

Supervisory Letter BAC-2007-15

Comptroller of the Currency
Administrator of National Banks

National Bank Examiners
101 South Tryon Street, NC1-002-31-15
Charlotte, NC 28255-0002

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Subject: Consumer Real Estate (CRE) First Mortgage Production Review

Messrs. Robinson, Kula, Griffith and Caruso:

Scope and Objectives

We recently completed an examination of CRE's first mortgage production functions. Our primary focus was to evaluate loan production activities, including origination, processing, underwriting, closing and funding activities. In addition, we evaluated the quality assurance (quality control) function, examined fraud prevention and monitoring systems, and assessed portfolio management activities. We also reviewed operational systems and controls, evaluated management and overall supervision, and assessed risk management systems. We met with CRE managers and reviewed workflows and operating processes in Charlotte, NC, Dallas, TX and Hillsboro, OR.

Conclusions

- Overall supervision of CRE's first mortgage production and origination functions is satisfactory.
- Asset quality and portfolio management is good as reflected by low levels of credit losses, and a manageable volume of borrower delinquencies. Effective underwriting and prudent risk selection have positively impacted the portfolio performance.

- Lines of business (LOB) managers and risk partners effectively self-identify operational processes requiring improvement. For example, management has undertaken Six Sigma initiatives to improve processes and controls for broker management, mortgage repurchase activity and mortgage fraud.
- The aggregate credit risk is low and the direction of risk is increasing. The quality of risk management is satisfactory.
- A Matter Requiring Attention (MRA) and Violation of Law are cited for inconsistency in the filing of Suspicious Activity Reports (SAR) for mortgage fraud.

Matters Requiring Attention

- **Management should refine its existing processes to ensure that SARs are consistently filed for suspicious activity.**

Failure to consistently file SARs as required by statute results in noncompliance with the Bank Secrecy Act. Our sample of 50 loans notes 16 or 32% of Quality Assurance (QA) referrals of suspicious activity had no SAR filings, despite activity descriptions supporting such a filing. Consistent investigation of mortgage fraud referrals from QA would result in increased compliance.

Improved process controls are needed to ensure proper review and investigation of fraud referrals from QA. For loan requests that are declined and referred to Corporate Security based on attempted fraud, there are inconsistent application standards for whether an investigation will be opened. Revised procedure guidelines and metrics should be developed to reconcile QA fraud referrals to final disposition by Corporate Security. This arrangement should be formalized through a written service level agreement outlining expectations between QA and Corporate Security. Based on discussions with SVP Linda Bei and SVP June Rogers, Bank of America has already initiated corrective action along these lines. Care should be taken to identify all potential SAR violation types for inclusion on the SAR form.

Management Response: Management has recognized the need to improve workflow, processes and controls for the mortgage fraud process. Management has placed a high priority on self-identified weaknesses that are being addressed through the implementation of a comprehensive Six Sigma process. Management agreed to expand the Six Sigma initiatives to implement corrective actions for the supervisory concerns discussed above. The aforementioned issues should be easily resolved within the normal course of business with enhanced training.

Violations of Laws and Regulations

31 USC 5318(g) – Reporting of Suspicious Transactions 12 CFR 21.11(c) (1-4) – Suspicious Activity Reports (SAR) Required

These sections ensure that national banks file a SAR when they detect a known or suspected violation of the Bank Secrecy Act (BSA). The regulation further requires a national bank to file a SAR with the appropriate federal law enforcement agencies and the Department of the Treasury in accordance with the form's instructions, by sending a completed SAR to FinCEN in the following circumstances:

- (1) Insider abuse involving any amount,
- (2) Violations aggregating \$5,000 or more where a suspect can be identified,
- (3) Violations aggregating \$25,000 or more regardless of potential suspects, and
- (4) Transactions aggregating \$5,000 or more that involve potential money laundering or violate the BSA.

Sixteen of the 50 accounts included in our sample population, with documented suspicious activity by the Fraud Quality Assurance Unit in August 2006, resulted in no SAR filings. All transactions meet dollar reporting thresholds as described above. For the SARs in the sample that were filed, they were evenly distributed among those that were funded, and those that were either still being underwritten or declined. In either case, a SAR should be filed on any attempt to defraud a bank whether successful or not.

Corrective Action: Strengthened SAR reporting processes are included as part of the Six Sigma initiative being implemented by Bank of America. Apart from this effort, near-term plans include bolstering SAR filing and documentation standards across the company. These enhancements should assist the Assistant United States Attorneys in prosecuting mortgage fraud activity by all parties to the transaction. Corporate Security has also initiated improvements to its process controls over referrals submitted by QA. A formal service level agreement will be developed between Corporate Security and QA that will outline production standards, deliverables, and expectations between the parties in handling fraud referrals.

Supporting Comments

Asset Quality and Portfolio Management

Asset quality is sound for CRE's first mortgage production and the overall portfolio. In the fourth quarter of 2006, first mortgage bookings' average FICO score is 723, with Corporate Treasury purchase activity included. This average FICO score is down only slightly from the prior quarters in 2006, and the average for the past two years. Management continues the practice of controlling the volume of mortgages to borrowers with a FICO score below 620, which could have the credit profile of subprime. Quarterly fundings with a FICO score below

620 range from 2.4% to 2.8% in 2006. Adjustable Rate Mortgage (ARM) products fundings were in the low-to-mid 30% range in 2006. However, the volume of Option ARM bookings remains low in 2006, ranging between 1.3% and 2.2% for the four quarters.

First residential mortgage's 2006 net credit loss ratio of 0.02% remains nominal and unchanged from a year ago. In addition, the bank's losses on recourse loans have been minimal. At December 31, 2006, the 30-days plus past due rate at 1.17% has increased only three basis points from the level at a similar period last year. The 90-days plus past due rate decreased five basis points to 0.05%. While the overall past due levels remain manageable, the 2006 production vintage's delinquencies are outpacing the levels for 2005 and 2004 vintages.

Retail Origination Channel

The overall underwriting process is sound for the retail origination channel. Written policies and underwriting criteria are reasonable, consistent with industry practices, and are designed to meet requirements from government-sponsored enterprises (GSEs) and investors. Substantial reliance on automated decision engines provides consistent application of underwriting criteria and promotes adherence to written policy and GSE requirements. The underwriting process should be enhanced by the recent implementation of a national underwriting review process.

Onsite visits to the Charlotte, NC and Hillsboro, OR underwriting centers, responsible for underwriting applications from different channels, indicate consistent and standardized practices across the centers. Both centers have adequate systems and controls in place over workflows. We observed that the closing and funding processes contain adequate controls to ensure conditions have been met for loan closing and funding. There are adequate controls over the funding area to ensure separation of duties. We did make a recommendation to implement a pre-closing/funding quality assurance process to periodically validate information used to make loan decisions.

CRE began originating 40-year amortization mortgages in the first quarter of 2006. The volume of the 40-year product represents 1% of originations for the nine-month period ending September 2006. However, during the month of September, the 40-year product consists of 7% of approvals. Additionally, our transaction testing indicated loans with underwriting exceptions were appropriately approved, with reasonable mitigating factors usually apparent.

Wholesale (Broker) Origination Channel

Broker management is supported by a tenured staff. The wholesale channel is the source of funding for approximately one-third of CRE's first mortgage originations. Our review confirms management's internal assessment that enhancements are needed to strengthen the broker approval and monitoring processes. Management has undertaken broker sales initiatives to establish broker metrics. Management is also making progress in addressing issues identified in a recent Corporate Audit report.

Additionally, management needs to enhance oversight of new broker relationships by establishing reasonable production and loan quality service level expectations. The existing broker relationships, in excess of 7,000, are considerable. The majority of the current brokers were approved within the past two years, with approximately one-third of the broker relationships established within the last six month of the examination date. Only half of the recently approved brokers are active, i.e., generating mortgages. We observed that approximately 1400 brokers (or 20%) generate 70% of brokered originated mortgages. In 2006, management established a minimum production requirement for brokers, consisting of generating one loan per month, or six loans within six months. The brokers' loan decline rate thresholds are liberal, tiered at 50% or greater to as high as 80% depending upon the length of the broker relationship and loan volume. We recommend management re-evaluate the appropriateness of establishing low loan production expectations for brokers, and consider establishing a dollar benchmark as well. Such efforts could improve operational efficiencies. In addition, the effective oversight of broker relationships should include a robust profitability analysis and broker scorecard processes. Management also needs to establish formal limits for underwriting exceptions and track these exceptions down to the underwriter and/or Home Service Specialist (HSS) levels.

Mortgage Fraud Prevention and Monitoring Systems

Management recognizes that mortgage fraud process improvements are needed. Management places high corporate priority on self-identifying weaknesses and effecting improvements through the Six Sigma process. Our transaction testing of fraud quality assurance confirmed weaknesses in mortgage fraud identification at the pre-closing/funding level for all channels except Home Equity. As previously mentioned, a Violation of Law and MRA are cited due to the failure to file SARs for suspicious activity, including instances where employee involvement is suspected. Improved training is needed around proper completion of SARs, especially in regards to identification of all appropriate SAR violation types.

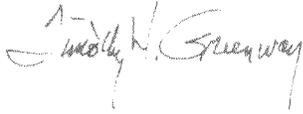
A separate list of "**Recommendations**" is included in the "**Appendix**" of this Supervisory Letter. We encourage management to consider these items to further enhance operations. However, a written response is not required for the list of recommendations.

Exit Meeting and Response

An exit meeting was held with CRE management on January 18, 2007. National Bank Examiners (NBE) Alvon S. Ward, Chris Hines, Janice DiMaria, Greg Phipps and Everett Tolbird represented the OCC. The bank attendees were SVP Lisa Patania, SVP Susan Thrasher, and Wali Molina, Executive Assistant-LMI Administration. Bank management was in agreement with our examination findings.

Please provide a written response to the Matter Requiring Attention and Violation of Law within 45 days from the date of this Supervisory Letter. Your response should include an action plan and timetable to address the issues. Please forward your response to Timothy W. Greenway, Examiner-in-Charge at mail stop NC1-002-31-15. If you have any questions about the contents of this document, please contact NBE Alvon S. Ward at (704) 386-4274.

Sincerely,

A handwritten signature in black ink that reads "Timothy W. Greenway". The signature is written in a cursive style with a large initial "T" and "G".

Timothy W. Greenway
Examiner-in-Charge
Large Bank Supervision

cc:

Regulatory Relations (for distribution)
HQ Records

Appendix

Recommendations

This section provides several recommendations to enhance processes. We are not requesting a response related to these items.

Retail Origination Channel

1. Management should consider establishing a pre-closing/funding quality assurance process to periodically validate application, credit, and collateral valuation information used to make the loan decision. Under the current structure, application information is input directly by the retail account executive (sales staff), may be automatically approved, have collateral value provided by Consumer Real Estate Settlement Services (CRESS), and sent directly to the loan processor with no qualitative review. While the processing system does contain controls that, in theory, should catch missing or unfulfilled requirements, exceptions continue to be found by the post-closing Quality Assurance unit. As with other mortgage lenders, there is strong emphasis on “speed to close”, management should ensure that the quality of production and underwriting processes are not compromised.

Wholesale (Broker) Origination Channel

2. Brokers have significant control over the appraisal process. Basically, the broker orders appraisals for loan requests under \$1,250,000. The underwriter or HSS checks to see if the appraiser is on the bank's "Ineligible Appraiser List". If the appraiser is not "ineligible", the HSS or underwriter completes a basic review of the appraisal. If everything looks fairly reasonable, another appraisal or AVM is not obtained. A more independent and effective process would be to have appraisers order appraisals through CRESS. Another alternative would be for the bank to order a separate AVM or a second appraisal (for loan requests exceeding a specified amount) on the property to validate the broker provided appraisal.
3. Management has a process to review account executives whose assigned brokers generate a large number of exceptions. There is no formal limit for underwriting exceptions. Management should set tolerance/limits for underwriting exceptions and track these exceptions down to the underwriter/HSS level. MIS reporting should also be expanded to track and monitor the volume of low-side and high-side overrides. Management needs to monitor exception levels and take appropriate action when tolerance levels are exceeded.
4. The scorecard for underwriters and HSS need to be enhanced to incorporate a qualitative assessment/score (e.g., volume of underwriting exceptions, defects, etc.). Management explained that this has not been part of the scorecard because of the random sample nature of quality reviews. Reportedly, management plans to incorporate a quality score component in the scorecard during 2007.

5. Management should develop and implement a comprehensive analysis to assess broker profitability. Such analysis should include an assessment of all-in costs to approve, train and monitor broker activity. Fulfillment costs, including loan re-submission, incomplete loan packages, etc. add to operating cost and should be evaluated to ensure that the relationship is profitable.
6. Oversight of broker activity is achieved through an annual evaluation and monthly monitoring. The monthly monitoring process includes a review of broker generated loans where performance attributes exceed guidelines. The review of performance guidelines supports consideration of more stringent risk tolerances. Risk tolerances are set at a higher level for newer and low producing brokers. The broker loan decline rate thresholds are liberal, tiered at 50% or greater to as high as 80% depending upon the length of the broker relationship and loan volume. Currently, broker performance is tracked for originations over a two-year period. Management should ensure that appropriate performance standards are established, incorporating an acceptable pull-through rate, loan decline rate and production volume. In addition, the broker's originations should be tracked in excess of 24 months to enable management to properly assess the impact portfolio seasoning has on delinquency, foreclosure and loss levels.
7. Management should develop and implement a robust broker scorecard to effectively monitor the quality and profitability of broker relationships. At a minimum, the following key metrics should be established and/or existing performance attributes revised, and incorporated in a broker scorecard:
 - Establish minimum production volume (dollar volume and/or units) over a specified time frame;
 - Establish limits on the volume and percentage of incomplete submissions;
 - Acceptable limits on application reject rate over an established time period;
 - Acceptable tolerance levels for critical errors and defects cited by the Quality Assurance group;
 - Establish a maximum acceptable delinquency level for a broker portfolio and maximum volume and percentage of first and early payment defaults;
 - Incorporate broker performance "attributes" and ensure performance triggers consider dollar volume as well as units;
 - Capture repurchased loan activity from investors, as well as track the volume of loans with confirmed fraud; and,
 - Track and monitor the volume of early payoffs (e.g., within six months of funding).
8. Production and loan quality performance standards should be incorporated into the broker agreement. The current agreement in use is general, with no specific language regarding acceptable production and/or quality metrics. In addition, there remains some reliance on brokers to provide timely notification to the bank of terminated, or officers that have resigned. We recommend that notification requirements be added to the broker agreement to communicate expectations and ensure accountability.

Quality Assurance (Quality Control) Process

9. The quality assurance program is satisfactory, but this area was in a phase of management transition during the examination. Former Quality Assurance Manager Sally Smith was reassigned to another position within the bank during the examination. It is important that a capable quality assurance manager is appointed in a timely manner. SVP Patania stated that VP Thomas Ahart will assume the quality assurance manager's responsibilities for First Mortgage.

Management should also ensure that the QA Operating policy is expanded to include the definitions for each different exception levels, and the definition for the overall risk evaluation ratings. There are a few gaps in the QA Operating policy. We encourage management to reference Fannie Mae's Originating Quality Mortgages Quality Assurance Best Practices for addressing gaps in the policy. We recommend that the policy incorporates Fannie Mae's best practices guidance, including documentation surrounding reviews of Third Party Originations.

10. The quarterly risk evaluation report should be distributed to each of the account executive channels and narrative comments included in the evaluation should be expanded. The narrative comments should include corrective measures undertaken to address identified deficiencies.
11. First payment defaults should be included in the monthly sampling of closed accounts reviewed by the QA unit. A process exists to review all accounts that become 60 days delinquent within the first six months from the origination date. However, QA should also review first payment defaults to highlight and provide early intervention for possible underwriting and operational (e.g., loan set-up) issues.
12. Management should ensure that QA personnel are knowledgeable of processes for placing an appraiser on the "ineligible" and "watch" appraiser lists. Such lists should be cross-referenced to the QA review process.

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