Federal Housing Finance Agency
1700 G Street, N.W., Washington, D.C. 20552
Phone: 202-414-3800
Fax: 202-414-3823

July 30, 2009

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington D.C. 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington D.C. 20510

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington D.C. 20515

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington D.C. 20515

Dear Chairmen and Ranking Members:

Enclosed please find the report that responds to Section 1215 of the Housing and Economic Recovery Act of 2008 (HERA).

As required, the Federal Housing Finance Agency conducted a study on securitization of home mortgage loans purchased, or to be purchased, by the Federal Home Loan Banks from member financial institutions under their Acquired Member Assets programs. The report details the results of the study and includes policy recommendations based on the Federal Housing Finance Agency's analysis of the feasibility of the Federal Home Loan Banks' issuing mortgage-backed securities and of the benefits and risks associated with such a program.

Should you have any questions about the enclosed report, please feel free to contact me at (202) 414-3801.

Sincerely,

James B. Lockhart III

James B. Lockhart III
Director

Federal Housing Finance Agency

Securitization of Mortgage Loans by the Federal Home Loan Bank System

A Report Submitted to

the Committee on Banking, Housing and Urban Affairs of the U.S. Senate

the Committee on Financial Services of the U.S. House of Representatives

Pursuant to Section 1215 of the Housing and Economic Recovery Act of 2008

July 30, 2009

Report on FHLBank Securitization
Table of Contents

Acronyms

CMO .... Collateralized Mortgage Obligation
HERA...Housing and Economic Recovery Act of 2008
FASB.. Financial Accounting Standards Board
FHFA ....Federal Housing Finance Agency
FHFB ....Federal Housing Finance Board
FHLBank...Federal Home Loan Bank
FHLBank Act... Federal Home Loan Bank Act
GSE...Government-Sponsored Enterprise
MBS ....Mortgage-Backed Securities
MPF...Mortgage Partnership Finance
MPP .... Mortgage Purchase Program
TBA .... To-Be-Announced

Report on FHLBank Securitization
Summary

Congress, in the Housing and Economic Recovery Act of 2008[1] (HERA), directed the Federal Housing Finance Agency (FHFA) to conduct a study on securitization of home mortgage loans purchased, or to be purchased, by the Federal Home Loan Banks (FHLBanks, collectively the FHLBank System) from member financial institutions under their Acquired Member Assets programs. Acquired Member Assets is the name given to the mortgage loans the FHLBanks purchase from their members. As directed by Congress this study focuses on five key elements:

1. The benefits and risks associated with FHLBank securitization;

2. The potential effect of securitization upon liquidity in the mortgage and broader credit markets;

3. The ability of the FHLBanks to manage the risks associated with such a program;

4. The effect of such a program on the existing activities of the FHLBanks, including their mortgage portfolios and advances; and,

5. The effect of such a program on joint and several liability of the FHLBanks and the cooperative structure of the FHLBank System.

In conducting the study, the FHFA consulted with the FHLBanks, the FHLBanks' fiscal agent (the Office of Finance), representatives of the mortgage lending industry, practitioners in the structured finance field, and other experts.

HERA was signed into law on July 30, 2008. In the second half of 2008, conditions in the housing and mortgage markets continued to worsen. Signs began to emerge that investors were growing concerned about the ability of Federal National Mortgage Association (Fannie Mae)[2] and Federal Home Loan Mortgage Corporation (Freddie Mac)[3] to continue to roll over their debt to finance their operations. On September 6, 2008, the Director of the FHFA, in consultation with the U.S. Department of Treasury, the Federal Reserve Board, and the Office of the Comptroller of the Currency, concluded that both firms were operating in an unsafe and unsound condition and placed them into conservatorship. At the same time, the Treasury committed to making capital and liquidity support available to Fannie Mae and Freddie Mac, as provided under HERA.

---

[1] Pub. L. No. 110-289, 122 Stat. 2654 (2008).

[2] Fannie Mae was established as a federal agency in 1938, and was chartered by Congress in 1968 as a private company.

[3] Freddie Mac was created in 1970 as part of the Emergency Home Finance Act (Pub. L. No. 91-351, 84 Stat. 450 (1970)). Its original purpose was to provide a secondary market for loans originated by savings and loan associations. The FHLBanks originally capitalized Freddie Mac with a $100 million contribution. Freddie Mac functioned as a cooperative owned by the FHLBank System, providing capital, liquidity, and services to its members. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub. L. No. 101-73, 103 Stat. 183 (1999)) transformed Freddie Mac from a federal instrumentality owned by the FHLBank System to one owned by public shareholders.

Summary

Considerable uncertainty surrounds the future of mortgage securitization in the United States, including the role of Fannie Mae and Freddie Mac, the role for the government, the types of products the industry will offer, the supply and demand for those mortgage-backed securities (MBS), and the nature of future regulation.[4] These unknowns make it difficult to assess the merits of allowing the FHLBanks to securitize mortgages. Despite these uncertainties, the FHFA has drawn general conclusions with respect to mortgage securitization and the FHLBanks.

The key conclusions of this study concerning a potential FHLBank securitization program are as follows:

Benefits of FHLBank securitization

- Securitization would enable the FHLBanks to purchase a larger volume of conforming mortgages from members than they otherwise would. This could increase the availability of mortgage credit from members that participate in the program.

- Securitization would enable the FHLBanks to securitize and sell existing mortgages held in Acquired Member Asset programs. This would allow those FHLBanks that choose to securitize their holdings of Acquired Member Assets to eliminate the market risk associated with holding those assets as well as the need to hold capital for market risk associated with those assets.

- An FHLBank securitization program could increase competition for the Enterprises and result in modestly lower mortgage rates for borrowers. In addition, such a program could reduce market dependence on Fannie Mae and Freddie Mac, thereby potentially reducing systemic risk. Today, Fannie Mae and Freddie Mac account for virtually all the securitization of conventional, conforming mortgages.

Risks of FHLBank securitization

- Starting a securitization program would entail both business and financial risk. The FHLBanks have little or no direct experience in managing a securitization program and would be faced with significant start-up costs. The FHLBanks would compete in a market dominated by Fannie Mae and Freddie Mac. There can be no assurance that the FHLBanks would be able to compete in this market on a profitable basis.

- The FHLBanks would be exposed to a range of risks including market risk, credit risk, operational risk, and reputation risk.

[4] See, for example, the Administration's proposals for financial regulatory reform in, Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009.

- The market risk associated with mortgages held in the "pipeline" in anticipation of securitization is a significant risk associated with the securitization business. Pipeline risk could increase the volatility of FHLBanks earnings.

- The risks associated with providing a guarantee of principal and interest on any securitized product would be significant. The FHLBanks would need to calculate and charge an appropriate fee for providing a guarantee. This fee would need to cover all the anticipated costs associated with providing such a guarantee.

- The operational risk associated with operating a securitization program would be new to the FHLBanks and may be substantial in the start-up phase of the program. For example, the FHLBanks would need to process large flows of data and funds, and meet more stringent financial reporting requirements than required for the Acquired Member Asset program.

Ability of the Banks to manage the risks associated with such a program

- The business of securitization is substantially different from the current business of the FHLBanks. Consequently, the FHLBanks would have to acquire the staff and technology needed to implement the program and manage effectively the risks associated with this business.

Effect of such a program on the existing activities of the Banks, including their mortgage portfolios and advances

- The impact of a securitization program on the existing activities of the FHLBanks would depend on the success of the program. A profitable program would strengthen the FHLBanks and enable them to better serve their members, while an unprofitable program could have an adverse effect on existing programs and services.

- The challenges involved in starting a securitization business may divert managerial attention from the existing mission-related activities of the FHLBank.

- With respect to the FHLBanks' advance business, a profitable securitization program would enable the FHLBanks to build retained earnings or pass any economic profits generated from that business to the members in the form of lower advance prices or higher dividends, while an unprofitable program would have the opposite effect.

- With respect to the FHLBanks' mortgage portfolios, securitization could enable those FHLBanks that might want to sell their mortgage portfolios to do so.

However, the FHLBanks may need to renegotiate certain agreements to sell their existing mortgage portfolios.

Effect on joint and several liability of the Banks and the cooperative structure of the FHLBank System

- Establishing a securitization program may require the FHLBanks to provide an FHLBank System guarantee, rather than an individual FHLBank guarantee. A System guarantee would increase the joint and several liability exposure of each FHLBank.

- If members perceive the FHLBank System to have greater risk with a securitization program, they might require a higher return on their investment in FHLBank capital stock or, alternatively, they might choose to forego membership in the FHLBank System.

- Investors may demand a higher return on their investments in FHLBank debt if they are concerned about the ability of the FHLBanks to operate a securitization program. If the cost of FHLBank debt increases, the attractiveness to members of advances and other FHLBank products would decrease, and earnings and affordable housing program contributions would be lower.

Current Market Conditions

- The current business and economic environment may not be conducive to launching a securitization business. Investor demand for securitized product has fallen dramatically and it is uncertain when demand will strengthen.

- The feasibility of an FHLBank securitization program would also depend on developing a liquid market for the FHLBanks' securitized product. Some commenters believe that to be successful the program would have to generate sufficient liquidity to support a forward market in FHLBank securities. Absent a forward market, the FHLBanks may find it difficult to compete effectively in purchasing and securitizing conforming mortgages.

- Recent accounting rule changes, which take effect in January 2010, pose new challenges that could reduce the attractiveness of securitization. These changes would require participants in mortgage securitization markets to keep most securitized mortgages on their balance sheets, which reduces the benefits of securitization. In addition, these changes could affect the members' willingness to sell mortgages to the FHLBanks under the Acquired Member Assets program.

Regulatory Reform

- On June 17, 2009, President Obama announced the Administration's plan to overhaul the financial regulatory system. Among other things, the plan, *A New Foundation: Rebuilding Financial Supervision and Regulation,* calls on the Treasury and the Department of Housing and Urban Development, in conjunction with other government agencies, to develop recommendations on the future of Fannie Mae, Freddie Mac, and the FHLBank System.

Policy Recommendations of the Director

Based on FHFA's study and findings regarding FHLBank securitization, and the recent calls for regulatory reform, I do not recommend permitting the FHLBanks to securitize mortgages at this time. Rather, the FHLBanks may continue to use programs such as MPF Xtra to serve as a conduit for mortgage purchases from their members to a third party that can securitize those mortgages. The potential for FHLBank securitization of mortgages should be considered after the Treasury Department and the Department of Housing and Urban Development, working with FHFA, develop recommendations on the future of Fannie Mae, Freddie Mac, and the FHLBank System, and in light of financial market conditions at that time.

Purpose of Report

Section 1215 of HERA requires the Director of the FHFA to conduct a study on securitization of home mortgage loans purchased, or to be purchased, from FHLBank member financial institutions under the Acquired Member Assets programs.

HERA requires that the study address the benefits and risks associated with securitization of Acquired Member Assets; the potential effect of securitization upon liquidity in the mortgage and broader credit markets; the ability of the FHLBanks to manage the risks associated with such a program; the effect of such a program on the existing activities of the FHLBanks, including their mortgage portfolios and advances; and the effects of securitization on the joint and several liability of the FHLBanks and the cooperative structure of the FHLBank System.

HERA further requires that in conducting the study, the Director consult with the FHLBanks, the Office of Finance, representatives of the mortgage lending industry, practitioners in the field of structured finance, and other experts as needed.

Acquired Member Assets is the name given to conforming mortgage loans that the FHLBanks purchase from their members pursuant to part 955 of current regulations.[5] The transactions through which the FHLBanks purchase Acquired Member Assets must meet a number of conditions set forth in the regulations.

As a general matter, the FHLBanks can acquire whole mortgages or interests in whole mortgages only if the purchase qualifies as Acquired Member Assets or if the FHLBank purchases investment grade MBS. An FHLBank's investment in MBS is subject to an overall investment limit based on the FHLBank's capital.

HERA requires the FHFA to submit a report to Congress by July 30, 2009, detailing the results of the study. The report must include policy recommendations based on the Director's analysis of the feasibility of the FHLBanks, either individually or collectively, issuing MBS.

This report and the data collection and analyses described in it satisfy the requirements in Section 1215 of HERA.

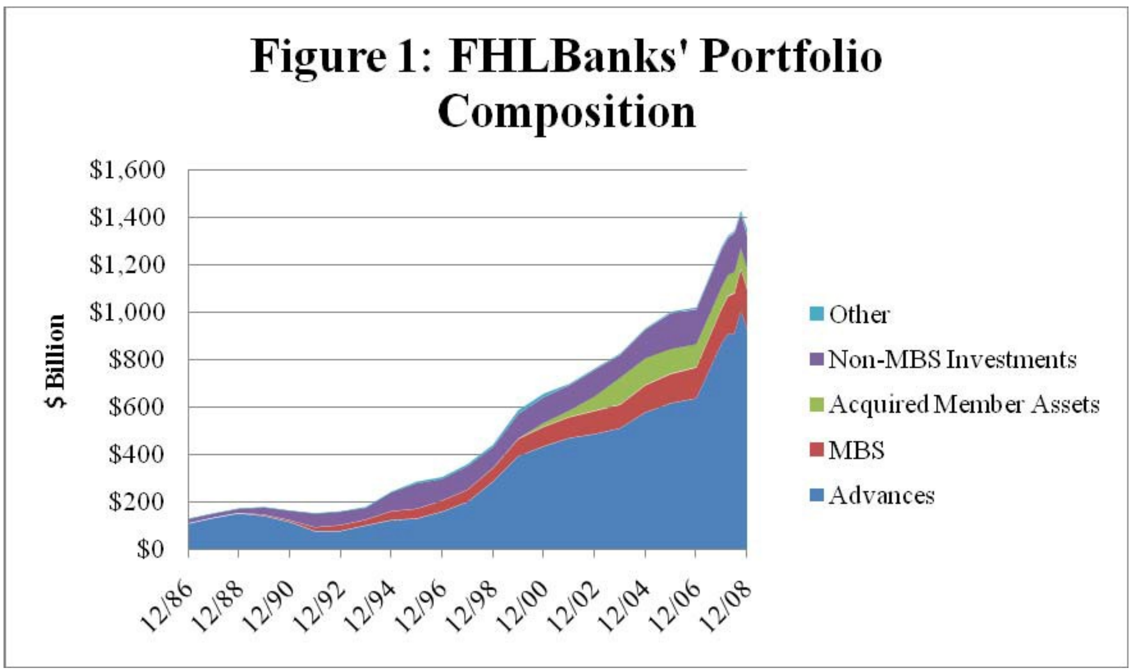
[5] 12 CFR part 955.

The FHLBank System

The twelve FHLBanks are instrumentalities of the United States organized under the Federal Home Loan Bank Act (FHLBank Act).[6] The FHLBanks are cooperatives. Only members of an FHLBank may own the capital stock of an FHLBank, and only members or certain eligible housing associates (such as state housing finance agencies) may obtain access to the products offered by an FHLBank. The FHLBanks serve the public by enhancing the availability of residential mortgage and community lending through their member institutions. Any eligible institution (typically, thrifts, federally insured depository institutions, or state-regulated insurance companies) may become a member of an FHLBank.

As government-sponsored enterprises (GSEs), the FHLBanks are able to borrow in the capital markets on terms more favorable than those at which most other entities can borrow. Typically, the FHLBank System can borrow funds at a modest spread over the rates on U.S. Treasury securities of comparable maturity.[7] The FHLBanks pass along their funding advantage to their members – and ultimately to consumers – by providing advances[8] and other financial services at attractive rates that would not otherwise be available to members.

Some of the FHLBanks have Acquired Member Assets programs whereby they acquire fixed-rate, single-family conforming mortgage loans from members. Even so, advances constitute, by far, the largest business segment for the FHLBanks. See Figure 1.



[6] 12 U.S.C. 1421 *et. seq.*
[7] This spread increased significantly in 2008, but has decreased substantially in 2009.
[8] Advances are secured loans provided to FHLBank members. Advances may have fixed or floating interest rates, may be for various maturities, and are secured through collateral pledged by the borrowing member.

As of December 31, 2008, the FHLBanks held $87 billion in Acquired Member Asset mortgage loans, about 7 percent of the System's total assets.[9] Holdings of Acquired Member Assets peaked at $116 billion, about 13 percent of the System's total assets, in 2004.

Consolidated obligations, consisting of bonds and discount notes, are the principal source of funding for the FHLBanks. The Office of Finance issues all consolidated obligations on behalf of the FHLBanks. Although each FHLBank is primarily liable for its borrowings, the FHLBanks are jointly and severally liable for all consolidated obligations should the borrowing FHLBank fail to meet its obligations.

Public Notice and Request for Comments on the Study

On February 27, 2009, the FHFA published a notice in the Federal Register requesting comment on the securitization study.[10] The notice provided background information on the FHLBank System and Acquired Member Asset programs and requested comment on a number of issues concerning securitization. A copy of the Federal Register Notice is attached as Appendix A.

The public had 60 days to submit comments, although the FHFA continued to accept comments after the close of the comment period on April 28, 2009. The FHFA received ten comments in response to its notice. Comments were submitted by FHLBanks, associations representing FHLBank members, mortgage insurers, home builders and mortgage bankers, and other parties. A list of those providing comments is included in Appendix B.[11]

FHFA staff consulted with the FHLBanks, the Office of Finance, and experts in mortgage finance and securitization**.** These consultations focused on the risks and benefits of FHLBank securitization, the financial viability of a program, and the potential effects of securitization on the FHLBanks' current activities and the mortgage markets more generally.

[9] Advances as of December 31, 2008, equaled just under $929 billion or about 69 percent of the System's assets.
[10] 74 FED. REG. 8955 (Feb. 27, 2009).
[11] Copies of the comment letters are available at www.fhfa.gov.

Under their Acquired Member Asset programs, the FHLBanks acquire single-family mortgage loans from their members. The members retain credit risk from these loans by providing credit enhancements on the loans sold to the FHLBanks.[12] In turn, the FHLBanks pay the members a fee for providing the credit enhancements.

The FHLBanks hold these mortgages in portfolio, although some FHLBanks have sold mortgages purchased to another FHLBank. The FHLBanks manage the interest rate,[13] prepayment[14] and liquidity[15] risks associated with the Acquired Member Assets.[16] The FHLBanks are also exposed to any credit[17] risk that exceeds the amount of the credit enhancement provided by the members, and to the risk that the members themselves may default on their credit enhancement or servicing obligations.

The two approved Acquired Member Asset programs are the Mortgage Partnership Finance program, known as "MPF," and the Mortgage Purchase Program, commonly referred to as "MPP."

While all the FHLBanks have purchased Acquired Member Assets in the past, only the FHLBanks of Boston, New York, Pittsburgh, Cincinnati, Indianapolis, Des Moines, and Topeka continue to purchase Acquired Member Assets.[18] The volume of loans acquired has fallen considerably since the peak in 2003. For example, the FHLBanks purchased just over 50,000 loans in 2008, down from a peak of approximately 606,000 in 2003.

Of the FHLBanks with active programs, the FHLBanks of Boston, New York, Pittsburgh, Des Moines, and Topeka offer the MPF program. The FHLBank of Chicago administers the program and provides back office functions for the other FHLBanks in the MPF program in return for a fee. It continues to provide these functions even though it suspended entering into new commitments to purchase conventional mortgage loans in August 2008. The FHLBanks of

---

[12] Credit enhancement is an instrument or agreement with the potential to provide investors with full or partial protection in the event of borrower default. Credit enhancement can take a variety of forms, including insurance, guarantees, cash or additional collateral. For example, a member may provide credit enhancement for a loan made to a borrower by obtaining an insurance contract sufficient to ensure that the contractually required payments continue to flow to the purchaser of the mortgage even if the borrower does not make one or more payments. This arrangement increased the credit quality of the combined loan and insurance policy to the purchaser of the loan.
[13] Interest rate risk refers to the risk that market interest rates will change and affect the market value of the loan.
[14] Prepayment risk refers to the risk that the mortgage loan may be paid back before the scheduled term. Prepayment occurs for a variety of reasons including because the borrower refinances a loan or sells the property to relocate to a new home. Prepayment can also result when a borrower defaults on a loan and the property is sold in foreclosure.
[15] Liquidity risk refers to the risk that the holder of a mortgage loan will not be able to sell it in the market for its true value.
[16] Collectively, these three risks constitute the market risk associated with an investment in a mortgage.
[17] Credit risk refers to the risk that a borrower will fail to make the payments as specified in the mortgage contract. As discussed elsewhere in this report, the FHLBank's exposure to credit risk is mitigated by the credit enhancement provided by the member as part of the sale of the AMA loan.
[18] The FHLBank of Chicago ceased acquiring loans from its members as of August 1, 2008, except for nonmaterial amounts of MPF loans related to previous commitments.

Cincinnati and Indianapolis offer the MPP program. Each MPP Bank administers its own program and is responsible for its own back office functions.

The FHFA also authorized two other mortgage programs, MPF Xtra and Global Mortgage Alliance Program.[19] The FHLBank of Chicago and some of the other MPF Banks offer their members a new product called MPF Xtra, and the FHLBank of Atlanta offers the Global Mortgage Alliance Program. However, the FHLBanks do not acquire loans for their portfolios through these programs. Instead, under the MPF Xtra program they sell these loans immediately to Fannie Mae. Under the Global Mortgage Alliance Program, the FHLBank of Atlanta would sell any loans that it may purchase to a member. Under these mortgage programs, members do not credit enhance loans or receive any credit enhancement fee for these loans. Instead, an FHLBank facilitates loan sales between members and a third party, and performs other services and functions in return for a fee. MPF Xtra and the Global Mortgage Alliance Program are not AMA products although the mortgages are consistent with standards established by the FHLBanks AMA programs.

For a description of the MPF, MPP, and the FHLBanks' other mortgage programs, see Appendix C.

[19] MPF Xtra and the Global Mortgage Alliance Program were authorized pursuant to the incidental authority provided the FHLBanks under the FHLBank Act. These programs are not Acquired Member Asset programs approved under the Part 955 rules. As of July 3, 2009, Fannie Mae had purchased $2.5 billion in loans under the MPF Xtra program. No transactions have occurred under the Global Mortgage Alliance Program.

Considerable uncertainty surrounds the future of mortgage securitization in the United States, including the role of Fannie Mae and Freddie Mac, the role for the government, the types of products the industry will offer, the supply and demand for those mortgage-backed securities, and the nature of future regulation.[20] These uncertainties make it difficult to assess the merits of allowing the FHLBanks to securitize mortgages. As explained below, the FHLBanks would face a number of questions related to how they would structure any MBS issuance, including:[21]

- What type and level of credit enhancements would the FHLBanks have to offer to attract potential investors to FHLBank-issued MBS?
- Would the FHLBanks issue plain vanilla "pass through" securities or more complex structured securities, such as collateralized mortgage obligations or securities with senior/subordinated tranches?
- How would recent changes to accounting rules affect an FHLBank securitization program?
- What would be the most effective way to issue an FHLBank MBS?
- Would the FHLBanks be able to introduce a new product given current market conditions?

Without knowing the answers to these and other questions, it is difficult to draw meaningful conclusions about the viability of any FHLBank securitization program. The difficulty is compounded by the uncertainties surrounding future conditions in housing and mortgage markets and evolving institutional and regulatory changes that are likely to reshape the future of mortgage finance. Nevertheless, the commenters and experts FHFA consulted identified several prerequisites for any successful product. The discussion of these features provides a framework for the subsequent analysis.

Credit Enhancement

Commenters and experts cited the form of the credit enhancement for the securitized product as the most critical design feature. Most commenters agreed that the FHLBanks would have to offer some type of guarantee to attract investors. Many commenters noted that a System guarantee, making all twelve FHLBanks jointly and severally liable for the timely payment of principal and interest would be a prerequisite for product acceptance and that a guarantee by a sub-group of FHLBanks would not be sufficient. Indeed, an FHLBank System guarantee may be a minimum requirement. Federal Reserve Chairman Bernanke stated that the Enterprises'

[20] See, for example, the Administration's proposals for financial regulatory reform in, Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009.
[21] The comment letter from counsel representing the FHLBanks of Cincinnati, Indianapolis, and Boston, with input from the FHLBanks of Atlanta, Chicago, Des Moines, and Topeka, discussed various aspects of a possible structure, but no definitive proposals for the structure of FHLBank MBS have been made to the FHFA at this time. See Comment letter on the Securitization Study from Paul Jorissen and Jeffrey Taft, Mayer Brown LLP (on behalf of the FHLBanks of Cincinnati, Indianapolis, and Boston, with input from the FHLBanks of Atlanta, Chicago, Des Moines, and Topeka), dated April 28, 2009 (hereafter Jorissen/Taft Letter).

"ability to continue to securitize when private firms could not did not appear to result from superior business models or management. Instead, investors remained willing to accept GSE mortgage-backed securities because they continued to believe that the government stood behind them."[22]

Some commenters suggested that, in the current market environment, investors would be unlikely to accept the credit enhancements from insurance providers.

Carrying over the member credit enhancement, as now used for Acquired Member Assets, into the MBS structure would be an attractive feature of an FHLBank program and supportive of a guarantee, but it could also raise issues with investors. If member credit enhancements were part of the structure, some investors may want information about the members so they could judge the adequacy of the underlying member enhancements in support of the guarantee. This would be especially true if investors viewed the member enhancements as financially important to the FHLBanks themselves.

Indeed, investors would likely want assurances that sufficient capital or collateral backed any enhancements or guarantees, whether these enhancements or guarantees were provided by the members, the FHLBanks, or a third party.[23] As a result, the FHLBanks would need to make clear who bears any credit losses associated with the underlying loans.[24] A full and simple guarantee and clear policies for underwriting are likely to be most effective in gaining investor confidence. In addition, the FHLBanks may be called upon to demonstrate that they would enforce any representations and warranties provided by members.

Collectively, the FHLBanks would also have to agree on the nature of any FHLBank System guarantee, if such a guarantee were applied to their MBS. For example, the FHLBanks would need to decide if each FHLBank would be primarily responsible for the losses on mortgages sold by its members into the securitization program, and the other FHLBanks only responsible to the extent that the primary obligor could not meet its obligations. This arrangement would be similar to how the FHLBanks assign liability on consolidated obligations. Alternatively, the FHLBanks could structure a System guarantee that made each FHLBank liable for an equal or some *pro* rata share of the losses.[25]

[22] Speech by Federal Reserve Chairman Ben S. Bernanke at the UC Berkley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California, October 31, 2008, http://federalreserve.gov/newsevents/speech/bernanke20081031a.htm.

[23] One expert pointed out that the FHLBanks' current capital structure may not be conducive to securitization. Specifically, capital, in the form of Class B stock, may be redeemed by members with a five year notice. As one expert noted, this redeemable capital structure may raise questions in the market about the type and amount of FHLBank capital that would actually be standing behind any guarantee.

[24] To the extent that the FHLBanks hold more capital to strengthen investors' perceptions of the FHLBank guarantee, they may reduce the return on FHLBank stock and, thus, decrease the attractiveness of FHLBank membership.

[25] The FHLBanks would also need to determine whether a guarantee on the MBS would be junior to or treated equal with that provided on its debt obligations.

Payment Structure

MBS are structured in a variety of ways to provide investors with different risk characteristics or maturity options. The simplest form of MBS are mortgage pass-through securities whereby all principal and interest payments (excluding a servicing fee) from a pool of mortgages are passed directly to investors each month. Each holder of an MBS pass-through, therefore, owns an undivided, *pro rata* interest in the underlying pool of loans.

Collateralized mortgage obligations (CMO) are a more complex form of MBS. CMO are multi-class securities in which the cash flows from a pool of mortgages are divided among different classes, or tranches, so that each tranche has different risk characteristics. For example, some tranches, known as "support" or "companion bonds," may be first in line to receive pre-payments of principal, thus displaying greater prepayment risk than those tranches that would not receive prepayments until later. CMOs are sometimes created by pooling pass-through MBS and dividing the underlying cash flows received on those securities.[26]

Issuing multi-class securities would present the FHLBanks with additional operational complexity and costs. In this respect, the FHLBanks would need to develop more sophisticated structured-finance operations, either internally or by contracting with third parties capable of identifying the specific risk parameters for the securities that investors would demand in a particular market, and structuring securities to meet their demand. Alternatively, other parties may design multi-class securities using FHLBank pass-through securities.

With respect to how the FHLBanks might structure MBS, many of the experts FHFA consulted viewed pass-through securities as preferable to multi-class securities, at least in the early stages of a securitization program.[27] They believed that the transparency and simplicity of pass-through securities would foster greater acceptance in the market. Nevertheless, they thought that once investors become comfortable with the FHLBank securities and the underlying mortgage collateral, the FHLBanks may find it possible to issue multi-class securities.

Accounting Rules

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued FASB Statements No. 166, *Accounting for Transfers of Financial Assets*, and No. 167, *Amendments to FASB Interpretation No. 46 (R)*, *Consolidation of Variable Interest Entities*, both of which amend the way entities account for securitizations and qualifying special-purpose entities.

---

[26] A more complete discussion of how MBS can be structured is found in Section III.D of the Notice. 74 FED. REG. at 8957.

[27] One expert suggested that a structured security would have a better chance to succeed than an FHLBank pass-through security that competes directly with the Enterprises.

The elimination of qualifying special-purpose entities might have an adverse effect on the benefits of securitization.[28] Before the amendments, qualifying special-purpose entities received off-balance-sheet accounting treatment, which allowed insured depository institutions that issued securities to hold a lower amount of capital against the assets held in the qualifying special-purpose entities. If the FHLBanks were to report securitized loans on their balance sheets and hold the same capital against them as they do now for mortgage loans that have not been securitized, the benefits of securitization would not be realized. However, the FHFA has stated that accounting rule changes should not drive decisions on capital.

In addition, the amendments to FASB 140 change the sales accounting treatment for the loans underlying an MBS. Depending on the level of credit enhancement provided by a member, a question could arise as to whether the member has made a “true sale” to an FHLBank. This could affect members’ willingness to provide credit enhancements to the mortgages that they sell to the FHLBanks, as is now required under the Acquired Member Asset regulations.

If these new accounting rules were to motivate FHLBanks and mortgage sellers to change the credit enhancement requirements of the Acquired Member Assets program, they would also alter the underlying economics of any securitization program and the associated risk analysis. For example, if there were no member credit enhancement, it would substantially increase the credit risk to which the FHLBanks were exposed, particularly if they provided a guarantee on the MBS. In addition, the fact that members would have little or no “skin in the game” because they no longer provide a credit enhancement may alter the credit quality of the loans that members would sell to the FHLBanks.

<u>Issuance of FHLBank Securities</u>

Although the FHLBanks have stated that their existing Acquired Member Asset systems were designed to facilitate expansion into securitization, they would face substantial start-up costs were they to begin securitizing loans. Some of the costs will include the purchase or upgrade of computer systems and software, the hiring of securities and marketing personnel, and engagement of attorneys and accountants to address disclosure and other regulatory requirements related to issuing MBS.

Most commenters believe that the FHLBanks would best accomplish securitization by centralizing certain securitization functions within the Office of Finance or a new entity. A centralized operation would allow the FHLBanks to exploit economies of scale.

Centralization would also facilitate the issuance of securities in the name of the FHLBank System, which would promote greater acceptance by investors, help create a more liquid market for the FHLBank MBS, and could facilitate System-wide (rather than individual FHLBank) support for the credit quality of the securities. In contrast, if each FHLBank issued its own MBS,

---

[28] These changes may also require significant investments in upgraded technology. For example, the costs of systems upgrades for Freddie Mac and Fannie Mae to implement the new accounting standards are expected to be substantial.

the market could become fragmented with investors viewing each FHLBank's MBS as constituting a separate market. The FHLBanks' willingness and ability to support the market for their MBS would also influence the demand for FHLBank securities. A central office could be useful in providing such support, rather than attempting to have the twelve FHLBanks coordinate their separate market support efforts. However, given the uncertainties about the future of the Enterprises, the conditions of primary and secondary mortgage markets, and the structure of any FHLBank securitization program, it may be possible for an FHLBank or a group of FHLBanks to successfully engage in such a program. For example, the MPF and MPP programs were established by subsets of the FHLBanks rather than all of the FHLBanks.

The FHLBanks may also be able to partner with other institutions that could help them to create and issue MBS. The MPF Shared Funding program is one example of how the FHLBanks may be able to develop a securitization program along these lines. Under Shared Funding, the FHLBank of Chicago, working with one of its members, created a senior security that was eligible for purchase as an Acquired Member Asset.

To accomplish this, the FHLBank of Chicago member bought mortgage loans from FHLBank member institutions[29] and structured the underlying pool of loans into senior securities that were supported by junior credit support tranches.[30] The FHLBank of Chicago acquired the senior securities and the member held the junior credit support tranches, thereby fulfilling the member credit enhancement responsibilities under the Acquired Member Asset rule.[31] However, the MPF Shared Funding program never developed into a full-scale securitization program. In the end, there only were two issuances under this program for a combined total of approximately $1 billion in securities. Nevertheless, Shared Funding provides an example of how the FHLBanks could work with members or other institutions rather than using the Office of Finance or creating a new centralized office to issue MBS. However, the small size of the Shared Funding program and the restricted marketing of the securities limit the ability to draw conclusions as to whether this approach would be viable.[32]

The MPF Xtra and Global Mortgage Alliance Programs are also examples of FHLBank partnerships designed to lead to securitization of mortgages. The Shared Funding and the Global Mortgage Alliance Program are not currently active. However, the MPF Xtra program has been actively used since it was approved in September 2008. As of July 3, 2009, members of four

[29] The member institutions that sold the underlying mortgage loans were members of the FHLBanks of Chicago, Pittsburgh and Des Moines.
[30] These junior tranches provided the sole credit enhancement for the senior securities.
[31] In seeking the FHFB approval for Shared Funding, the FHLBank of Chicago represented that the senior securities could be re-sold only to other FHLBanks or FHLBank members, and the program was approved under the condition that this limit on re-sales of the senior securities would be maintained. The FHLBank also represented that any sale would be accompanied by disclosure that equaled or exceeded standards for MBS that re-registered under the Securities Act of 1933, although the securities themselves were sold pursuant to an exemption from registration.
[32] In fact, under this approach, the FHLBanks' continued issuance of MBS would depend upon any partner institution's willingness to continue with the program. In the case of Shared Funding, one reason that the program ceased was that the member with which the FHLBank of Chicago originally partnered was merged into another institution that was not located in the FHLBank of Chicago's district and was not interested in continuing to take part in Shared Funding.

FHLBanks (Boston, Chicago, Des Moines, and Pittsburgh) had sold $2.5 billion in mortgages into the MPF Xtra program.[33] The FHLBank of Chicago facilitates these transactions and passes the mortgages from eligible FHLBank members to Fannie Mae.

Market Conditions

Over the past two years, mortgage markets have suffered severe disruption and stress. Markets for MBS were particularly disrupted. Higher than expected losses and defaults on underlying mortgages caused outsized losses on private-label MBS. Private sector demand for all types of MBS plummeted and the market for private-label MBS ceased to function. Markets were further shaken when the FHFA placed Fannie Mae and Freddie Mac under conservatorship in September 2008. Also at this time, the Treasury and the Federal Reserve both began supporting the mortgage markets in various ways including making large purchases of agency MBS.

These unprecedented events caused some commenters to question whether the FHLBanks should introduce a securitization program. The commenters identified a number of market-related issues that could affect the success or failure of any FHLBank securitization program at this time. One key issue was the potential demand for mortgage securities issued by the FHLBanks. Another key issue was the future of Fannie Mae and Freddie Mac, and in particular, whether and how they would emerge from conservatorship.

Indeed, with respect to the latter issue, President Obama's financial reform plan, *Financial Regulatory Reform*, *A New Foundation*, *Rebuilding Financial Supervision and Regulation*, released on June 17, calls on the Treasury and Department of Housing and Urban Development, together with other government agencies, to explore options regarding the future of the GSEs. As stated in the President's plan:

> There are a number of options for the reform of the GSEs, including: (i) returning them to their previous status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals; (ii) gradual wind-down of their operations and liquidation of their assets; (iii) incorporating the GSEs' functions into a federal agency; (iv) a public utility model where the government regulates the GSEs' profit margin, sets guarantee fees, and provides explicit backing for GSE commitments; (v) a conversion to providing insurance for covered bonds; (vi) and the dissolution of Fannie Mae and Freddie Mac into many smaller companies.[34]

[33] The FHLBank of Topeka is also approved to participate in MPF Xtra.
[34] Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009, p. 42.

This section discusses the analysis of core issues regarding FHLBank securitization. First, it summarizes the key assumptions for the analysis. It then uses these assumptions to: analyze the financial and economic feasibility of the FHLBanks securitizing mortgage loans, discuss the risks and benefits of a securitization program, describe the likely effects of FHLBank securitization on housing finance and broader credit markets, analyze the effect of securitization on other FHLBank programs, and discuss how such a program may affect joint and several liability and the cooperative nature of the FHLBank System.

Key Assumptions Underlying the Analysis

The uncertainties discussed above make it difficult to analyze the ability of the FHLBanks to compete in the mortgage securitization business. To complete the analysis, FHFA, therefore, had to make a number of assumptions about how FHLBanks might structure a securitization program. Key assumptions were:

- An FHLBank System guarantee would back FHLBank mortgage securities;
- FHLBanks would issue pass-through securities, retaining certain beneficial interests;
- Recent amendments to the accounting rules, which will change the way entities will account for securitizations, special purpose entities, and transfers of assets, would not eliminate the economic incentives for engaging in securitization;
- Members would continue to provide a credit enhancement as required under the current Acquired Member Asset rules;[35]
- The FHLBanks would issue securities through a single office, either the Office of Finance or a new joint office;
- Market conditions for mortgage securities would improve substantially and structural uncertainties regarding regulation and the structure of the GSEs are resolved; and,
- Securitization is a permissible activity under the FHLBank Act.[36]

Financial and Economic Feasibility

The financial and economic feasibility of FHLBank securitization depends on the basic competitive forces in the industry. For this study, the primary competitive force at issue is the ease or difficulty with which the FHLBanks can enter the market (i.e., barriers to entry).[37]

---

[35] HERA required FHFA to consider securitization under the FHLBanks' Acquired Member Assets program. This assumption affects some of FHFA's conclusions in this study. However, as a general matter, the FHLBanks could design a program with different requirements for mortgage purchases.

[36] In preparing this study, FHFA fulfilled the Congressional requirements of the study. The study itself makes no finding or conclusion as to whether securitization, or any related guarantee of FHLBank MBS, would be permissible under the current law.

[37] See Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: The Free Press, 1980), p. 6 (hereafter, Porter). Porter identifies five forces that determine the state of competition in any industry: (1) the ease or difficulty with which potential competitors can enter the market, (2) the availability of

The barriers to entry faced by the FHLBanks would play a key role in the outcome of any FHLBank securitization program. The economies of scale built by Fannie Mae and Freddie Mac in the areas of marketing, distribution, information technology, underwriting, service, and funding pose a barrier to entry.[38] Since the FHLBanks would enter at a much lower scale than Fannie Mae and Freddie Mac, they could have a significant cost and pricing disadvantage in the market. If the FHLBanks purchase the same types of mortgages as the Enterprises and issue the same types of securities, they would have difficulty obtaining a significant volume of business without offering competitive pricing. At the same time, commenters suggested that the FHLBanks may have difficulty offering competitive pricing until they obtain significant volume.[39]

A second barrier to entry arises from the Enterprises "brand" recognition. Fannie Mae and Freddie Mac securities are well known in the market, whereas the FHLBanks would be new to this market sector. Lack of brand recognition would force the FHLBanks to spend heavily on marketing their securities. This may be less of an issue if a securitized product were marketed primarily to members. Most mortgage originators are already System members.

Finally, the startup costs of a securitization program are a barrier to entry. Depending on the size of the securitization program, the FHLBanks may not need to match the Enterprises' personnel and systems infrastructure. Nevertheless, even for a significantly smaller program the required resource expenditure in personnel and business systems would be substantial.[40]

The feasibility of any FHLBank securitization program would also depend on the System's ability to create a liquid market for its mortgage securities.[41] This could prove to be a significant challenge. A liquid market is needed to attract investors. A liquid market is also needed to facilitate the "mortgage pipeline activities" of members who would supply the mortgages and the FHLBanks. Members would need to hedge the market risk on their mortgages during the period between the time members commit to sell the mortgages to the FHLBanks and the time the FHLBanks determine the price. Similarly, the FHLBanks would benefit from a liquid market to hedge the mortgages they acquire for securitization.

---

substitute products, (3) the bargaining power of buyers, (4) the bargaining power of suppliers, and (5) the intensity of rivalry among existing competitors.

[38] Economies of scale refer to declines in the costs of a product or service as the absolute volume per period increases. See Porter, p. 7.

[39] The Enterprises' current size may not reflect only economies of scale. Rather, their size may also reflect their unique position as GSEs in the securitization market.

[40] This investment would include information technology infrastructure and hiring and retaining staff that perform many of the same functions as the staff at the Enterprises. These functions include financial analysis, trading, policymaking, operational and organizational management, legal and disclosure analysis, customer management, servicer management, liquidity management, marketing (both domestic and international), and other functions.

[41] Liquidity will affect the price at which investors will purchase FHLBank MBS. The less liquid the market, the worse price the FHLBanks will receive for their securities because investors will want to pay less for the securities to compensate for the expected difficulties in trying to resell securities in a less liquid market. The price at which the FHLBanks sell their securities in turn affects the price at which the FHLBanks can buy the underlying mortgages and still turn a profit.

Whether the FHLBanks could develop a liquid market for their securities would depend on factors such as the type or types of mortgages the FHLBanks securitize, the ability of the FHLBanks to acquire a steady flow of mortgages from their members, and the ability of the FHLBanks to create sufficient investor demand for their securities. At present, FHLBank purchases of mortgages under the Acquired Member Asset program are limited to conforming, fixed-rate mortgages. Limiting the FHLBanks' securitization program to this segment of the market would put the FHLBanks in direct competition with Fannie Mae and Freddie Mac. This competition could make it more difficult for the FHLBanks to develop a liquid market for their securities.

The FHLBanks may enjoy advantages in other areas in part because of the cooperative nature of the FHLBank System and the FHLBanks' mission of member service. Indeed, the FHLBanks could treat securitization as a service for members and seek to cover their costs without making a profit. In this case, the relevant question is whether the FHLBanks could pay a price for mortgages that would make the program profitable for their members. On the other hand, even within the cooperative structure of the FHLBank System, some members, especially those that do not actively sell mortgages to the FHLBank, may object to their capital investment in the FHLBanks being exposed to potential losses from securitization programs if these programs do not generate sufficient profit to provide an adequate return for assuming these risks.

In discussing the future of mortgage finance in the United States, Federal Reserve Chairman Bernanke recently identified three principles for successful mortgage securitization.[42] First, investors must be convinced that the credit quality of the underlying mortgages is high and that the originators have incentives to engage in careful underwriting practices. Second, because the mortgages underlying MBS carry interest rate, prepayment, and credit risk, the investors holding MBS must have the ability to manage those risks. Such investors are likely to be large, sophisticated firms. Third, because of the complexity of pricing MBS, the underlying assets and the structure of the MBS must be transparent.

With respect to the first principle, the credit quality of the loans the FHLBanks have acquired under the Acquired Member Asset program has been relatively high. As of December 31, 2008, only 1.10 percent of the Acquired Member Asset mortgages were seriously delinquent.[43] By comparison, at the national level, 2.25 percent of all prime fixed-rate mortgages were seriously delinquent as of that date.[44] The serious delinquency rates for Fannie Mae and Freddie Mac were 2.42 percent and 1.72 percent, respectively.[45] In practice, investors may be more likely to

[42] Speech by Federal Reserve Chairman Ben S. Bernanke at the UC Berkley/UCLA Symposium: *The Mortgage Meltdown, the Economy, and Public Policy*, Berkeley, California, October 31, 2008, http://federalreserve.gov/newsevents/speech/bernanke20081031a.htm.

[43] Seriously delinquent is defined as 90 days or more delinquent or foreclosed.

[44] Data are from the Mortgage Bankers Association National Delinquency Survey.

[45] There are three primary reasons for the superior performance of the AMA portfolio. First, the FHLBanks only hold fixed rate loans, and these types of loans have experienced far fewer losses than adjustable rate mortgages. Second, the FHLBanks have adopted and maintained underwriting standards that are more stringent than those at the Enterprises. These underwriting standards may need to be relaxed if the FHLBanks significantly increase the scale

focus on the perceived strength of the guarantee on FHLBank securities rather than on the underlying mortgages.

Chairman Bernanke's second principle for an effective mortgage securitization program relates to the ability of investors to manage the interest rate, prepayment, and credit risk associated with mortgage securities. A liquid market in FHLBank securities would assist these investors in managing risk. To attract sufficient new originations to develop a liquid market, the FHLBanks would need to offer mortgage originators prices on their loans that are comparable to or better than those paid by the Enterprises. It is estimated, however, that the liquidity of the to-be-announced (TBA) market[46] allows Freddie Mac to pay prices that are 25 basis points lower than they would pay without the TBA market.[47] The market for Freddie Mac securities is less liquid than that for Fannie Mae's securities, and an FHLBank fixed-rate conforming MBS would initially be substantially less liquid than Freddie Mac's MBS, suggesting an even bigger price gap with Fannie Mae.[48] This price gap could be reduced by other factors, such as the structure of the FHLBank MBS.[49]

For an FHLBank to achieve the most efficient pricing for a securitized product, it would be desirable, and perhaps even necessary, to create a TBA market for that product. Such a TBA market would be helpful for hedging pipeline risk.[50] However, to establish a TBA market would require the FHLBanks to purchase and securitize a significant volume of mortgages, though not necessarily as many as Fannie Mae or Freddie Mac. Opinions on the minimum scale required vary widely, ranging from \$10 billion to \$100 billion per year.[51] If the market were smaller than

---

of their purchases. Finally, the loans in the AMA portfolio are seasoned, with the majority of the loans purchased in 2002 and 2003. Since home prices were generally rising through 2005, fewer of these loans are likely to have an unpaid balance that exceeds the value of the property.

[46] TBA refers to a forward market in MBS. Pass-through securities issued by Fannie Mae and Freddie Mac trade in the TBA market. In this market, the actual MBS that will be delivered to fulfill a TBA trade are not designated at the time the trade is made. Rather, the securities are "to be announced" 48 hours before the specified trade settlement date. See http://www.investopedia.com/terms/t/tba.asp. According to Freddie Mac, "the use of the TBA market increases the liquidity of mortgage investments and improves distribution of investment capital..." See Freddie Mac 10-K, dated March 11, 2009, p. 13.

[47] This estimate was provided during a consultation.

[48] Information provided during a consultation.

[49] Liquidity is one factor affecting the price of a security. However, other factors may also be important. For example, TBA securities must satisfy Securities Industry and Financial Markets Association rules.

[50] Pipeline risk is the interest rate risk borne by the entity accumulating mortgages in its "pipeline" in anticipation of securitizing these mortgages. The FHLBanks could hedge pipeline risk using the Enterprises' TBA markets. Private label issuers used the Enterprises' TBA markets to hedge pipeline risk because they could never develop a TBA type market of their own given the number of issuers and the differences in products and quality of products. However, hedging niche products using the Enterprises TBA markets could be risky. For example, over the last year, pricing in Fannie Mae and Freddie Mac securities remained relatively steady while pricing for private-label MBS often fell dramatically, so that issuers of private-label MBS could not rely on the TBA market to successfully hedge their pipeline risk. This risk is called "basis risk" and would exist for the FHLBanks if they used the Enterprises' TBA markets to hedge either conforming or non-conforming loans. This risk would exist for the FHLBanks simply because FHLBank MBS is not the same as Enterprise MBS. The only way to eliminate this risk would be for the FHLBanks to develop their own TBA market.

[51] The low estimate of \$10 billion was provided by the FHLBank of Chicago. See the comment letter on the Securitization Study from Matthew R. Feldman, President and Chief Executive Officer of the FHLBank of Chicago,

the minimum required scale, investors in FHLBank MBS would demand a higher liquidity premium, which could further lower the pricing an FHLBank could offer to members for their mortgages.

Historically, the Acquired Member Asset program has been small relative to the overall housing market and to the volume of business at the Enterprises. See Table 1 and Figure 2.

Table 1: Purchases by FHLBanks, Fannie Mae, Freddie Mac, and All Single-Family Originations ($billions)

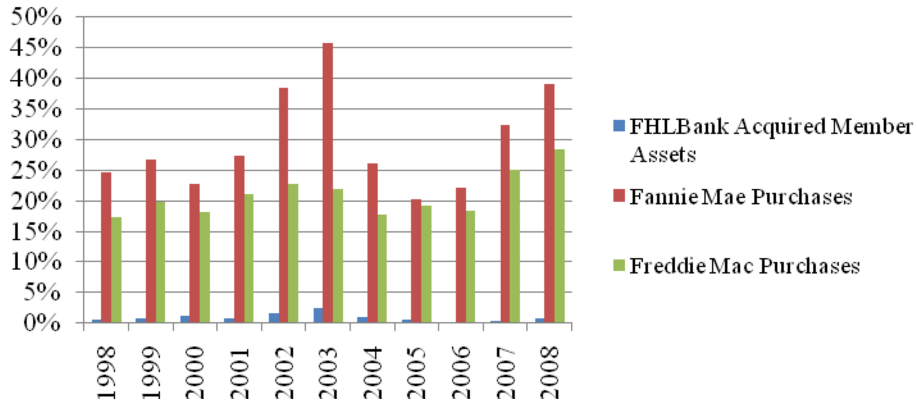
Year	FHLBank Purchases	Fannie Mae Purchases	Freddie Mac Purchases	Single-Family Originations
1998	$9.6	$409.2	$288.3	$1,656
1999	$9.4	$370.1	$272.5	$1,379
2000	$14.5	$259.6	$207.4	$1,139
2001	$19.2	$615.3	$475.1	$2,243
2002	$45.2	$1,096.8	$650.7	$2,854
2003	$91.4	$1,745.8	$834.9	$3,812
2004	$25.6	$725.2	$494.6	$2,773
2005	$14.3	$612.3	$581.9	$3,027
2006	$6.3	$603.0	$502.0	$2,980
2007	$8.3	$746.1	$577.7	$2,430
2008	$12.3	$631.4	$460.0	$1,485

Source: FHLBank data; Fannie Mae 10-Ks, 2003, 2004 and 2009; Freddie Mac Monthly Volume Summaries; Freddie Mac Annual Report, 2001 and 2004; and Mortgage Bankers Association, *Mortgage Originations Estimates*, released March 24, 2009.

Notes: Fannie Mae and Freddie Mac purchases are primarily single-family mortgages, but also include some multi-family mortgages. Purchases for Fannie Mae and Freddie Mac equal the total retained portfolio purchases plus MBS/Participation Certificates issued, less purchases of MBS/Participation Certificates into the retained portfolio. Data prior to 2002 are prior to restatement.

dated April 28, 2009, pp. 6 and 11. The high estimate was provided by an expert in the area of securitization. Another expert estimated the minimum scale to be between $12 billion and $24 billion annually. Generally these estimates appear to be based on an assumption the FHLBanks would be targeting conforming loans for securitization.

Figure 2: Share of Single Family Originations



Given the difference in liquidity and its effect on prices, it is unclear how much volume from large originators an FHLBank securitization program might initially attract. Thus, even if the FHLBanks could translate advantages in credit quality and access to small originators into an increase in price, this advantage would compete with the Enterprises' liquidity advantage in the market for their securities.[52] Indeed, some FHLBanks expressed concern about their ability to compete with the Enterprises.[53]

An economic analysis of an FHLBank securitization program would need to consider several factors.[54] For such a program to be successful, an originator would require a yield that is competitive with that it could obtain from other mortgage purchasers. The yield from a transaction with the Enterprises would depend on the mortgage note rate, servicing cost, guarantee fee, and excess servicing. The guarantee fee is a critical component of this calculation, and it depends on factors such as the mortgage product, its risk class, and the size of the seller. The yield to a seller into a program for securitizing Acquired Member Assets would depend on the mortgage note rate, servicing cost, supplemental mortgage insurance cost, credit enhancement fee, and actual credit losses. The factors associated with credit (supplemental mortgage insurance cost, credit enhancement fee, and actual credit losses) will have a substantial

---

[52] Based on comments we received from experts during the preparation of this report.

[53] The FHLBank of New York expressed a significant concern that the FHLBanks may not be able to compete successfully with Fannie Mae and Freddie Mac in the securitization of mortgages. Some experts stated that an FHLBank securitization program may have a better opportunity for success if the FHLBanks choose a different niche for securitizing loans, such as the jumbo or Alt-A segments.

[54] It is difficult to conduct an economic analysis of an FHLBank securitization program for several reasons. First, some of the costs, such as the Enterprises guarantee fee, depend on the specific transaction considered. Second, since the Enterprises are in conservatorship and have incurred substantial losses, their pricing may change. Third, it is not clear that the FHLBanks would continue to purchase mortgages under the existing Acquired Member Asset structure. Finally, given uncertainties in the mortgage markets and the Administration's proposed regulatory changes, it is difficult to determine appropriate prices for many of the required inputs.

effect on the yield from the transaction.[55] The difference between the yield on the Enterprise security and the FHLBank security, adjusted for costs,[56] would determine the economic viability of a securitization program.

Chairman Bernanke's third principle for a successful mortgage securitization program relates to transparency of the mortgage securities. Because mortgage securities are difficult to price, information relating to the underlying mortgages and the structure of the securities must be transparent to potential investors. If the FHLBanks were issuing pass-through securities backed by conforming loans, then the security structure likely would closely resemble those issued by Fannie Mae and Freddie Mac. However, a primary difference would be the structure of the mortgage purchases by the FHLBanks, where the member retains a substantial portion of the credit risk.[57] As mentioned above, investors may want more financial information on the members bearing this credit risk, particularly if the members' credit enhancements were viewed as important to the FHLBanks. However, the FHLBanks may be able to overcome this additional complexity by supplementing the credit enhancements with a clear and simple FHLBank System guarantee.

Risk to the FHLBanks Associated with FHLBank Securitization

Typical of any mortgage portfolio lender, FHLBanks face credit, market, and operational risk from holding mortgages under the Acquired Member Assets program. Indeed, some FHLBanks have chosen to limit or discontinue their participation in Acquired Member Asset programs because of the difficulty in managing these risks. According to some FHLBanks, a securitization program would enable them to reduce risk by securitizing and selling their existing Acquired Member Asset loans.[58] Even with securitization, however, the FHLBanks would retain some credit risk from the securitized loans because the mortgage securities would carry an FHLBank guarantee. The FHLBanks would also be exposed to servicing risk with respect to members

[55] Changes in the transaction or credit enhancement structures would alter the types and magnitudes of the costs.
[56] The relevant costs that the FHLBanks would incur include operating expenses, hedging costs, and loan loss reserves. In addition, the FHLBanks may require a profit margin on these transactions and may need to absorb a liquidity premium.
[57] Under the Administration's proposals for financial regulatory reform, this difference could be eliminated. Specifically, the Administration has proposed that all loan originators should retain 5 percent of the credit risk of the securitized exposure. See Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009, p. 44.
[58] For example, if an FHLBank were to securitize mortgages that it is currently holding in portfolio, it would reduce its market risk without increasing its credit risk. Despite this potential benefit of balance sheet and risk management from securitization, it is notable that even if securitization were permitted, the FHLBanks appear to have no immediate plans to securitize Acquired Member Assets already in portfolio. Rather, they view securitization as primarily a tool for managing future purchases of mortgages rather than mortgages that they are already carrying on their balance sheets. See Jorissen/Taft Letter, p.10; and Comment Letter on the Securitization Study from Matthew R. Feldman, President and Chief Executive Officer of the FHLBank of Chicago, dated April 28, 2009, p.6. The lack of interest in securitizing existing Acquired Member Assets may be due to difficulties associated with securitizing existing Acquired Member Assets with some shared ownership among FHLBanks. Overcoming these challenges may require renegotiation of agreements with multiple parties.

acting as servicers of the loans, modeling risk with respect to credit enhancement and pricing, and political risk from changes in laws, rules, and regulations.[59]

Credit risk. Under a securitization program, the overall credit risk exposure of the FHLBanks would increase in line with the volume of loans securitized as the FHLBank would be guaranteeing the principal and interest on the securities. Given the structure of the AMA program, the FHLBank System's exposure to credit losses is constrained by the size of the AMA portfolio, which is in turn constrained by the FHLBanks' capital positions.[60]

The FHLBanks would also face the risk that one or more counterparties that enter into business contracts with the FHLBanks will fail to meet their obligations. To engage in the securitization business, the FHLBank may need to do business with mortgage servicers, mortgage insurers, third party providers of credit enhancements, and derivatives counterparties.

In addition to credit risk, there are other risk associated with securitization, including mortgage pipeline risk, operational risk (including any additional disclosure and reporting to investors),[61] guarantee fee management risk, and all the risk associated with starting a new business venture.

Mortgage Pipeline Risk. Pipeline risk is the risk of changes in the market value of the mortgage loans that are in the securitization pipeline before issuance of the MBS.[62] Pipeline risk may be relatively more manageable than other risks because products exist that can be used to hedge it, albeit imperfectly (i.e., the Enterprises' TBA market).[63] However, while pipeline risk is short term relative to the risk of a portfolio of mortgage loans, some FHLBanks have performed poorly in managing interest rate risk. Indeed, holding loans in the pipeline with the intent to sell them is likely to result in increased earnings volatility from marking the mortgages to the lower of cost

[59] Indeed, proposed regulatory reform of the securitization market would require increased transparency and standardization, but could also increase the cost of securitization. See Moody's, "U.S. Financial Regulatory Reform: Securitization," *Moody's Global Structured Finance*, June 2009, p. 1.

[60] For mortgage pools with a AA rating, the FHLBanks must currently hold 0.60 percent of their Acquired Member Asset balance for credit risk-based capital, a model-determined amount for market-risk based capital, and 30 percent of the sum of the market and credit risk-based capital amounts for operational risk. Thus, even if market risk is zero, the risk-based capital requirement on an Acquired Member Asset loan is 0.78 percent [0.60 x (1+.30)]. If the rating on the mortgage pool deteriorates, the FHLBank would be required to hold higher amounts of capital.

[61] It is likely that any MBS issued by the FHLBanks would be exempt from registration under the Securities Act of 1933. Such an exemption would be similar to the status provided to other FHLBank securities and the exemption from registration for MBS issued by the Enterprises. See Jorissen/Taft Letter at p.14. Nevertheless, the FHLBanks likely would need to provide disclosure that would be the equivalent of, or exceeds the standards of, that provided under federal securities laws in order to gain acceptance in the market place.

[62] The FHLBank of Chicago bears a small amount of pipeline risk under the MPF Xtra program.

[63] If the FHLBanks were able to develop a TBA market in the FHLBank securitized product, they will be able to use this new TBA market to better hedge their pipeline risk. The current Agency TBA market would be more costly for the FHLBanks to use for hedging the pipeline risk for their MBS, potentially exposing the FHLBanks to significant basis risk. For example, if the FHLBanks used the Freddie Mac TBA market to hedge pipeline risk, the hedge would be effective only if the prices of FHLBank securities moved in tandem with the prices of Freddie Mac securities. If the prices of FHLBank securities diverged from those of Freddie Mac securities, this basis risk could render the hedge ineffective.

or fair value on the FHLBanks' financial statements.[64] As a result of this volatility, the FHLBanks may need to hold more capital and reserves than at present, which could result in increased advance rates, lower dividends, and lower affordable housing program contributions.

Operational Risk. Several experts noted that the operational risk of the FHLBanks would increase significantly if they implemented a securitization program. Operational risk is the exposure to loss resulting from inadequate or failed internal processes, people, and systems, or from external events. Operational risk is usually defined to include legal risk, which is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations.

With a securitization program, the FHLBank would become the master servicer of the trust and, thus, be required to collect, process, and remit large amounts of data and funds, which would present new operational risk. This data processing would involve multiple transfers of information and require expensive and sophisticated information technology, as well as sophisticated internal controls. Even though the FHLBanks have some experience in this area because they have been processing data for the Acquired Member Asset programs, disclosure and other requirements associated with issuing MBS are likely to require some alteration in current processes. Moreover, if as expected, a securitization program results in the FHLBanks increasing the volume of loan purchases, the FHLBanks may be dealing with larger volumes of data and information, and larger flows of collections and remittances of funds than in the past.

The FHLBanks would also have to consider the operational risks associated with securities disclosure requirements (and the potential liability that could arise from inadequate or misleading disclosure). The existing Acquired Member Asset programs do not require a detailed disclosure document for investors.[65] To develop good disclosure documents, the FHLBanks will need to be sensitive to market needs for information, especially in the early stages when it tries to introduce the new FHLBank MBS and explain features such as the member credit enhancement component, as this would be fairly unique in securitizations. In addition, the Administration has proposed that the Securities and Exchange Commission increase transparency and standardization in securitization markets through disclosure.[66] With the uncertainty about any new requirements, the level of disclosure risk is likely to increase in the future.

---

[64] Marking a mortgage to fair value is to identify an exit price in the current market. Currently, the FHLBanks are not required by accounting regulations to mark mortgages they hold for investment to fair value as they have no intention to sell them. They do, however, have to analyze the portfolio and establish loan loss reserves for probable losses in the portfolio.

[65] The FHLBank of Chicago has some experience in developing disclosure materials for mortgage-related securities because of the Shared Funding program. However, as already noted, the Shared Funding transactions were limited to sales to two other FHLBanks so that the experience garnered by the FHLBank in this area is limited and may not be readily applicable for a wider market (especially under current conditions). More generally, the FHLBanks have knowledge of disclosure requirements and standards under federal securities laws because FHLBank capital stock is registered under the Securities Exchange Act of 1934.

[66] Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009, p. 45.

Model (Guarantee Fee) Risk. Another significant new risk that the FHLBanks could face is business risk associated with determining and managing a guarantee fee. MBS providers, such as Freddie Mac and Fannie Mae, charge lenders a guarantee fee to cover the expenses associated with the securitization process and make a profit. The main purpose of the guarantee fee is to protect against credit-related losses in the mortgage portfolio, but the fee also covers internal expenses related to the securitization process. To profitably and competitively price the guarantee fee, the FHLBanks will need to accurately project the costs, in the form of credit losses, float,[67] and capital expenses, and revenues over a range of interest rate and house price scenarios. This requires appropriate economic and statistical models to make these projections, which introduces model risk. Successful management of the securitization business will require the FHLBanks to charge a guarantee fee that will cover projected costs, earn an adequate return on equity, and be competitive with other providers.

Start-up risk. Finally, the challenge of launching a new securitization program given current conditions in the housing and mortgage markets cannot be overstated. The competitive landscape in the mortgage market may change dramatically in the years to come. Fannie Mae and Freddie Mac are under conservatorship, and their futures are unclear. This creates uncertainty about the extent to which the FHLBanks would compete with Fannie Mae and Freddie Mac if the FHLBanks were to enter the securitization market. Moreover, the demand for mortgage-related investments in the near future is uncertain.

In sum, the FHLBanks would face many new risks and challenges in undertaking a securitization program. Once markets stabilize and the uncertainties surrounding the future of mortgage finance in the United States recede, the attractiveness of securitization to the FHLBanks and their members could change.

Potential Benefits for the FHLBanks from Securitization

Allowing the FHLBanks to compete with Fannie Mae and Freddie Mac in the securitization arena could potentially benefit mortgage originators and consumers. An additional competitor in this market could result in originators receiving higher prices for mortgages they sell and borrowers receiving lower mortgage rates. To deliver these benefits, however, the FHLBanks may need to capture a significant share of the mortgage securitization market. Given the current market dominance of Fannie Mae and Freddie Mac, the FHLBanks could face difficulty in penetrating this market.

Another potential benefit of securitization is that it may enable the FHLBanks to manage liquidity and capital constraints. The FHLBanks face liquidity and capital constraints that limit the amount of mortgages they can hold on their balance sheets. By securitizing and selling the mortgages they hold in their portfolios, the FHLBanks would be able to liquefy their balance sheets and free up capital. This in turn would allow them to purchase more mortgages from

[67] Float is the cost or benefit stemming from the mismatch between alternative seller/servicer remittance cycles and security payment cycles.

members. This benefit applies if the FHLBanks operate both a large scale securitization program and an active Acquired Member Assets program.

Since the FHLBanks have existing credit relationships with smaller members, the FHLBanks could further expand access to the secondary market for these institutions. However, the FHLBanks could not rely on small originators to generate the volume needed to compete directly with the Enterprises.

Under the current Acquired Member Asset programs, the FHLBanks bear substantial interest rate, prepayment, and credit risk. Securitization would allow the FHLBanks to move interest rate and prepayment risk from the FHLBank and their members to investors who may be better able to manage those risks (assuming that if the FHLBanks adopted a securitization program, the FHLBanks and their members would continue to share the credit risk in the manner now required in the Acquired Member Asset regulations).

Another benefit of securitization is that it may allow the Banks to exit AMA programs. While credit risk has not, to date, been a problem for the FHLBanks under the Acquired Member Asset program,[68] managing interest rate and prepayment risk has created difficulties for some FHLBanks. The loans purchased under the Acquired Member Asset programs have been long-term, fixed-rate mortgages. Properly matching these assets with appropriate liabilities can be difficult given the propensity for the loans to prepay when interest rates fall.

The FHLBanks have used a variety of risk management tools to transfer the interest rate and prepayment risks of Acquired Member Assets to third parties, which include funding Acquired Member Asset purchases with a mix of fixed-rate and callable consolidated obligations and buying derivative products such as swaps, options, swaptions, caps and floors. However, the FHLBanks have had mixed success in using these tools to manage the Acquired Member Asset risks.

The FHLBanks of Seattle and Chicago, especially, have had well-publicized problems in this respect, which has caused both FHLBanks to cease buying loans under their Acquired Member Asset programs. The problems managing the interest rate and prepayment risks of their Acquired Member Asset programs also contributed to the earnings difficulties faced by these FHLBanks in the past few years. Securitization involves transformation and reallocation of interest rate risk by the transferor of the asset and can transfer risk more efficiently than the methods the FHLBanks have used to date.

Finally, in terms of the potential benefits of securitization, the central question is whether the FHLBanks could gain and sustain a strong enough competitive position in this market that would allow them to generate sustainable earnings and profits. From the perspective of the FHLBank, the prospect of improved earnings and profitability would be the primary motive for engaging in

[68] Many FHLBanks have experienced credit-related difficulties, and in some cases losses, through their purchases of private-label MBS.

this business. However, several of the FHLBanks have raised questions about their ability to compete effectively in the business.

Potential Effects of Securitization on Housing Finance and Credit Markets

The potential effects of an FHLBank securitization program on the housing finance and credit markets is difficult to assess because conditions in those markets remain unsettled. These markets experienced substantial deterioration and stress in 2008, including accelerating housing price depreciation, rising default rates, and a precipitous decline in the demand for MBS. The market for private label MBS shut down altogether, and Fannie Mae and Freddie Mac were placed under conservatorship. Meanwhile, the Federal Reserve and the Treasury Department have been purchasing Agency MBS to support the secondary mortgage market. Adverse trends in the housing and finance markets continued throughout the first half of 2009. Although activity in the housing and credit markets have shown some signs of improvement in recent months, it is not clear when conditions in those markets will return to normal, and whether or when demand for MBS would be strong enough to support an FHLBank securitization. The demand for FHLBank-issued MBS would depend on whether the FHLBanks are able to differentiate their mortgage securities from those of Fannie Mae and Freddie Mac.[69]

If the FHLBanks securitization program were confined to conforming mortgages, it may not add substantial liquidity or have any noticeable effect on the price of mortgage credit.[70] Specifically, the FHLBanks may not be able to add significant volume to the market (see Table 1 comparing Acquired Member Asset volumes to Fannie Mae volumes) or divert significant volume away from Fannie Mae and Freddie Mac in a way that would cause the Enterprises to pay higher prices for mortgages. The ultimate effect on liquidity and prices, of course, remains uncertain. The private-label MBS market took market share from the Enterprises, but that market severely underpriced credit risk. The Enterprises landed in conservatorship, in part, from underpricing credit risk and it remains to be seen what form they take post-conservatorship and how credit risk will be priced in the future.

Some experts noted that the FHLBanks could potentially bring additional liquidity and better pricing to the non-conforming loan market by buying and securitizing non-conforming loans.[71] At present, large banks appear reluctant to underwrite jumbo loans and hold them in portfolio. As of June 16, 2009, rates on jumbo loans were 72 basis points above those on conforming loans.[72] FHLBank securitization of jumbo loans would provide members with a sales outlet for

[69] Alternatively, the FHLBanks could benefit from issuing a homogeneous security that is effectively the same as the securities issued by the Enterprises. For example, homogeneity may promote more rapid market acceptance or facilitate use of the Enterprises' TBA markets for hedging.
[70] Based on comments we received from experts during the preparation of this report.
[71] The Enterprises are currently securitizing mortgages that were previously considered jumbo mortgages—the maximum conforming loan limit is currently $729,750. However, in the first quarter of 2009, Fannie Mae and Freddie Mac have issued $1.34 billion and $90.8 million, respectively, of conforming jumbo mortgage securities. See "GSEs and Jumbos: Not Living Up to Their Potential," *Inside the GSEs*, May 6, 2009, pp. 4-5. It is notable that private sector entities entered the securitization market mainly with products that were not based on fixed rate conforming mortgages.
[72] Data from www.banx.com.

these loans, which could lead to lower interest rates on jumbo loans. However, the effect on rates would depend on the amount of added liquidity. Specifically, the price of mortgage credit in a given market sector would decrease if members become more willing to provide funds to borrowers at lower rates, and new borrowers become more willing to borrow funds at the lower rates. If these two conditions were met, the FHLBanks would be successful in reducing the price of mortgage credit in a market for non-conforming loans.

Potential Effects of Securitization on Other FHLBank Programs and Products

The views of commenters on the effects of securitization on other FHLBank programs and products are mixed. On the one hand, some commenters expressed concern that a securitization program could jeopardize the strength and stability of the FHLBanks and their ability to provide low cost advances. These members see advances as the most important benefit that FHLBanks offer and cite advances as the primary reason community banks are FHLBank members.[73] Indeed, the Independent Community Bankers of America noted that its members have access to a variety of other secondary mortgage market options, such as Fannie Mae, Freddie Mac, and private investors, while "there is no ready replacement for advances."[74]

One commenter stated that if the FHLBanks began a large-scale securitization program, investors may demand higher risk premiums on FHLBank debt obligations, resulting in higher funding costs for the FHLBanks that would have to be passed along to members.[75]

On the other hand, eight FHLBanks would like the authority to engage in securitization.[76] These FHLBanks believe that providing members with a securitization option would not adversely affect their advances programs. These FHLBanks cite the FHLBanks' experience with MPP and the MPF program as support for this view.[77]

Some FHLBanks want the flexibility both to securitize loans and hold mortgages in portfolio. Such flexibility would allow the FHLBanks to acquire assets to hold on their balance sheets when beneficial to the FHLBanks, while providing members with secondary market access through securitization at other times. However, the FHLBank members may not be able to provide a sufficient volume of loans to support both a successful securitization program and active Acquired Member Asset programs.

---

[73] See, for example, comment Letter on the Securitization Study from Ann M. Grochala, Vice President, Lending and Accounting Policy, Independent Community Bankers of America, p.2 (hereafter ICBA Letter).
[74] ICBA Letter, p.2.
[75] Since mortgages serve as collateral for both AMA and advances, members that are active in both programs may need to determine their desired mix of mortgage sales and advances.
[76] They are the FHLBanks of Boston, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, and Topeka. The FHLBanks of New York and San Francisco were opposed, the FHLBank of Dallas was neutral to the general concept, and the FHLBank of Seattle did not provide a formal comment.
[77] Given the difficulties some FHLBanks have faced due to their Acquired Member Asset programs, it is possible that these programs have resulted in higher advance rates and lower dividends for some FHLBanks.

Potential Effects of Securitization on Joint and Several Liability

The FHLBanks are jointly and severally liable for the consolidated obligations issued through the Office of Finance. A securitization program could increase the exposure of an FHLBank to losses and increase the likelihood that an FHLBank would default on its consolidated obligations, in which case the joint and several liability of the FHLBanks would be triggered. Whether a securitization would increase or decrease the risk of default, however, would depend on a wide range of factors, including how the program is structured and managed, the intensity of competition in the securitization market, the demand for FHLBank mortgage securities, and conditions in financial markets and the broader economy. New business ventures are inherently risky. The FHLBanks could take a number of steps to reduce the risk of entering the securitization business, such as conducting thorough research on all aspects of the business, developing a sound competitive strategy, hiring qualified and experienced staff, and putting in place appropriate systems and controls.

While market reactions to events are difficult to anticipate, some FHLBanks also argued that any losses in FHLBank MBS could create a reputation risk that would have a negative effect on FHLBanks. The FHLBank of San Francisco suggested that default of even a single FHLBank MBS could adversely affect investors' views of the FHLBanks' consolidated obligations and the FHLBanks' ability to sell this debt, particularly because some investors could be expected to have purchased both consolidated obligations and FHLBank MBS.[78] As a result, if any one FHLBank issued MBS, the potential effect on the other FHLBanks would compel all twelve to participate in the MBS issuance or, at a minimum, in the guarantee of the MBS provided by issuing FHLBank or FHLBanks. Similarly, the FHLBank of New York wrote:

> …the securitization of Acquired Member Asset product will require that the FHLBanks provide a guarantee behind the securitized product. This guarantee will likely be in the form of an FHLBank System guarantee, rather than an individual FHLBank guarantee. Such guarantee will increase the joint and several obligation risks for each FHLBank and their respective shareholders.[79]

The FHLBank of New York further suggested that securitization be approved only with the unanimous consent and support of all twelve FHLBanks.[80]

Potential Effects of Securitization on the Cooperative Nature of the FHLBank System

According to the FHLBank of Chicago, FHLBank securitization would increase the value of FHLBank membership, strengthening the cooperative nature of the System, by offering members a new type of MBS with attractive risk characteristics. Members might be more willing to invest in FHLBank MBS than other market participants because they would have more familiarity with

---

[78] Comment letter on the Securitization Study from Dean Schultz, President and Chief Executive Officer of the FHLBank of San Francisco, dated April 28, 2009.
[79] Comment letter on the Securitization Study from Michael Horn, Chair of the Board of Directors of the FHLBank of New York, dated April 23, 2009 (hereafter, Horn Letter), p. 2.
[80] Horn Letter, p. 2.

the quality of Acquired Member Assets and the nature of the credit enhancement requirements. Moreover, members have a long standing business relationship with the FHLBanks and may be more willing to buy the new product from the FHLBanks.

One expert, however, stated that a large-scale securitization program could harm the cooperative nature of the System if members conclude that the program is too risky and decide to leave the System.

Conclusions

As directed by Congress, the FHFA conducted a study on FHLBank securitization of home mortgage loans. In conducting the study, the FHFA consulted with the FHLBanks, the Office of Finance, representatives of the mortgage lending industry, practitioners in the structured finance field, and other experts. The FHFA considered several factors in the study, including the benefits and risks of securitization, the effect of an FHLBank securitization program on the FHLBanks existing activities, as well as the cooperative nature of the FHLBank System.

The key conclusions of the study concerning a potential FHLBank securitization program are as follows:

Benefits of FHLBank securitization

- Securitization would enable to FHLBanks to purchase a larger volume of conforming mortgages from members than they otherwise would. This could increase the availability of mortgage credit from members that participate in the program.
- Securitization would enable the FHLBanks to securitize and sell existing mortgages held in Acquired Member Asset programs. This would allow those FHLBanks that choose to securitize their holding of Acquired member Assets to eliminate the market risk associated with holding those assets as well as the need to hold capital for market risk associated with those assets.
- An FHLBank securitization program could increase competition for the Enterprises and result in modestly lower mortgage rates for borrowers. In addition, such a program could reduce market dependence on Fannie Mae and Freddie Mac, thereby potentially reducing systemic risk.

Risks of FHLBank securitization

- Starting a securitization program would entail substantial business and financial risk. The FHLBanks have little or no direct experience in managing a securitization program and would be faced with significant start up costs. The FHLBanks would compete in a market dominated by Fannie Mae and Freddie Mac. Consequently, there can be no assurance that the FHLBanks would be able to compete in this market on a profitable basis.
- The FHLBanks would be exposed to a range of risks including market risk, credit risk, operational risk, and reputation risk.
- The market risk associated with mortgages held in the "pipeline" in anticipation of securitization is a significant risk associated with the securitization business. Pipeline risk could increase the volatility of FHLBanks earnings.

- The risks associated with providing a guarantee of principal and interest on any securitized product would be significant. The FHLBanks would need to calculate and charge an appropriate fee for providing a guarantee. This fee would need to cover all the anticipated costs associated with providing such a guarantee.

- The operational risk associated with operating a securitization program would be new to the FHLBanks and may be substantial in the start-up phase of the program. For example, the FHLBanks would need to process large flows of data and funds, and meet stringent reporting requirements than they need to do for the Acquired Member Asset program.

Ability of the Banks to manage the risks associated with such a program

- The business of securitization is substantially different from the current business of the FHLBanks. Consequently, the FHLBanks would have to acquire the staff and technology needed to implement the program and manage effectively the risks associated with this business.

Effect of such a program on the existing activities of the Banks, including their mortgage portfolios and advances

- The impact of a securitization program on the existing activities of the FHLBanks would depend importantly on the success of the program. A successful program would strengthen the FHLBanks and enable them to better serve their members, while an unsuccessful program could have an adverse effect on existing programs and services.

- The challenges involved in starting a securitization business may divert managerial attention from the existing mission-related activities of the FHLBank.

- With respect to the FHLBanks' advance business, a successful securitization program would enable the FHLBanks to build retained earnings or pass any economic profits generated from that business to the members in the form of lower advance prices, while an unsuccessful program would have the opposite effect.

- With respect to the FHLBanks mortgage portfolios, securitization could enable those FHLBanks that might want to sell their mortgage portfolios to do so. However, the FHLBanks may need to renegotiate certain agreements to sell their existing mortgage portfolios.

Effect on joint and several liability of the Banks and the cooperative structure of the FHLBank System

- Establishing a securitization program may require the FHLBanks to provide an FHLBank System guarantee, rather than an individual FHLBank guarantee. A System guarantee would increase the joint and several liability exposure of each FHLBank.

- If members perceive the FHLBank System to have greater risk with a securitization program, they may require greater returns or, alternatively, they may choose to forego membership in the FHLBank System.

- Investors may demand a higher return on their investments in FHLBank debt if they are concerned about the ability of the FHLBanks to operate a securitization program. If the cost of FHLBank debt increases, the attractiveness to members of advances and other FHLBank products will decrease, and earnings and affordable housing program contributions will be lower.

Current Market Conditions

- The current business and economic environment is not conducive to launching a securitization business. Investor demand for securitized product has fallen dramatically and it is uncertain when demand will strengthen significantly.

- The feasibility of an FHLBank securitization program would also depend on developing a liquid market for the FHLBanks' securitized product. Some commenters believe that to be successful the program would have to generate sufficient liquidity to support a forward market in FHLBank securities. Absent a forward market, the FHLBanks may find it difficult to compete effectively in purchasing and securitizing conforming mortgages.

- Recent accounting rule changes, which take effect in January 2010, pose new challenges that could reduce the attractiveness of securitization. These changes would require participants in mortgage securitization markets to keep securitized mortgages on their balance sheets, which would reduce the benefits of securitization. In addition, these changes could affect the members' willingness to sell mortgages to the FHLBanks under the Acquired Member Assets program.

Regulatory Reform

- On June 17, 2009, President Obama announced the Administration's plan to overhaul the financial regulatory system. Among other things, the plan, *A New Foundation: Rebuilding Financial Supervision and Regulation*, calls on the Treasury and the Department of Housing and Urban Development, in conjunction with other government agencies, to develop recommendations on the future of Fannie Mae, Freddie Mac, and the FHLBank System.

Policy Recommendations of the Director

Based on FHFA's study and findings regarding FHLBank securitization, and the recent calls for regulatory reform, I do not recommend permitting the FHLBanks to securitize mortgages at this time. Rather, the FHLBanks may continue to use programs such as MPF Xtra to serve as a conduit for mortgage purchases from their members to a third party that can securitize those mortgages. The potential for FHLBank securitization of mortgages should be considered after the Treasury Department and the Department of Housing and Urban Development, working with FHFA, develop recommendations on the future of Fannie Mae, Freddie Mac, and the FHLBank System, and in light of financial market conditions at that time.

____

James B. Lockhart III
Director

FEDERAL HOUSING FINANCE AGENCY

[No. 2009–N–03]

FHFA Study of Securitization of Acquired Member Assets

AGENCY: Federal Housing Finance Agency

ACTION: Notice of Concept Release; request for comments.

SUMMARY: The Federal Housing Regulatory Reform Act (Act), Division A of the Housing and Economic Recovery Act of 2008 (HERA), requires the Federal Housing Finance Agency (FHFA) to conduct a study on the securitization of home mortgage loans purchased or to be purchased from Federal Home Loan Bank (Bank) System member financial institutions under the Acquired Member Assets (AMA) programs. FHFA is seeking public comment and hopes that the responses to this request for comments will constitute an important source of information that will assist it in its preparation of the study. FHFA urges commenters to analyze, in light of current market conditions, the benefits and risks associated with securitization, the potential impact of securitization upon liquidity and competitiveness in the mortgage and broader credit markets, the ability of the Banks to manage the risks associated with a securitization program, and the effect of a securitization program on the Banks' existing activities, as well as on the joint and several liability of the Banks and the cooperative structure of the Bank System. This release in no way alters current requirements, restrictions or prohibitions on the Banks with respect to the purchase or sale of mortgages or to the AMA programs.

DATES: Comments on the Concept Release must be received on or before April 28, 2009. For additional information, see **SUPPLEMENTARY INFORMATION**.

ADDRESSES: You may submit your comments on this Concept Release, identified by a subject line of ''Securitization Study'' by any of the following methods:

- *U.S. Mail, United Parcel Post, Federal Express, or Other Mail Service:* The mailing address for comments is: Alfred M. Pollard, General Counsel and Christopher T. Curtis, Senior Deputy General Counsel and Managing Counsel, Attention: Comments/Securitization Study, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- *Hand Delivered/Courier:* The hand delivery address is: Alfred M. Pollard, General Counsel and Christopher T. Curtis, Senior Deputy General Counsel and Managing Counsel, Attention: Comments/Securitization Study, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The package should be logged at the Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.
- *E-mail:* Comments to Alfred M. Pollard, General Counsel and Christopher T. Curtis, Senior Deputy General Counsel and Managing Counsel, may be sent by e-mail at *RegComments@FHFA.gov*. Please include ''Securitization Study'' in the subject line of the message.
- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.

FOR FURTHER INFORMATION CONTACT:
George G. Korenko, Senior Economist, (202) 408–2543 or Christina Muradian, Senior Financial Analyst, (202) 408– 2584, Division of Federal Home Loan Bank Regulation; or Thomas E. Joseph, Senior Attorney-Advisor, Office of General Counsel for Federal Home Loan Bank Supervision, (202) 408–2512, Federal Housing Finance Agency, 1625 Eye Street, NW., Washington, DC 20006. The telephone number for the Telecommunications Device for the Deaf is (800) 877–8339.

SUPPLEMENTARY INFORMATION:

I. Comments

The Federal Housing Finance Agency (FHFA) invites comments on all aspects of the Concept Release and will consider all comments before issuing a report to Congress. FHFA requests that comments submitted in hard copy also be accompanied by the electronic version in Microsoft® Word or in portable document format (PDF) on CD– ROM.
Copies of all comments will be posted on the internet web site at *https://www.fhfa.gov*. In addition, copies of all comments received will be available for examination by the public on business days between the hours of 10 a.m. and 3 p.m., at the Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. To make an appointment to inspect comments, please call the Office of General Counsel at (202) 414–3751.

II. Purpose of Release

Effective July 30, 2008, the Act, Public Law 110-289, 122 Stat. 2654 (2008), transferred the supervisory and oversight responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) over the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, Enterprises), and the oversight responsibilities of the Federal Housing Finance Board (FHFB) over the Banks and the Office of Finance (which acts as the Banks' fiscal agent) to FHFA, a new independent executive branch agency. FHFA is responsible for ensuring that the Enterprises and the Banks operate in a safe and sound manner, that they maintain adequate capital and internal controls, that their activities foster liquid, efficient, competitive and resilient national housing finance markets, and that they carry out their public policy missions through authorized activities. *See* § 1102, Public Law 110–289, 122 Stat. 2663–64. The Enterprises and the Banks continue to operate under regulations promulgated by OFHEO and the FHFB until FHFA issues its own regulations. *See id.* at §§ 1302, 1313, 122 Stat. 2795, 2798.
Section 1215 of the Act requires the Director of FHFA to conduct a study on securitization of home mortgage loans purchased or to be purchased from Bank member financial institutions under the AMA programs.[1] *See id.* at § 1215, 122 Stat. 2791. The Act requires FHFA to submit a report to Congress by July 30, 2009, detailing the results of the study. The report must include policy recommendations based on the Director's analysis of the feasibility of the Banks, either individually or collectively, issuing mortgage-backed securities (MBS), and the benefits and risks associated with such a program.
The Act stipulates that the study address the benefits and risks associated with securitization of AMA; the potential impact of securitization upon liquidity in the mortgage and broader credit markets; the ability of the Banks to manage the risks associated with such a program; the impact of such a program on the existing activities of the Banks, including their mortgage portfolios and advances; and the effects of securitization on joint and several liability of the Banks and the cooperative structure of the Bank System. The Act further requires that in conducting the study, the Director

[1] As explain

consult with the Banks, the Office of Finance, representatives of the mortgage lending industry, practitioners in the field of structured finance, and other experts as needed. The Director also must establish a process for the formal submission of comments on the study. The purpose of this release is to solicit such comments regarding a potential Bank securitization program.

III. Background

A. The Bank System

The twelve Banks are instrumentalities of the United States organized under the Federal Home Loan Bank Act (Bank Act). *See* 12 U.S.C. 1423, 1432(a). The Banks are cooperatives; only members of a Bank may own the capital stock of a Bank and only members or certain eligible housing associates (such as state housing finance agencies) may obtain access to the products provided by a Bank. *See* 12 U.S.C. 1426, 1430(a), 1430b. Each Bank is managed by its own board of directors and serves the public by enhancing the availability of residential mortgage and community lending credit through its member institutions. *See* 12 U.S.C. 1427. Any eligible institution (typically, thrifts, Federally insured depository institutions or state-regulated insurance companies) may become a member of a Bank by satisfying certain criteria and by purchasing a specified amount of the Bank's capital stock. *See* 12 U.S.C. 1424, 1426; 12 CFR part 931.

As government sponsored enterprises (GSEs), the Banks are able to borrow funds in the capital markets on terms more favorable than could be obtained by most other entities. Typically, the Bank System can borrow funds at a modest spread over the rates on U.S. Treasury securities of comparable maturity, although under recent market conditions spreads to U.S. Treasuries have widened considerably. The Banks can pass along their GSE funding advantage to their members—and ultimately to consumers—by providing advances (secured loans) and other financial services at rates that would not otherwise be available to their members. Some of the Banks also have AMA programs whereby they acquire fixed-rate, single-family mortgage loans from participating member institutions.

Consolidated obligations, consisting of bonds and discount notes, are the principal source for the Banks to fund advances, AMA programs, and investments. The Office of Finance issues all consolidated obligations on behalf of the twelve Banks. Although each Bank is primarily liable for the portion of consolidated obligations corresponding to the proceeds received by that Bank, each Bank is also jointly and severally liable with the other eleven Banks for the payment of principal of, and interest on, all consolidated obligations. *See* 12 CFR 966.9

B. AMA Regulation

In July 2000, the Board of Directors of the Finance Board adopted a final regulation governing AMA activities. *See* Final Rule: Federal Home Loan Bank Acquired Member Assets, Core Mission Activities, Investments and Advances, 65 FR 43969 (July 17, 2000) (hereinafter Final AMA Rule). The rule, contained in Part 955 of the Finance Board's regulations, remains in effect today. To date, two separate mortgage programs are authorized under Part 955—the Mortgage Partnership Finance (MPF) program and the Mortgage Purchase Program (MPP).

The AMA products are structured such that the Banks acquire, through either a purchase or funding transaction, whole, single-family mortgage loans from their members. Products exist for both conventional and government-guaranteed/-insured loans. The risks associated with the mortgages are such that the Bank manages the interest-rate risk and the member manages a substantial portion of the risks associated with originating the mortgage, including a substantial portion of the credit risk. Part 955 requires that the member provide a credit enhancement sufficient to enhance the credit quality of the assets to an equivalent of an instrument rated at least investment grade (*e.g.*, BBB), although all approved AMA programs require members to enhance the loans to the second highest investment grade (*e.g.*, AA). The member may provide this credit enhancement through various means.

In order for a Bank to acquire a mortgage loan as AMA, the loan must meet the requirements set forth under a three-part test established by regulation. *See* 12 CFR 955.2. The three-part test consists of a loan type requirement; a member or housing associate nexus requirement; and a credit risk-sharing requirement.

The loan type requirement establishes the types of assets that could be considered as AMA-eligible. Assets acquired by a Bank must fall within three certain categories. The assets may be whole loans eligible to secure advances that do not exceed the conforming loan limits that apply to the Enterprises. Further, the loans must be secured by property located in a state.[2] The assets also may be whole loans secured by manufactured housing, regardless of whether such housing qualifies as residential real property. Finally, state and local housing finance agency (HFA) bonds are AMA-eligible. Interests in whole loans backed by mortgages that meet the previously noted asset type requirements are also eligible for purchase under AMA.[3]

The second part of the three-part test is the member or housing associate nexus requirement. The nexus requirement was established to ensure that the assets acquired by the Banks have some connection to a System member or housing associate. In order for an asset to be considered AMA-eligible, the asset must be originated (if a loan) or issued (if a bond) by, through, or on behalf of a Bank System member, housing associate, or affiliate thereof; or held for a ''valid business purpose'' by a Bank System member or housing associate prior to the acquisition by the Bank. In addition, the asset must be acquired from either a member or housing associate of the acquiring Bank; a member or housing associate of another Bank, but only pursuant to an arrangement between the Banks; or another Bank.

The final part of the three-part test is the credit risk-sharing requirement. The risk-sharing requirement was established to emphasize the cooperative nature of the Bank System by ensuring that the member or housing associate shares with the Bank the credit risks associated with the asset. *See* Final AMA Rule, 65 FR at 43975–78. While the first and second parts of the three-part test focus on asset eligibility, the third part focuses on the transactions through which the Bank acquires AMA. In general, the credit risk-sharing requirements prescribe the manner in which AMA products must be structured in order to ensure that the member bears the economic costs associated with enhancing AMA pools to at least a BBB level. The AMA regulation provides detailed credit risk-sharing structure requirements. *See* 12 CFR 955.3. Essentially, these

[2] As defined by regulation, ''state'' means a state of the United States, American Samoa, the Commonwealth of the Northern Mariana Islands, the District of Columbia, Guam, Puerto Rico, or the United States Virgin Islands. *See* 12 CFR 900.3.

[3] In fact, the Banks purchase whole, single-family mortgage loans under the AMA programs. The Chicago, Pittsburgh and Des Moines Banks have also purchased securities that represented senior interests in pools of AMA-qualified single-family mortgage loans under the MPF Shared Funding Program, but this program is not active. Banks have not purchased any manufactured housing loans or HFA bonds under the AMA programs.

requirements provide that AMA products must be structured such that the member provides a credit enhancement sufficient to bring a pool up to the equivalent of an instrument rated at least the BBB level or such higher level required by the Bank. The member must have direct economic responsibility for the credit enhancement that covers expected losses (*i.e.*, the member must be in the first loss position). For the portion of the credit enhancement beyond expected losses, the credit enhancement may be provided by a member's insurance affiliate; loan-level insurance (which includes U.S. Government insurance or guarantee) provided that the insurer is rated at least the second highest investment grade rating established by a Nationally Recognized Statistical Rating Organization (NRSRO); pool insurance, but only to cover the portion of the credit enhancement attributable to pool size; or another member. A member's credit enhancement obligation must be secured fully in parallel with the requirements for securing advances under Part 950 of the Finance Board's regulations.

C. Mortgage Programs

Two AMA programs have been authorized by the Finance Board, MPF and MPP, under the AMA regulation. Additionally, two programs, MPF Xtra and Global Mortgage Alliance Program (GMAP), were authorized under the Banks' incidental authority. Prior to offering these programs to its members, each FHLBank underwent an application process with the Finance Board or FHFA, as appropriate. This application process included a safety and soundness examination to verify that the Banks had in place adequate policies, procedures, and controls to manage the risks presented by these programs.

As already noted, the AMA programs are designed, pursuant to regulation, such that members are responsible for a substantial portion of the credit risk while the Banks manage the interest rate, prepayment, and funding risks. The exact method through which the member assumes responsibility for the credit risk varies depending upon the structure of the AMA product. For example, the ''MPF–Plus'' and ''MPP– Conventional'' products both rely on supplemental mortgage insurance purchased by the member to credit enhance the mortgage pools to the equivalent of an AA–rating. The ''MPF– Government'' and ''MPP–FHA'' products rely on government insurance or guarantee to meet the credit-risk sharing requirements of the AMA regulation. For other MPF products, members provide the amount of credit enhancement necessary to enhance the mortgage pools to achieve a putative rating of the second highest investment grade rating. The Banks determine the amount of the required credit enhancement by using methodologies verified by an NRSRO. The AMA programs allow members to receive compensation for providing the credit enhancement to the loans sold. The structure of this compensation varies both between MPF and MPP and among the various products offered under the MPF program.

The Banks that currently offer MPF to their members (MPF–Banks) are Boston, New York, Pittsburgh, Chicago, Des Moines, Dallas, and Topeka. The ''MPP– Banks'' are Atlanta, Cincinnati, and Indianapolis. Outstanding mortgages in the Bank System totaled $87.9 billion as of September 30, 2008. Mortgage loans comprised 6 percent of total Bank System assets while advances (*i.e.*, loans made to member institutions) represented 71 percent of total assets.

In May 2007, the Finance Board approved the Atlanta Bank's request to offer GMAP under which it would facilitate the sale of certain qualified conforming mortgage loans from eligible members to another of its members, which would then securitize those loans. To date, no transactions have occurred under GMAP. In September 2008, FHFA approved the Chicago Bank's request to engage in the MPF Xtra program, under which it would buy certain qualified, conforming mortgages from eligible members for immediate onward sale to Fannie Mae. Neither MPF Xtra nor GMAP are AMA programs authorized under part 955 of the Finance Board rules. Since September 2008, five additional Banks requested and received approval to engage in MPF Xtra through the Chicago Bank. In both the GMAP and MPF Xtra programs, the mortgages are not held by the Banks and are not assets of the Banks. Instead, the participating Banks receive a fee for their role in the program.

D. Securitization

In its most basic form, securitization of mortgages involves the sale of pools of mortgages from the holder of those instruments to a special purpose vehicle (SPV). The SPV would be organized to be legally distinct from the entity selling the mortgages and would be structured so that it would not be affected by problems associated with or bankruptcy of the original seller of the mortgages. The SPV often is structured as a trust. The SPV would in turn issue securities—generally referred to as mortgage-backed securities (MBS)—that are backed by the pool of mortgages held by the SPV and represent an interest in the payments generated from that pool of mortgages. These securities themselves may be pooled together and new securities issued representing various claims to the underlying cash flows.

There are alternate formats for securitizing loans. For example, a simple form of an MBS is a mortgage pass-through, whereby all principal and interest payments (excluding a servicing fee) from the pool of mortgages are proportionately passed directly to investors each month. Thus, a holder of the MBS has an undivided, *pro rata* interest in the underlying pool of loans. By contrast, a collateralized mortgage obligation (CMO) is another type of MBS. Unlike a pass-through, a CMO has different classes of securities where net cash flows are divided differently among each class or tranche. The tranches are structured to have different risk characteristics and maturity ranges. Examples of differing structures are sequential pay, interest-only (IO), principal only (PO), and z-bonds. CMOs can be created directly based on an underlying pool of mortgages, but they are often created by pooling pass-through MBS and dividing the underlying cash flows from those securities into the various tranches. For tax purposes, transactions creating the CMOs generally are structured to qualify as Real Estate Mortgage Investment Conduits (REMICs) under the Internal Revenue Code. *See* 26 U.S.C. 860A–860G.

In securitizing loans, the Banks could also consider adding a guarantee that principal and interest on the MBS created under a Bank securitization program will be paid. The holders of the MBS, therefore, would not assume the credit risk associated with the pool of loans but would retain the market, interest rate, and prepayment risk. Essentially, the Enterprises currently operate in this way. They purchase conforming mortgage loans, use those loans to back the MBS they issue, and add a guarantee that the principal and interest on these securities will be paid in return for a fee that is paid by the seller of the loans. Banks could also have the option of securitizing loans directly or selling loans on to a third party and allowing that party to undertake the actual securitization.

IV. Policy and Safety and Soundness Considerations

A. Securitization of AMA

Certain characteristics of the AMA program make the securitization of the Bank's existing mortgage holdings more difficult than the securitization of new mortgages that may be acquired. For example, members enter into master commitments with the Banks participating in the MPF program. These master commitments define the terms under which loan sales to the Bank will take place, including the amount of the first-loss account, amount of the credit-enhancement fees paid to the participating financial institution, and the amount of the credit enhancement obligation. In addition, Banks have engaged in ''participations,'' whereby one Bank has acquired an interest in the AMA holdings of another Bank. These two features leave the responsibility for losses, the credit enhancement responsibilities, and the ownership of some of the AMA, fragmented throughout the Bank System. To securitize the existing loans, the Banks may have to negotiate termination of these provisions.

To avoid these issues arising with newly purchased loans, the AMA regulation could be amended to make buying loans for securitization less complicated. For example, the credit risk sharing requirement could be waived for loans that would be securitized. In this way, their mortgage purchases would be similar to those of Fannie Mae and Freddie Mac. When purchasing mortgages, the Enterprises must, for example, purchase ''conforming'' loans and abide by any limits on the size of their overall portfolio that are imposed by FHFA. The conforming loan requirements include loan-to-value ratio limits, documentation requirements, and maximum loan size. For a securitization program, the Banks could follow existing loan-type requirements of the AMA program, including the purchase of only conforming loans, or they could be allowed to purchase mortgages from a more or less expansive pool of loans. In addition, some Banks have had difficulty managing the risks associated with their AMA portfolios. Thus, it may be prudent to limit the size and the growth of the AMA portfolio at the Bank level and/or at the System level.

With respect to securitization, we are seeking comment on the following:

A.1. Should the Banks be authorized to securitize loans? If so, should the Banks be authorized to continue their existing AMA programs in addition to being authorized to securitize loans? Would a pass-through program such as MPF Xtra provide a better alternative to a direct securitization program?

A.2. Should individual Banks be authorized to securitize loans or should the securitization be conducted by the Bank System as a whole?

A.3. Should any limitations be imposed on the Banks with respect to the mortgages purchased either under the AMA program as it currently exists or under a modified AMA program? If so, what types of limitations should be imposed?

A.4. What are the ways that the master commitment obligations and participations between Banks can be unwound so that the existing AMA mortgages could be securitized and sold?

B. Credit Enhancement on MBS

One potentially critical feature of any MBS that the Banks securitize is the level of credit enhancement. For example, the Enterprises provide a guarantee of interest and principal payments on their MBS. If the Banks were to securitize mortgages, it may be beneficial to the program for them to provide a similar guarantee. The guarantee could be the joint and several obligation of all the Banks in the System or by a subset of the Banks if not all Banks are participating in the program. Alternatively, the Banks could securitize the AMA in a CMO structure, providing tranches, some with more protection against credit losses and some with less. The Banks could also purchase credit enhancement in the form of an insurance ''wrap'' provided by a highly rated private mortgage insurer.

With respect to credit enhancements, we are seeking comments on the following:

B.1. If the Banks securitize mortgages, should they guarantee the resulting MBS?

B.2. Given the Banks' joint and several liability for consolidated obligations, would it be reasonable for only a sub-set of the Banks to guarantee MBS?

B.3. If the Banks did not provide a guarantee, would other types of credit enhancement be economically viable or more efficient?

B.4. Would there be a viable market for MBS issued by the Banks or the Bank System?

B.5. How would the market in which these securities would trade be affected by the level and type of credit enhancement?

B.6. Would these securities be likely to trade similarly to Private Label MBS or Agency MBS, and if so, how might such a program affect these markets? Alternatively, would such securities constitute a new market? How large would this program need to be to achieve a liquid market?

C. Benefits and Risks of Securitization

An important consideration in the establishment of a securitization program is an evaluation of the potential benefits and risks of such a program. If a securitization program were allowed, the potential benefits of such a program would need to be weighed against possible risks. Potentially, benefits could include increased liquidity and competition in the markets and greater access to smaller member financial institutions to sell mortgage loans. When the AMA programs were introduced, a primary goal was to provide participating member financial institutions with an alternative avenue to sell single-family mortgage loans with the risks aligned to the competencies of the members and the Banks. A securitization program could also help the Banks manage some of the risks such as interest rate risk associated with holding mortgages on their balance sheet. Difficulty in managing the interest rate risks associated with the AMA program has caused financial problems for some Banks.

The benefits of securitization would need to be weighed against the risks. For example, the Banks currently classify their AMA portfolios as held-in-portfolio. This classification is available to the Banks since they can demonstrate the intent and ability to hold these assets to maturity, and can insulate them from some changes in the market value of the assets. Mortgages acquired for a securitization program would likely be classified as held-for-sale, and fluctuations in the values of these assets would need to be reflected on the Banks' financial statements, potentially affecting earnings—and therefore, affect contributions to the Affordable Housing Program (AHP)[4]—and economic and regulatory capital. In addition, a successful program may require the Banks to build portfolios of mortgages that are substantially larger than those they are currently holding. While these mortgages are held in the portfolio and not yet securitized, the Banks may assume substantial market and credit

[4] Each Bank is required to allocate at least 10 percent of its prior year's net income to fund the AHP. Under the terms of the AHP, a member may submit an application to its Bank for funds to finance the purchase, construction or rehabilitation of housing for very low-, low-, and moderate-income households. *See* 12 CFR part 951.

risk, depending on the terms under which the mortgages are acquired.

With respect to the potential benefits and risks of a securitization program to the Banks, their members and housing markets more generally, we are seeking comment on the following:

C.1. Would the Bank's securitization of mortgages provide added liquidity and competition to the housing finance market?

C.2. What are the benefits to Bank System members?

C.3. Would the benefits be different for large and small members?

C.4. How would this activity further the public purpose of the Banks and promote the cooperative nature of the System? How would it affect the availability and affordability of mortgage credit, especially for low- and moderate-income households and first-time homebuyers?

C.5. How could the Banks' joint and several liability be affected?

C.6. What types of risk would the Banks face under a securitization program?

C.7. Do the Banks have the ability to manage these risks? What activities would the Banks need to undertake to mitigate and manage any such risks?

C.8. What prudential principles are needed and what prudential rules, limitations, and constraints would FHFA need impose on the Banks to ensure that securitization is conducted in a safe and sound manner?

D. Capital Requirements

The Bank Act states that each Bank must hold total capital equal to at least 5 percent of its total assets, provided that in determining compliance with this ratio, a Bank's total capital shall be calculated by multiplying its permanent capital by 1.5 and adding to this product any other component of total capital.[5] *See* 12 U.S.C. 1426(a)(2) and 12 CFR 932.2(b). The Bank Act also requires that when total capital is calculated without application of the multiplier of 1.5, a Bank's total capital must equal at least 4 percent of its total assets. *See* 12 U.S.C. 1426(a)(2)(B) and 12 CFR 932.2(a). A Bank also must hold sufficient permanent capital to meet its market, credit and operations risk, as measured under current regulations. *See* 12 U.S.C. 1426(a)(3) and 12 CFR 932.3.

Under current capital requirements, loans purchased for securitization would be subject to the same capital requirements as AMA for the period of time a Bank held the loan, assuming the loans were purchased with a member credit enhancement. If the loans the Bank intended to securitize were purchased without a member credit enhancement, however, credit risk charges under the risk-based capital rules would likely be higher than for AMA because the credit quality of the unenhanced loans would be lower.[6] *See* 12 CFR 932.4.

If the Banks were to guarantee any mortgages that they sold for securitization against default, the current risk based capital rules would likely require the Banks to treat those mortgages as ''Asset sales with recourse where the credit risk remains with the Bank.'' *See id.* and Table 2 of 12 CFR part 932. Under this provision, a Bank would have to treat the pools of loans underlying the guaranteed MBS as if it owned the loans and apply a credit risk charge appropriate for the credit rating of those loans. Such capital charges could prove prohibitive to a securitization program, especially if the loans did not retain a credit enhancement from the member after securitization. Banks may also need to modify their market risk models to assure that the models would calculate an appropriate market risk capital charge associated with the guarantees. *See* 12 CFR 932.5.

With respect to capital requirements, we are seeking comments on the following:

D.1. What, if any changes, to the current capital requirements may be necessary if the Banks were to undertake a securitization program?

D.2. Would the current rules need to be changed to account for credit or other risks associated with mortgage loan guarantees, if the Banks were to provide a guarantee, as part of the securitization program?

D.3. What are the risks related to mortgage loans and associated hedging instruments that would be in a securitization pipeline?

D.4. How should the potential increased exposure to operational risk associated with a securitization program be captured by the risk based capital rules?

E. Financial Viability

For any securitization program to be a viable business line for the Banks, the program would need to generate an adequate return. The outlook for generating such a return can be affected by many factors including market conditions, economies of scale, and the form of the securitization program (*e.g.*, whether the Banks provide a guarantee on the securitized mortgages).

With respect to financial viability, we are seeking comments on the following:

E.1. What conditions, resources, and capabilities, including technological capabilities, would be necessary for the Banks to implement a viable securitization program?

E.2. What are the key factors for launching and operating a successful securitization program in the foreseeable future? What scale of operations would be necessary to operate a successful securitization operation?

E.3. Given the Banks' capabilities, what are the feasible strategic alternatives for competing in the securitization market?

E4. How might the Banks achieve a comparative advantage over existing competitors in the market?

E.5. What segment of the market for MBS would the Banks serve? How would the Banks differentiate their MBS product from existing competitors in that market? Would there be sufficient demand for product securitized by the Banks?

E.6. Would the Banks be able to earn a sufficient return if the current structure of the AMA programs in which members provide the credit enhancement were carried over to the securitized products? Would a Bank guarantee of the mortgages be necessary to assure an adequate return for the Banks and/or the success of the program?

E.7. How would the Banks' advances programs (and returns from the advances business) be affected if the Banks also bought mortgages from members to securitize? Could a securitization program affect other Bank products, such as MPF Xtra?

E.8. How would the development of a market for covered bonds affect the feasibility of launching a securitization program?

[5] The Bank Act defines ''permanent capital'' as the amounts paid for Class B stock by members plus the Bank's retained earnings as determined in accordance with generally accepted accounting principles (GAAP), and defines ''total capital'' as permanent capital plus the amounts paid by members for Class A stock, any general allowances for losses held by a Bank under GAAP (but not any allowances or reserves held against specific assets) and any other amounts from sources available to absorb losses that are determined by regulation to be appropriate to include in total capital. *See* 12 U.S.C. 1426(a)(5). However, because the Banks have no general allowances for losses (not held against specific classes of assets) and no additional sources have been determined to be appropriate to include in total capital, a Bank's total capital currently consists of its permanent capital plus the amounts, if any, paid by its members for Class A stock.

[6] Current regulations would not allow the Banks to purchase and accumulate mortgage loans for securitization unless they were credit enhanced to investment grade by the member. The regulations would need to be amended before the Banks could purchase loans that were not credit enhanced. *See* 12 CFR 956.3(a)(4).

F. Accounting Issues

Currently, the mortgages purchased under the mortgage purchase programs are designated by the Banks as Held-in-portfolio. Therefore, short-term market gains and losses on their purchased mortgage portfolios are not recognized in financial statements. If the Banks developed a securitization program, mortgage loans that they purchased for securitization would have to be designated as held-for-sale. Fluctuations in current market values of these loans would be recognized through current income while the loans are held by the Bank. Allowing a mortgage securitization program, therefore, could in theory create greater volatility in Banks' reported income, although such possibility must be weighed against the longer terms effects on income that might arise from not needing to hold purchased mortgages on their books for the life of the loans. The Banks could also be expected to implement hedging strategies that could mitigate the effects of market value changes in the mortgages held for securitization on their income

Accounting considerations may also affect a Bank's decision as to whether it would securitize loans that it previously purchased with the intent to hold them to maturity. If a Bank determined that it wanted to securitize any of these loans, the Bank would need to identify which loans that it would likely securitize, and designate such loans as held-for-sale. It would also have to recognize immediately current market value gains and losses in current income and continue to recognize future changes in market value through income until the loans actually are securitized. Given that the mortgages portfolio for most Banks currently show market value losses, such immediate recognition of the losses initially could negatively affect a Bank's reported income.

If the Banks were to guarantee the payment of principal and interest on the MBS they issue, they would also have to record the guarantee on their balance sheets. Guarantees generally would appear to meet the definitions of derivatives under Statement of Financial Accounting Standard 133, but may qualify for the exemption provided for financial guarantee contracts in that statement. In any case, the use of a guarantee as part of the securitization program would affect the timing and the amounts of the Banks' reported income.

In September 2008, the Financial Accounting Standards Board (FASB) issued Exposure Drafts requesting public comment on a proposed amendment to Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46(R)) as well as to FASB Statement No. 140, *Accounting for Transfers of Financial Assets*. These amendments could significantly affect financial reporting for securitizations and associated guarantees. Therefore, the amendments could present challenges for the Banks in implementing a securitization program.

F.1. Would accounting considerations, including, but not limited to amendments to FIN 46(R) and FASB 140, present a major obstacle to the Banks' implementing a securitization program?

G. Legal Issues

The Banks currently purchase mortgages under the incidental authority in sections 11(a) and 11(e)(1) of the Bank Act. 12 U.S.C. 1431(a) and (e)(1). In approving the initial mortgage purchase programs, the Finance Board noted that the programs were a way for the Banks to channel funds into residential housing finance in a manner that was functionally similar but technically more sophisticated than the advances programs. For that reason, it saw the activity as incidental to the dominant statutory purpose of the Banks to make advances. *See* Fin. Brd. Res. No. 96–111 (Dec. 23, 1996). *See also*, Office of General Counsel Opinion, 1996–GC–10 (Fin. Brd. Dec. 18, 1996).

The Finance Board's decision to allow the Banks to purchase mortgages was challenged in court, but it was eventually upheld by the Fifth Circuit Court of Appeals. *See Texas Savings* v. *Fed. Housing Fin. Brd.*, 201 F.3d 551 (5th Cir. 2000). In upholding the Finance Board's action, the court concluded that the Finance Board's interpretation of the Bank's incidental authority was ''permissible * * * because it is consistent with the structure and purpose of the * * * Bank Act, *i.e.*, to use the FHLBanks' access to low-cost funds in the securities markets in an effort to improve the level of housing finance.'' [7] *Id.* at 556. While major amendments were made to the Bank Act in 1999 by the Gramm-Leach-Bliley Act and more recently by HERA, the Banks' central mission remains providing funding for housing finance so that the underlying reasoning in *Texas Savings* is still applicable. *See* 12 U.S.C. 1430. *See also*, § 1313, Public Law 110–289 (amending 12 U.S.C. 4513(a)(1)(B)(ii)).

Securitization would go beyond the Banks' current mortgage purchase programs. It would provide the Banks an additional means to manage the risks of these programs by allowing them to package and sell the loans that they purchase. The underlying purpose of the mortgage purchase programs—to channel funding into housing finance— would not be altered, however, by a securitization program. Thus, the underlying legal reasoning applicable to the mortgage programs might apply to a securitization program so that the Banks should be able to undertake such a program without additional changes to their authorizing statutes. This would especially appear to be true if the Banks do not also guarantee the payment of principal and interest for the MBS as part of the securitization program.

In fact, in 1999, the Finance Board approved a program for the New York Bank that allowed it to buy certain conforming mortgages and community development loans originated by members, pool the loans and create credit support and other tranches from those pools, and sell those interests back to its members. *See* Fin. Brd. Res. 1999– 43 (Aug. 18, 1999) (approving modifications to Community Mortgage Asset Activities Program). *See also* Office of General Counsel Opinion, 1999–GC–03 (Fin. Brd. Aug. 12, 1999). The program required that the member that originated the loans buy the credit support tranche from the Bank, and that the loans sold by the member meet certain other requirements. The Bank was not authorized to guarantee payments on the pooled loans.

This program was approved under the Banks' incidental powers, as were the other mortgage purchase programs. *See* Fin. Brd. Res. 1999–43, and 1999–GC– 03. In analyzing the program, the Finance Board's Office of General Counsel reasoned that the securitization of the loans in question both would be a means to help members control the risks of their housing and community development lending [8] and would be a means for the Bank itself to manage the risk of its investment portfolio so that the program would be ''convenient and useful'' in carrying out the Bank's express investment powers. *See* 1999–

[7] The court determined that it was sufficient that the Banks had authority to purchase mortgages as an activity incidental to their housing finance mission, and it did not find it necessary to consider the Banks' investment authority or the Finance Board's construction of the investment authority provision of the Bank Act. *See Texas Savings*, 201 F.3d at 551 n.5.

[8] The Opinion noted that one of the underlying purposes of amendments to the incidental power provisions of the Bank Act made by Federal Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) was to permit the Banks to assist members in controlling their costs, and the interest and credit risks arising from their activities. *See* 1999–GC–03 at 4–5.

GC–03 at 5. Although the Bank in question never implemented this program, so no loans were securitized under it, the legal reasoning remains valid given that the incidental powers provisions have not been amended since the program was approved. The same legal reasoning could be extended to a more general securitization program for the Banks.

With respect to legal issues, we are specifically seeking comment on the following:

G.1. Do the incidental authorities in section 11(a) and 11(e)(1) of the Bank Act provide a sufficient basis to authorize a securitization program, especially if the Banks are allowed to guarantee the securitized mortgages?

G.2. Are there other laws, such as the Government Corporation Control Act or specific tax provisions, which could create obstacles to a Bank securitization program?

G.3. Given that different formats for securitization could be adopted by the Banks, would some formats present more legal obstacles to a program than others?

V. Summary of Request for Comment

In anticipation of presenting a report to Congress by July 30, 2009, FHFA is seeking public comment with respect to a possible securitization program in the Bank System. Some of the policy and safety and soundness issues that FHFA would need to address in the study are described in this notice. FHFA anticipates that responses to the questions raised in this notice will constitute an important source of relevant data and analysis. In addition to responses on the specific questions raised, commenters should provide other information that they believe may be useful in our analysis and preparation of the FHFA report to Congress.

Dated: February 23, 2009.

James B. Lockhart III,

Director, Federal Housing Finance Agency.

[FR Doc. E9–4262 Filed 2–26–09; 8:45 am]

BILLING CODE 8070–01–P

9 For example, if the Banks were to issue CMOs as part of the program, the Banks would want such interests to qualify for the tax treatment provided to REMICs. The Banks, however, because they are not subject to Federal taxes, would most likely be considered a ‘‘disqualified organization’’ under the REMIC tax provisions and therefore could not hold any residual interests that were created by the securitization. See 26 U.S.C. 860E.

Appendix A: Federal Register Notice

The text of the following letters is available at www.fhfa.gov.

- Federal Home Loan Bank of New York, April 23, 2009
- Mortgage Bankers Association, April 27, 2009
- National Association of Home Builders, April 28, 2009
- Mortgage Insurance Companies of America, April 28, 2009
- Mayer Brown LLP, April 28, 2009
- Federal Home Loan Bank of San Francisco, April 28, 2009
- Federal Home Loan Bank of Chicago, April 28, 2009
- The Honorable Evan Bayh, United States Senate, April 28, 2009
- Independent Community Bankers of America, April 29, 2009
- Federal Home Loan Bank of Dallas, April 28, 2009

Mortgage loans must meet three requirements to qualify as eligible for purchase as Acquired Member Assets.[1]

Loan-Type Requirement. Loans acquired as Acquired Member Assets must be whole loans eligible to secure advances and must not exceed the conforming loan limits that apply to the Enterprises. The loans must be secured by real property located in a state,[2] or be whole loans secured by manufactured housing. State and local housing finance agency bonds are eligible to be Acquired Member Asset, as are interests in whole loans backed by mortgages that meet the previously noted asset type requirements.[3]

Member Nexus Requirement. The Acquired Member Assets must be originated (if a loan) or issued (if a bond) by, through, or on behalf of an FHLBank System member, housing associate, or affiliate thereof; or held by an FHLBank System member or housing associate for a "valid business purpose" before acquisition by the FHLBank. In addition, the asset must be acquired from either a member or housing associate of the acquiring FHLBank; a member or housing associate of another FHLBank, but only pursuant to an arrangement between the FHLBanks; or another FHLBank.

The requirement that there be a nexus with an FHLBank member or associate helps ensure that AMA assets have some connection to the FHLBank System so that the benefits of the programs flow to members or housing associates.

Credit Risk Sharing Requirement. Acquired Member Assets purchased from members must meet certain risk-sharing requirements.[4] These risk-sharing requirements were established to emphasize the cooperative nature of the FHLBank System by ensuring that the member or housing associate shares with the FHLBank the credit risks associated with Acquired Member Assets.[5] Acquired Member Asset products must be structured such that the member provides a credit enhancement sufficient to bring a pool of loans up to the equivalent of an instrument rated at least investment grade (e.g., BBB) or such higher level required by the FHLBank.[6] All

---

[1] See 12 CFR part 955.
[2] As defined by regulation, "state" means a state of the United States, American Samoa, the Commonwealth of the Northern Mariana Islands, the District of Columbia, Guan, Puerto Rico, or the United States Virgin Islands. See 12 CFR 900.3.
[3] In fact, the FHLBanks purchase primarily whole, single-family mortgage loans under the Acquired Member Assets programs. The FHLBanks of Chicago, Pittsburgh and Des Moines, however, also purchased securities that represented senior interests in pools of Acquired Member Asset-qualified single-family mortgage loans under the MPF Shared Funding Program, but this program is not currently active. The FHLBanks have not purchased any manufactured housing loans or housing finance agency bonds under the Acquired Member Asset programs.
[4] Final Acquired Member Asset Rule, 65 FED. REG. 43969, 43975-78 (July 17, 2000).
[5] 12 CFR § 955.3.
[6] The nationally recognized statistical rating organizations assign credit ratings that are meant to provide information on the likelihood that a borrower will default on its obligations. A rating of AAA means that the borrower has the highest level of credit quality. Lower ratings, including AA, A, and BBB, each correspond to sequentially lower credit ratings for the borrower. However, each of these credit ratings is still considered to be

FHLBank Acquired Member Asset programs require the loans to be enhanced to the equivalent of an instrument rated the second highest investment grade (e.g., AA). The various Acquired Member Asset products have different credit enhancement structures. Under the regulations the member must have direct economic responsibility for the credit enhancement that covers expected losses (i.e., the member must be in the first loss position).

For the portion of the credit enhancement beyond expected losses, the credit enhancement may be provided by a member's insurance affiliate; loan-level insurance (which includes U.S. Government insurance or guarantee) provided that the insurer is rated at least the second highest investment grade rating established by a nationally recognized statistical rating organization; pool insurance, but only to cover the portion of the credit enhancement attributable to pool size; or another member. A member's credit enhancement obligation also must be secured fully in parallel with the regulatory requirements for securing advances.

The table at the end of this Appendix provides more detail on the AMA products.

Other FHLBank Mortgage Programs

In addition to MPF and MPP, the FHFA authorized two other FHLBank mortgage programs, MPF Xtra and Global Mortgage Alliance Program.[7] Under MPF Xtra and the Global Mortgage Alliance Program, the FHLBanks do not acquire mortgage loans for their portfolios and members do not credit enhance loans or receive any credit enhancement fee for these loans. Instead, an FHLBank facilitates loan sales between members and a third party, and performs other services and functions in return for a fee. Before offering these programs, each FHLBank underwent a review process that included a safety and soundness examination to verify that the FHLBanks had adequate policies, procedures, and controls to manage the risks presented by these programs.

In May 2007, the FHFB approved the FHLBank of Atlanta's request to offer the Global Mortgage Alliance Program. Under that program, the FHLBank of Atlanta proposed to facilitate the sale of certain qualified conforming mortgage loans from eligible members to another of its members, which intended to then securitize those loans. To date, no transactions have occurred under the Global Mortgage Alliance Program. Nor, given current market conditions, does the FHLBank of Atlanta expect any transactions to occur.

In September 2008, the FHFA approved the FHLBank of Chicago's request to engage in the MPF Xtra program. Under that program, the FHLBank of Chicago buys certain conforming mortgages from eligible members for immediate sale to Fannie Mae. The FHLBank of Chicago

investment grade, or relatively safe. Any rating lower than BBB is considered to be below investment grade, or of speculative credit quality.

[7] MPF Xtra and the Global Mortgage Alliance Program were authorized pursuant to the incidental authority provided the FHLBanks under the FHLBank Act. These programs are not Acquired Member Asset programs approved under the Part 955 rules.

makes customary warranties to Fannie Mae regarding the eligibility of the loans and requires the member that originated the loan to make similar representations and warranties. Thus, if the FHLBank of Chicago were required by Fannie Mae to repurchase any loan because of a breach of any representation or warranty, the FHLBank could require the member that originated the loan to repurchase it. The FHLBank of Chicago is also responsible to Fannie Mae for the servicing of the MPF Xtra loans by its members.

Since September 2008, five additional FHLBanks –Boston, New York, Pittsburgh, Des Moines, and Topeka requested and received approval to engage in MPF Xtra through the FHLBank of Chicago. The FHLBanks of Boston, Pittsburgh, and Des Moines, in addition to the FHLBank of Chicago, currently offer MPF Xtra to their members.

The FHLBanks, for the most part, view this program as a service for members that provides members with liquidity for mortgage lending and furthers the FHLBanks' own housing finance mission. The program is not expected to generate substantial profits for the FHLBanks. As of July 3, 2009, Fannie Mae had purchased $2.5 billion in loans under the MPF Xtra program.

Product Name	FHLBank First Loss Account Size	PFI Credit Enhancement Description	Average Credit Enhancement Amount	Credit Enhancement Fee to PFI (1)	Credit Enhancement Fee Offset (2)	Servicing Fee to PFI
Original MPF	3 to 6 basis points/added each year based on the unpaid balance	Equivalent to "AA"	1.76%	7 to 11 basis points/year – paid monthly	No	25 basis points/year
MPF 100	100 basis points fixed based on the size of the loan pool at closing	After First Loss Account to "AA"	1.52%	7 to 10 basis points/year – paid monthly; performance based after 2 or 3 years	Yes – after first 2 to 3 years	25 basis points/year
MPF 125	100 basis points fixed based on the size of the loan pool at closing	After First Loss Account to "AA"	1.91%	7 to 10 basis points/year – paid monthly; performance based	Yes	25 basis points/year
MPF Plus	An agreed upon amount not less than expected losses	0 to 20 basis points after First Loss Account and Supplemental Mortgage Insurance to "AA"	1.70%	13 to 14 basis points/year in total, with a varying split between performance-based (delayed for 1 year) and a fixed rate; all fees paid monthly	Yes	25 basis points/year
MPF Government (3)	N/A	N/A (Unreimbursed servicing expenses)	N/A	N/A	N/A	44 basis points/ year plus 2 basis points/year- paid monthly (U.S. Government loan fee)
MPF Xtra (4)	N/A	N/A	N/A	N/A	N/A	25 basis points/year
MPP	30 to 50 basis points based on pool risk factors and expected losses	After First Loss Account to "AA" using Supplemental Mortgage Insurance	N/A	N/A	N/A	25 basis points/year
MPP FHA	N/A	Unreimbursed servicing expenses	N/A	N/A	N/A	44 basis points/year

Source: *FHLBank 2008 Combined Financial Report*, pp. 11-12.

Current as of December 31, 2008

(1) For the FHLBank of Des Moines, the credit enhancement fees on certain MPF products differ from those listed above as follows: Original MPF: 8 to 11 basis points/year – paid monthly; MPF 100: 7 to 11 basis points/year – paid monthly; performance-based after 3 years; MPF Plus: 6.5 to 8.5 basis points/year – plus 8 to 10 basis points/year performance-based (delayed for one year); all fees are paid monthly.

(2) Future payouts of performance-based credit enhancement fees are reduced when losses are allocated to the First Loss Account.

(3) Formerly called Original MPF for FHA/VA. For master commitments issued prior to February 2, 2007, the participating financial institution is paid a monthly government loan fee equal to 2 basis points per annum based on the month-end outstanding aggregate principal balance of the master commitment, which is in addition to the customary 44 basis points per annum servicing fee that continues to apply for master commitments issued after February 1, 2007, and that is retained by the participating financial institution on a monthly basis, based on the outstanding aggregate principal balance of the MPF Government loans.

(4) MPF loans acquired by the FHLBank of Chicago under the MPF Xtra product are concurrently sold to Fannie Mae and are not held in the FHLBank of Chicago's retained portfolio.