FEDERAL HOME LOAN BANK OF CINCINNATI
FEDERAL HOME LOAN BANK OF INDIANAPOLIS
FEDERAL HOME LOAN BANK OF SEATTLE

March 15, 1999

The Honorable Bruce A. Morrison
Chairman
Federal Housing Finance Board
Washington, DC 20006

Dear Chairman Morrison:

The concept of pilot programs to test new service areas for Federal Home Loan Banks, as you introduced in 1996, is an excellent one which has inspired extensive customer research, analysis and development among the Banks ever since. As a group, we share your enthusiasm for developing new ways to support our customers' roles in building homeownership opportunities through the mortgage finance markets.

After considerable research and discussion with our customers over the last year, we have concluded that there is a very strong demand for an alternative to selling to Fannie Mae and Freddie Mac in the secondary market for residential mortgages. Our customers have expressed growing concerns about the domination and market power of these two enterprises. In our search to expand and enhance Federal Home Loan Bank products to meet their needs, we are developing a new single family purchase product. We have appreciated the thoughts and suggestions you have provided on other single family pilot concepts surfaced up to this point and deliberately tried to craft a model that addresses the key criteria you have identified to date:

1. **Mission consistency:** It directly supports our mission by assisting community financial institutions with economical home lending.

2. **Risk sharing:** Federal Home Loan Bank customers effectively retain most of the credit risk.

3. **AA equivalent investment:** The FHLB credit risk is limited in that the Bank would have the equivalent of an AA-rated security.

4. **Unique structure:** The program offers an approach to the market distinct from Fannie Mae or Freddie Mac.

Also, this product addresses the two major issues that have been identified by our customers as obstacles to their participation in Chicago's Mortgage Partnership Finance (MPF): operational complexity and the uncertain capital treatment of the credit enhancement feature of that program.

Proposed Features

The mortgage purchase program would be simple and direct, as outlined below. The management of credit risk under this program is also shown in the attached chart.

1. Underwriting

Lenders would underwrite and process mortgages in the same manner as they do loans being sold to the secondary market GSEs, using underwriting standards and paperwork similar to that used by Fannie Mae and Freddie Mac. The Federal Home Loan Bank would develop criteria for which loans were acceptable, by type of loan, property type, and credit quality. Loans eligible for purchase would be 15 and 30 year fixed rate, fully conforming loans. Lenders would have the option of using full delegated underwriting authority and could use Loan Prospector, Desktop Underwriter, or other models as approved, for scoring. Lenders would obtain primary mortgage insurance coverage from their preferred providers.

2. Delivery

When members deliver loans to the Federal Home Loan Bank, the loans would be screened for completeness, credit quality, and other quality controls. Those loans that do not comply with the standards would be returned to the lender.

3. Pricing

For accepted loans, the Federal Home Loan Bank would pay the member a higher price than that currently used in the secondary market, approximately 10 basis points in dollar price. In addition to the amount paid to the lender in cash, the Federal Home Loan Bank would set aside for the customer a portion of the proceeds in an amount sufficient to fund an account that would absorb the first level of loan losses not covered by primary mortgage insurance. This lender risk account is described below.

4. Credit Risk Sharing

A three-layer credit enhancement would be used to protect the Federal Home Loan Bank. The precise numbers used for each section of the credit enhancement are preliminary and are for discussion only at this point. Financial analysis work remains to determine the optimum distribution of risk among the three layers.

First, the Federal Home Loan Bank would establish a lender risk account approximately equal to 60 basis points of the amount of the mortgages purchased, an amount about four times expected losses. This account would be funded from the proceeds of the purchase price of the loans and set aside in each member's name at the time of purchase. Losses incurred on a customer's loans would be charged to this non-interest bearing account for a period of ten years from the date of purchase. The amount remaining in the account after losses would be paid to the member over the ten-year period, beginning at the end of year two, on a predetermined schedule that retains sufficient funds to cover expected losses as they occur. The lender risk account would provide significant protection to the Federal Home Loan Banks, and anticipation of receiving income from this account would create a powerful incentive for the members to deliver high quality loans and to service them effectively.

Second, for additional protection, the Federal Home Loan Bank would obtain supplemental mortgage insurance on each separate loan to cover losses that go beyond the lender risk account. This coverage would reduce the exposure on each loan to 60 percent of the original value.

Third, a spread account would be established by the Federal Home Loan Bank from the interest earned on the mortgages to cover any losses not covered by the other layers. This would be funded at 5 to 10 basis points per year and maintained at 50 basis point coverage on the outstanding portfolio.

5. Servicing

Customers would service the loans that they originate or sell that servicing to an approved institution. The Federal Home Loan Bank will retain a master servicer to handle the institutional reporting functions. Customers can use their regular document custodian or work with a central custodian approved by the Federal Home Loan Bank.

<u>Advantages to This Product</u>

1. Customers benefit from the ability to sell their mortgages to the Federal Home Loan Banks on terms that they have said are more attractive than their current options, ultimately benefiting home owners.

2. The Federal Home Loan Banks are provided with high quality, mission-related assets that will provide a reasonable return to the Federal Home Loan Bank relative to their risk.

3. The risk-sharing concept pioneered by MPF is maintained. Customers have every incentive to originate and sell high quality loans to the Federal Home Loan Banks. The higher the quality of loans the greater the members' returns.

4. The mechanics of the program are simple and straightforward. Customers could use their current procedures and avoid the cost and confusion inherent in setting up a different method of internal processing. The simplicity of the processing would make the program very attractive to customers.

5. We believe that this proposal resolves the customers' capital issue, since the mortgage would be sold outright to the Federal Home Loan Bank with no recourse and because the capital treatment of the lender risk account is clear cut and reasonable. According to FASB, lenders should book the present value of the lender risk account as an asset, in which case the lender would hold 100% risk based capital

against this amount. If it is not practical to estimate the cash flows from the lender risk account, the lender would recognize revenues as they are distributed from the Federal Home Loan Bank and would not record an asset or hold risk based capital. Our customers have indicated that they regard this capital treatment as acceptable from a financial standpoint.

Our Request

The development of a pilot based on this idea should be fairly straightforward because the structure is relatively simple. Each participating Federal Home Loan Bank would process their own loans, a program condition that our customers strongly prefer. However, development costs could easily be minimized by a group of Federal Home Loan Banks, such as ourselves, working together to share the cost of developing contractual agreements, accounting standards, data processing standards, and operational structures. Each Bank could then adapt these jointly produced methods to its own local needs.

We are excited about the possibility of working together to develop such a pilot. We have discussed this product concept with many of our active lenders and they are very interested in working with us to bring this program to fruition, believing that it meets their needs and those of their customers. The product structure meets the key criteria developed as a result of our market research – attractive pricing as compared with current options, operational simplicity and execution, excellent service by their local Federal Home Loan Bank and clear cut and reasonable capital treatment. Most importantly it enhances the choices in the secondary market for community financial institutions and their customers.

We have appreciated your support of innovative programs, such as MPF, that enhance our mission by meeting identified community financial institution needs. We believe that this concept is consistent with the criteria you have identified for pilot evaluation and would like to discuss its possibilities with you at your earliest convenience. It is our hope that you can meet with the undersigned Federal Home Loan Banks to discuss this proposal in more detail. Thank you for your consideration of this request.

Sincerely,

Martin L. Heger
President/CEO
FHLBank of Indianapolis

Norman B. Rice
President/CEO
FHLBank of Seattle

Charles L. Thiemann
President/CEO
FHLBank of Cincinnati

CC: Finance Board Directors Timothy O'Neill and William Apgar

Risk Tiers – Pilot Program Proposal

First loss tier

Primary Mortgage Insurance
if applicable

↓

Second loss tier

Lender Risk Account
60 basis points

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Third loss tier

Supplemental Mortgage Insurance
Purchased by FHLB on Loans to 60% LTV level

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Final loss tier

Loan Loss Reserve
5 -10 basis points/year on outstanding balances
up to 50 basis points pool