

PRODUCTION DUE DILIGENCE – CASE STUDY

CLIENT INFORMATION:

Federal Home Loan Bank

BACKGROUND:

- The FHLB provided a \$1 billion mortgage funding facility for a large member bank that purchases residential mortgages in bulk third party originators.
- The member bank is responsible for sending key loan data regarding the loans pledged and providing a risk grade for each pledged loan. The risk grade establishes the “haircut” percentage

PROBLEM STATEMENT:

- The FHLB was concerned about the integrity of the loan level data provided by the member bank and if the risk grades were accurate
- The FHLB was concerned if the collateral is being pledged properly

SOLUTION SUMMARY AND KEY BENEFITS:

- Selected a representative sample of loans pledged on a specific day
- Worked with the FHLB and the member bank’s document custodians to verify if the mortgage notes were pledged to the FHLB for the specific day
- Reviewed the member bank’s loan purchase processes to determine if they met industry best practices
- Performed a data integrity review by matching the data provided to the FHLB with the source data in the sample loan files
- Underwrote the pledge loans in the sample to determine if they met the member bank’s underwriting criteria and if the assigned risk grade was accurate

THE RESULTS:

- We found material deficiencies in a high percentage of the sample of pledged loans especially regarding underwriting and risk grading
- The FHLB significantly reduced the amount of the funding facility available to the member bank and increased the haircuts for pledged loans
- The member bank failed about 12 months after the FHLB changed the terms of the line of credit and the FHLB’s exposure to losses was minimal