FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

March 14, 2003

**BANKING SUPERVISION AND REGULATION:
MORTGAGE BANKING ACTIVITIES**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Risk Management and Valuation of Mortgage Servicing Assets Arising from Mortgage Banking Activities (SR 03-4)

The Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the agencies), issued an Interagency Advisory on Mortgage Banking. The advisory highlights various supervisory concerns regarding the valuation and hedging of mortgage servicing assets (MSAs) and similar mortgage banking assets. It also provides supervisory guidance on sound risk management practices regarding valuation and modeling processes, management information systems, and internal audit as applied to mortgage banking activities.

Background

The findings of recent examinations at some banking organizations that engage in mortgage banking and mortgage servicing activities suggest the need for enhanced rigor in the specification and documentation of the underlying assumptions, models, and modeling processes used to value MSAs. The need for improvement in specific areas varies by institution and depends to a large extent on the materiality of the positions involved.

In particular, some institutions may need more rigorous processes for validating their MSA valuation models and underlying model assumptions, incorporating available market data in their valuations, amortizing remaining MSA cost bases, and evaluating MSAs for impairment. In addition, some institutions may require more robust processes in adequately characterizing, supporting the inclusion of, and estimating certain benefits of mortgage servicing activities as ancillary income. Some institutions also may need to enhance the risk management controls surrounding their mortgage banking operations and MSAs. Such improvements may entail greater segregation of duties between valuation, hedging, and accounting functions, and greater consistencies in the assumptions used for valuing, hedging, and pricing in mortgage-related activities.

Risk Management Guidance

As set forth in the guidance, the agencies expect institutions to conduct all aspects of their mortgage-banking operations in a safe and sound manner and consistent with sound risk management practices. Institutions are expected to take into account the potential exposure of both earnings and capital to changes in mortgage banking assets and operations under expected and stressed market conditions. The practices advanced in the interagency advisory supplement and expand upon existing Federal Reserve supervisory guidance on interest rate risk management, mortgage-banking, and financial modeling.[1]

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[1]See section 3010, “Interest Rate Risk Management,” and section 3020, “Securitization and Secondary Market Credit Activities,” in the *Trading and Capital Markets Activities Manual*, and section 3070," Mortgage Banking," of the *Bank Holding Company Supervision Manual*.

In general, management should ensure that detailed policies, procedures, and limits are in place to monitor and control mortgage banking activities, including loan production, pipeline (unclosed loans), and warehouse (closed loans) administration, secondary market transactions, servicing operations, and management (including hedging) of MSAs. Institutions are expected to have comprehensive documentation that adequately substantiates and validates both the carrying values of their MSAs and the underlying assumptions used to derive these values. Institutions should have documented analyses and processes that adequately support the amortization and timely recognition of impairment of their MSAs.

Management information reports should provide comprehensive and accurate information on the institution's mortgage banking operations and MSAs. Senior management and the board should be aware of and focus on key risks, profitability, and accounting and valuation practices. Given the risks inherent in these activities, internal auditors should review the risks of and controls over an institution's mortgage banking operations on an on-going basis.

Scope and Applicability

The guidance applies to the mortgage banking activities conducted by state member banks, bank holding companies, Edge corporations and U.S. branches and agencies of foreign banks.[2] This guidance builds on, supports, and is fully consistent with existing guidance on risk management issued by the Federal Reserve.[3]

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at **http://www.frbsf.org/banking/letters**. Paper copies of the interagency advisory and the Board's notice (SR 03-4) are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information about the advisory, please contact our Banking Supervision and Regulation Department at (415) 974-3826.

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Attachment: Interagency Advisory on Mortgage Banking

Cross References: SR letters 99-37. 97-21, 96-40, 96-14, and 95-51
Section 3010 of the Trading and Capital Markets Activities Manual
Section 3010 of the Bank Holding Company Supervision Manual

[2] This guidance applies to U.S. branches and agencies of foreign banks with recognition that appropriate adaptation may be necessary to reflect the following:

1) those offices are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and recognizing potential obstacles to cash movements among branches
2) the foreign bank is subject to overall supervision by its home country authorities

[3] For a more detailed discussion of risk management, refer to SR letter 99-37, "Risk Management and Valuation of Retained Interests Arising from Securitization Activities;" SR letter 97-21, "Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities;" SR letter 96-40, "Interim Guidance for Purposes of Applying FAS 125 for Regulatory Reporting in 1997 and for the Treatment of Servicing Assets for Regulatory Capital;" SR letter 96-14, "Risk-focused Safety and Soundness Examinations and Inspections;" and SR letter 95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."