FEDERAL HOME LOAN BANK
OF INDIANAPOLIS

MEMORANDUM

TO: James Bothwell
Scott Smith

FROM: Milton Miller

SUBJECT: Meeting regarding MPP on May 5

DATE: April 30, 1999

This memo is to confirm the attendance of Dave Hehman, Federal Home Loan Bank of Cincinnati; Cindy Chirot, Federal Home Loan Bank of Seattle; [redacted]; and me at a meeting with you on May 5 at 1 p.m. We plan to review issues raised by the draft version of Chairman Morrison's letter, as he requested.

For your convenience, we enclose the following briefing documents addressing some of those points.

1. Product and Credit Enhancement Description
2. Financial and Credit Exposure Comparison
3. Summary of Market Demand for the Product

We look forward to discussing these issues with you.

CC: Dave Hehman, FHLB Cincinnati
Cindy Chirot, FHLB Seattle
[redacted]

MORTGAGE PARTNERSHIP PROGRAM
PRODUCT AND CREDIT ENHANCEMENT DESCRIPTION

1. **Loan Underwriting and Origination**

   - Lender would underwrite, close, fund and deliver loans to Federal Home Loan Bank in same fashion as FNMA/FHLMC deliveries.

   - Lender could utilize full delegated underwriting subject to Federal Home Loan Bank loan program criteria. Loans that receive a LP or DU accept, or that are underwritten by [redacted], or have passed through other approved models are waived for buyback liability.

   - Lenders would obtain normal primary mortgage insurance from their preferred providers. Lenders would be able to reinsure the business in a captive reinsurance company, if they so desire.

2. **Loan Quality**

   - The Federal Home Loan Bank would negotiate a master commitment with each lender specifying loan program criteria and mix of business parameters (i.e. mix below 620 credit score, cash-out refinance, investor, multi-unit, over 90% LTV, etc.).

   - Loans delivered to Federal Home Loan Bank would be immediately screened for data completeness and compliance with Federal Home Loan Bank loan program criteria and mix of business parameters.

   - [redacted] could be licensed by the Federal Home Loan Bank to further gauge a lender's loan quality and to identify issues.

   - Loans would be audited shortly after delivery for underwriting compliance.

[redacted]

3. **Loan Delivery**

- Upon delivery and successful screening, the Federal Home Loan Bank would pay the lender a modestly better price for the loans versus FNMA/FHLMC, in the range of 8-10 bps, to provide an upfront incentive for participation. This would complement the longer term performance incentive discussed below.

- The FHLB would aggregate the individual lender deliveries and create large diversified pools avoiding issues associated with small pool size or geographic concentrations.

4. **Lender's "AA" Credit Enhancement**

- Comprised of three components, a Lender Risk Account, Supplemental MI Coverage and a Cleanup Fund, as described below:

A. Lender Risk Account

- The first component of the Lender's "AA" credit enhancement is a 60 bps Lender Risk Account that would be funded and held by the Federal Home Loan Bank.

- The 60 bps Lender Risk Account would provide a sizable incentive for lenders to originate quality loans.

- Losses in excess of normal primary MI would be charged to the Lender Risk Account during the first 10 years after origination, to the extent funds are available.

- Starting at the end of year 2, excess Lender Risk Account funds would be paid to the lender as shown below:

End of Year	Required Account Balance	Potential Lender Payment
1	60 bps	0 bp
2	55	5
3	50	5
4	40	10
5	30	10
6	20	10
7	15	5
8	10	5
9	5	5
10	0	5
		60 bps

[redacted]

B. Supplemental MI Coverage

- The second component of the Lender's "AA" Credit Enhancement is a layer of supplemental primary insurance for coverage beyond normal primary insurance and the Lender Risk Account.

- The amount of coverage would reduce exposure on individual loans to 60% of original value so that: Equity + Normal MI + Supplemental MI = 40%.

- The Federal Home Loan Bank would buy the insurance on behalf of the lender by paying an annual premium to the MI carrier in order to ensure consistent execution and reduce administrative costs. Another important benefit of having the Federal Home Loan Bank obtain the supplemental insurance directly is that it enables the Bank to replace the MI carrier in the event the credit rating of the mortgage insurer drops to "A."

C. Cleanup Fund

- The final component of the Lender's "AA" Credit Enhancement is a Cleanup Fund which would be established to cover losses that penetrate normal primary insurance, Lender Risk Account and Supplemental MI Coverage.

- The fund would be established by the Federal Home Loan Bank through a 5-10 bps annual contribution on the outstanding portfolio so that the balance grows to and is maintained at 50 bps of the outstanding portfolio.

5. **Loss Protection Afforded to Federal Home Loan Bank**

- Primary mortgage insurance and equity of the homeowner absorbs losses up to amount available.

- The lender has 60 basis points at risk through the first loss account maintained at the Federal Home Loan Bank. The expected losses over the life of average loans are 15 basis points. Thus the lender risk account is expected to pick up all normal expected losses. The lender risk account would not pay out any funds to the lender until after year two and significant amounts are not paid out until year 4, after which time the loans are seasoned. Even at year six 20 basis points would remain in the account for additional losses. The large lender risk account provides a sizable incentive for the lender to deliver high quality loans and to service them well.

- Additional losses to 60% loan to value will be covered through supplemental MI. The proposed MI company is AA+ rated.

[redacted]

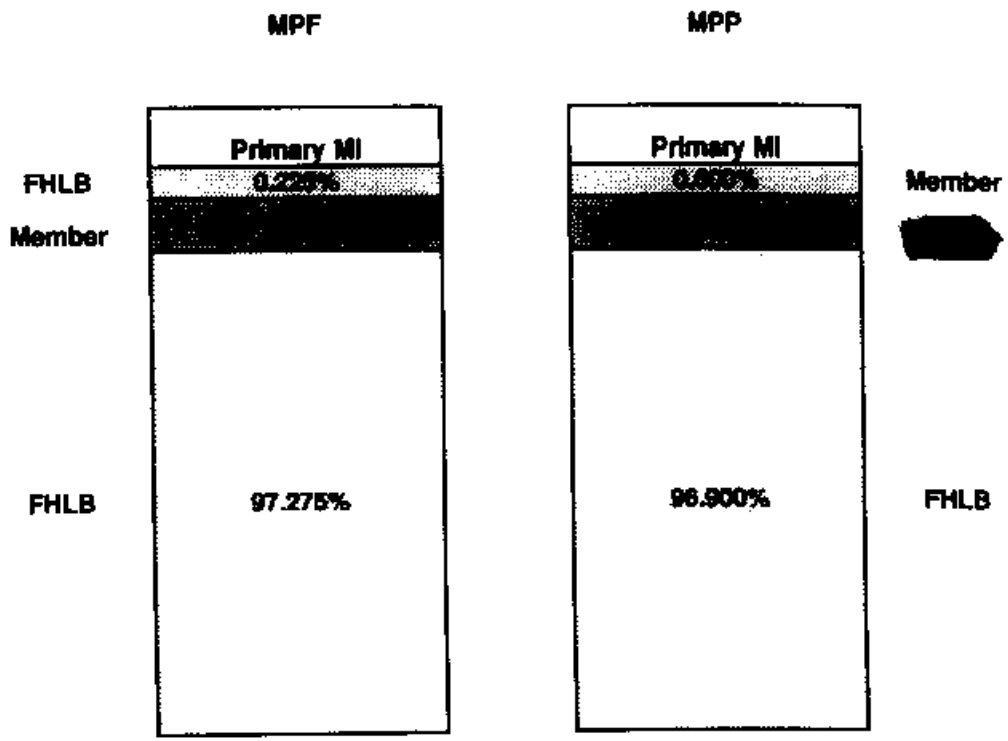
- Only after losses exceed the above would the Federal Home Loan Bank's clean up fund be tapped. Based on loss experience for normal pools, the Federal Home Loan Bank would only be tapped in highly unusual circumstances. After year ten, the lender risk account would be extinguished and the primary and secondary MI would pick up all first and second losses before the Federal Home Loan Bank clean up fund is tapped. Loss experience after year 10 is minimal.

- The ability of the Federal Home Loan Bank to replace the supplemental MI carrier if their credit rating drops to "A" protects the Bank against potential exposure due to deterioration of the financial strength of the MI carrier.

Comparative Analysis
Agency Sale, MPF and MPP

	Agency sale	MPF	MPP
Note rate	7.50%	7.50%	7.50%
Servicing	(0.25)	(0.25)	(0.25)
Guarantee fee	[illegible]	-	-
First loss account	-	[illegible]	-
Credit enhancement fee	-	[illegible]	-
Lender risk account	-	-	[illegible]
Supplemental insurance	-	-	[illegible]
Clean-up fund	-	-	[illegible]
Available for member subsidy	-	[illegible]	[illegible]
Excess servicing	[illegible]	[illegible]	[illegible]
Investment coupon	6.75%	6.75%	6.75%

Mortgage Partnership Program/Mortgage Partnership Finance
Credit Exposure Comparsion



Notes:

For MPF - Initial FHLB exposure is 4.5 x 5.0 bp. Member exposure is estimated credit support.

For MPP - Member exposure is the total value of lender risk account. [redacted] exposure is estimated minimum protection. Maximum [redacted] exposure is estimated to be 11.75%.