will be greater than the simple average of the incremental cost of a higher rate paid on new borrowings and an unchanged cost on existing borrowings.

Marginal cost analysis may not be as appropriate for monitoring and evaluating the cost of additional borrowings because the rate paid on new borrowings is limited to the incremental funds raised, not total funds.

REFERENCES