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Introduction

Federal Home Loan Banks (FHLBanks) serve as the conduit between capital markets and FHLBank members principally through loans called advances. The FHLBanks are also authorized to purchase mortgages under the Acquired Member Assets (AMA) regulation. The AMA programs discussed in this module are unique to the FHLBanks. As such, this examination module does not have applicability in the examination of Fannie Mae, Freddie Mac or the Office of Finance, except as a resource in understanding AMA purchased by the Enterprises.

In December 1996, the Federal Housing Finance Board (the "Finance Board") authorized the FHLBank of Chicago's Mortgage Partnership Finance ® (MPF) program. Authorized on a pilot basis, the MPF program was the first mortgage purchase program among the FHLBanks. In 1999, with the adoption of Resolution Number 1999-50, as modified by Resolution Number 1999-66, the Finance Board broadened the FHLBanks' AMA authority and emphasized that the mortgage programs must involve credit risk-sharing with FHLBank System members or housing associates.

In July 2000, the Finance Board adopted Part 955 to its regulations governing AMA activities. Part 955 established new requirements and codified many of the parameters for AMA programs that the Finance Board previously set forth by resolution. With the adoption of Part 955, the previously approved mortgage programs moved from pilot to permanent status.

Two distinct mortgage programs have been authorized under Part 955 – the MPF program and the Mortgage Purchase Program (MPP). All of the FHLBanks received Finance Board approval to offer MPF and/or MPP to their members. Members may participate in the MPF and MPP programs through various products with differing credit risk-sharing structures. These mortgage programs, as described in this section of the Examination Manual, are available only through participating FHLBanks.

Except for the FHLBank of Chicago's Shared Funding® (Shared Funding) Program, an MPF product, the AMA products are structured such that the FHLBanks acquire, through either a purchase or funding transaction, whole, single-family mortgage loans from their members. Products exist for both conventional and government-guaranteed or government-insured loans. The programs require that the FHLBank manage the interest-rate risk and the member assumes and manages 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. The member may provide this credit enhancement through various means, such as loan-level or pool-level insurance.

Because of concerns related to funding and hedging risks of loans in the AMA portfolios, the FHLBanks have explored and implemented alternatives to the traditional AMA programs. FHLBanks considered options whereby they would continue to offer the service of AMA programs to member institutions, but eliminate the related market and credit risks associated with owning the assets. Notably, the FHLBank of Chicago implemented the MPF Xtra program, which pools these assets and sells the assets to Fannie Mae.

This examination module focuses on risks associated with traditional AMA programs and risks associated with managing the on-balance sheet exposure of AMA assets. Examiners should remain cognizant of other risks, particularly operational risk, associated with programs, such as MPF Xtra, whereby the FHLBanks serve as a conduit for members to sell whole loans.

Regulatory Environment

The primary authorities governing or relevant to AMA activities of the FHLBanks are set forth below. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

1) ***Rules and Regulations of the Federal Housing Finance Agency (FHFA) and its predecessor, the Federal Housing Finance Board (Finance Board), which include the following parts and sections relevant to AMA activities:***

   12 CFR Part 955, sets forth requirements for FHLBank participation in AMA programs and activities. The regulation's four main elements are:

   a) Three-part test to determine AMA eligibility;
   b) Regulatory reporting requirements;
   c) Administrative transactions between FHLBanks; and
   d) Risk-based capital requirements for AMA.

   12 CFR Part 917 of the Finance Board regulations addresses powers and responsibilities of FHLBank boards of directors and senior management. In particular, Section 917.3, Risk Management; Section 917.4, Bank Member Products Policy; Section 917.5, Strategic Business Plan; and Section 917.6, Internal Control System, are pertinent.

   12 CFR Part 1272 of FHFA regulations defines and sets forth the procedural requirements regarding FHLBank's new business activities. With respect to AMA, a new business activity is considered one in which the FHLBank is involved in either managing a risk or undertaking operations that it has not previously or regularly managed. The new business activity regulation prohibits FHLBanks from undertaking a new business activity without first complying with the requirements of

the regulation.

2) ***Rules and Regulations of the Federal Housing Finance Agency (12 CFR Part 1236):*** Specifically, the final rule on Prudential Management and Operations Standards ("PMOS") Standard 6 and Standard 7 highlight the need for the regulated entities to establish clear and explicit guidelines for the acquisition and growth of assets and investments that are consistent with the organization's mission, objectives, business strategy, board-approved policies, risk tolerances, and safe and sound operations.

3) ***Advisory Bulletins of the Federal Housing Finance Board that provide supervisory guidance relating to the topic of AMA activities:***

   Advisory Bulletin 01-2 (*Securing AMA Credit Enhancements*), dated January 24, 2001, provides that an FHLBank must maintain a security interest in collateral that is sufficient to secure fully the member's retained credit enhancement, over and above the collateral that is necessary to support any advance or other obligation of the member to the FHLBank.

   Advisory Bulletin 01-8 (*Asset Review and Classification*), dated October 4, 2001, provides guidance to the FHLBanks in establishing procedures to address the periodic review, classification and reporting of problem assets.

   Advisory Bulletins 02-3 (*Disaster Recovery Planning*), dated February 13, 2002 and 03-2, dated February 10, 2003, provide guidance on specific attributes to be considered by FHLBanks in the formation of their business continuity plans and the establishment of bilateral agreements with other FHLBanks.

   Advisory Bulletin 03-12 (*Credit Risk Exposure to Supplemental Mortgage Insurance Providers*), dated December 3, 2003, provides that each FHLBank should establish policies that include criteria to determine individual exposure limits to each supplemental mortgage insurance provider based on an independent credit analysis of the provider.

   Advisory Bulletin 04-01 (*Service Organizations*), dated March 10, 2004, provides guidance on the evaluation of an organization providing services to an FHLBank whose activities could affect the FHLBank's financial condition. This includes the performance of an assessment of the service organization's internal controls, including the procurement of a service organization's independent auditor's report in accordance with SAS 70, Reports on the Processing of Transactions by Service Organizations, or the performance of alternative methods necessary to gain confidence with the service organization's internal controls.

Advisory Bulletin 05-05 (*Risk Management Oversight*), dated May 18, 2005, provides guidance on the risk management responsibilities of the FHLBank's board of directors, senior management, and risk management function.

Advisory Bulletin 05-08 (*Guidance on FHLBank Anti-Predatory Lending Policies*), dated August 25, 2005, provides guidance on establishing anti-predatory lending policies to govern the FHLBank's purchasing of mortgages and calculating the level of advances that can be made to its members.

Advisory Bulletin 07-01(*Nontraditional and Subprime Residential Mortgage Loans*), dated April 12, 2007, establishes regulatory expectations for the FHLBanks to adopt and implement policies and risk management practices that establish appropriate risk limits for, and appropriate mitigation of, credit exposure on nontraditional and subprime mortgage loans, whether the loans are purchased as AMA, accepted as collateral for advances, or are acquired indirectly through investment in MBS.

Advisory Bulletin 08-02 (*Application of Guidance on Nontraditional and Subprime Residential Mortgage Loans to Specific FHLBank Assets)*, dated July 1, 2008, supplements Advisory Bulletin 07-01 by providing written guidance regarding mortgages purchased under AMA programs, investments in private–label mortgage-backed securities, and collateral securing advances.

4) Regulatory Interpretations of the Federal Housing Finance Board are the following:

Regulatory Interpretation 2000-25, dated November 17, 2000, addresses some of the factors that should be considered in determining if mortgage assets meet the valid business purpose requirement of 12 CFR Part 955. The Regulatory Interpretation specifies that a member must have meaningful influence over or control of the assets being acquired by the FHLBank. Assets will not be considered eligible as AMA if they were merely passed from a nonmember through a member to an FHLBank without the same or equivalent degree of scrutiny as would have been the case if the member had originated the asset itself.

Regulatory Interpretation 2002-02, dated March 6, 2002, provides that under 12 CFR Part 955, a Participating Financial Institution (PFI) may sell the servicing rights associated with a mortgage loan to a PFI other than the PFI responsible for the credit enhancement.

Regulatory Interpretation 2002-03, dated March 6, 2002, provides that an FHLBank may obtain pool insurance to supplement the credit enhancements provided by the member. Within the context of the credit enhancement structure, the pool insurance must follow the other credit enhancement components such as the first loss account and the supplemental mortgage insurance.

Regulatory Interpretation 2005-05, dated October 21, 2005, provides that 12 CFR Part 955 does not allow an FHLBank to sell or transfer either the mortgage loans or the related PFI-provided credit enhancement obligation while continuing to hold the other piece of the transaction.

5) ***Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")*** This statute includes various corporate governance requirements that relate to the responsibilities of corporate boards of directors, the external and internal audit function, and the quality of management's attestation of internal controls pertaining to the accuracy of financial reporting.

6) ***FASB Accounting Standards Codification™ (ASC)*** is the single source of authoritative U.S. generally accepted accounting principles (GAAP) governing the preparation of financial reports and is officially recognized as authoritative by the SEC and the AICPA. Effective July 1, 2009, changes to the source of authoritative U.S. GAAP, the *FASB Accounting Standards Codification*, are communicated through an Accounting Standards Update (ASU). Specific Accounting Standards Codification topics applicable to AMA activities include ASC 310 - *Receivables* and ASC 815 – *Derivatives and Hedging*.

<u>Issues Specific to the FHLBanks</u>

AMA Programs

Two distinct AMA programs were authorized by the Finance Board: the MPF and the MPP. In order to offer MPF and/or MPP to its members, each FHLBank underwent an application process with the Finance Board. This application process included a safety and soundness examination to verify that the FHLBanks had in place adequate policies, procedures, and controls to manage the risks presented by these programs.

For MPF, the FHLBank of Chicago serves as "MPF Provider," providing operational support to all of the other MPF-Banks as permitted under 12 CFR Section 955.5(a). The services the FHLBank of Chicago provides include program development, pricing, legal services, marketing, quality control, accounting, processing, development of underwriting and other processing guides, policies, and procedures, and maintenance of the MPF website. The FHLBank of Chicago annually obtains a Type II SAS 70 (*Statement of Standards 70: Service Organizations*) report from its external auditor covering its MPF program that documents and tests the design and operational effectiveness of internal controls the institution has established in connection with the program.

In contrast, each MPP-Bank conducts its own back-office operations and operates independently from the other MPP-Banks. Unlike the MPF-Banks, each MPP-Bank has autonomy over its own processes, including pricing and execution.

The MPF-Banks and MPP-Banks maintain written guides that govern their respective administration of the AMA programs. The guides, at a minimum, govern origination, underwriting and servicing. Collectively, these materials are generally referred to as "FHLBank Guides."

The AMA programs are designed, pursuant to 12 CFR Part 955, such that the FHLBanks manage the interest rate and prepayment risks while the FHLBanks share credit risk with members and housing associates. With the exception of certain AMA programs approved by the Finance Board at the time of the adoption of 12 CFR Part 955, members or housing associates bear the direct economic consequences of actual credit losses on an asset or asset pool either (i) from the first dollar of loss up to the amount of expected losses or (ii) immediately following expected losses, but in an amount at least equal to expected credit losses. In either case, a member's or housing associate's direct loss obligation precedes the application of any loan-level or pool-level insurance.

How the member assumes responsibility for the credit risk varies depending upon the structure of the AMA product. Although MPF and MPP offer different products with different risk-sharing structures, the basic AMA program elements are consistent. Following are some of the common elements found in both the MPF and MPP programs.

1) *Participating Financial Institution*. A PFI is a member or housing associate that has been approved to participate in the AMA programs. Both MPF and MPP use this term in common.

2) *PFI agreements.* An agreement between the FHLBank and PFI establishing the terms under which the PFI will deliver loans to the FHLBank and/or perform the servicing function. Under MPF, these agreements are known as "PFI Agreements." Under MPP, these agreements are known as "Mortgage Selling and Servicing Master Agreements."

3) *Master Servicer*. The MPF Provider (on behalf of the MPF-Banks) and each MPP-Bank have retained servicing firms to act as "Master Servicer." The duties of the Master Servicer include the supervision, monitoring, and oversight of the servicing of the mortgage loans and the performance of each "Servicer" of its duties and obligations pursuant to the FHLBanks' requirements. Both MPF and MPP use this term in common.

4) *Servicer*. Under both MPF and MPP, Servicers are required to be PFIs. The duties of Servicers include the collecting of funds from borrowers, preparing monthly accounting reports, reconciling cash flows, providing mortgage loan documents to a "Custodian," ensuring insurance is in force, and performing loss mitigation functions. Both MPF and MPP use this term in common.

5) *Custodial agreements.* This agreement establishes the rights and obligations of the Custodian. Under MPF, the custody agreement is between a Custodian and the MPF Provider. Under MPP, the custodial agreement is between the Custodian and the PFI.

6) *Custodian.* This designated institution verifies and maintains documents in connection with mortgage loans, including original notes and assignment of mortgages. Under MPF, the term "Custodian" is used. Under MPP, the term "Document Custodian" is used.

7) *Master commitments.* Under both MPF and MPP, the FHLBank and PFI sign Master Commitment Agreements that provide the terms under which the PFI may deliver loans to the FHLBank. Under MPF, these agreements are known as "Master Commitment Agreements." Under MPP, these agreements are known as "Master Commitment Contracts."

8) *Delivery commitments.* Delivery commitment agreements are entered into between the FHLBank and PFI. These commitments legally obligate the PFI to deliver loans with certain characteristics to the FHLBank within a specified period of time. Under MPF, these agreements are known as "Delivery Commitment Agreements." Under MPP, these agreements are known as "Mandatory Delivery Contracts."

9) *Accounts designed to absorb expected credit losses*. Under MPF, this account is known as the "First Loss Account" (FLA). Under MPP, the account is known as the "Lender Risk Account" (LRA).

MPF Products

When a member is approved as a PFI under MPF, the member immediately enters into a Master Commitment Agreement with the FHLBank. This agreement defines and specifies the funding terms, product type, credit enhancement and servicing fees, First Loss Account, and maximum credit enhancement. When the PFI is prepared to deliver loans under the Master Commitment Agreement, the member enters into a Delivery Commitment Agreement with the FHLBank. Once signed, the PFI is legally obligated to deliver the loans to the FHLBank. If the PFI fails to deliver the loans, the FHLBank, depending on the provisions of the Delivery Commitment Agreement, may assess the PFI a fee.

For each Master Commitment Agreement, the FHLBank allocates an amount to a specific off-balance sheet First Loss Account that represents the FHLBank's first loss exposure. The credit losses by the FHLBank are offset over time by the FHLBank withholding performance credit enhancement fees. The FHLBank will apply any realized loss remaining after the application to the First Loss Account to the PFI's credit enhancement obligation for the applicable master commitment. Any further realized loss remaining after applications to both the First Loss Account and the PFI's credit enhancement obligation will be allocated directly to the FHLBank. The FHLBank must secure credit enhancement obligations in parallel with the Federal Housing Finance Agency's requirements for securing advances.

The following briefly summarizes the seven different MPF products. Depending on the product, PFIs have the option either to sell closed loans to the FHLBank or to originate "flow" loans as agent for the FHLBank. For flow loans, the PFI performs its usual origination function; however, the FHLBank funds the loans at the time of closing. Since the FHLBank funds the loans, the PFI never books the loan as an asset on its balance sheet; the flow loans are an asset of the FHLBank immediately upon closing. The flow loan program is available only under the MPF 100 program described below.

1) *Original MPF*. Under Original MPF, the first layer of losses (following the application of any primary mortgage insurance) is applied to an FHLBank-funded FLA in an amount specified in the Master Commitment Agreement. The PFI then provides a second layer credit enhancement obligation for each master commitment sized to bring the master commitment to "AA" or equivalent rating. Loan losses that exceed the second layer are then absorbed by the FHLBank. For providing the credit enhancement obligation, the member typically is paid a fixed monthly credit enhancement fee specified in the Master Commitment Agreement. Only closed loans may be sold to the FHLBank under this product.

2) *MPF 100*. Under MPF 100, the FHLBank applies the first layer of losses (following the application of any primary mortgage insurance) to the FLA in the amount of 100 basis points of the aggregate principal balance of the MPF Loans funded under the master commitment. The PFI then provides a second layer credit enhancement sized to bring the master commitment to "AA" or equivalent rating. Unless otherwise agreed, the PFI's minimum credit enhancement obligation is 20 basis points based on the delivered amount. The FHLBank absorbs loan losses beyond the first and second layers. For providing the credit enhancement, the member is paid a fee specified in the Master Commitment Agreement. The PFI's monthly credit enhancement fee becomes performance based after the first two or three years, because the fee is reduced by losses charged to the FLA. The FHLBank may acquire only flow loans under this product.

3) *MPF 125*. Under MPF 125, the FHLBank applies the first layer of losses (following the application of any primary mortgage insurance) to the FLA in the amount of 100 basis points of the aggregate principal balance of the MPF Loans funded under the master commitment. The PFI then provides a second layer credit enhancement obligation sized to bring the master commitment to "AA" or equivalent rating. The FHLBank absorbs loan losses beyond the first and second

layers. Unless otherwise agreed, the PFI's minimum credit enhancement obligation is 25 basis points based on the delivered amount. The member receives a monthly performance-based fee specified in the master commitment agreement for providing the credit enhancement. Only closed loans may be sold to the FHLBank under this product.

4) *MPF Plus.* Under MPF Plus, the FHLBank applies the first layer of losses (following the application of any primary mortgage insurance) to the FLA equal to a specified percentage of the loans in the pool as of the sale date. The member procures additional credit enhancement in the form of a Supplemental Mortgage Insurance (SMI) policy to cover the second layer of losses. The SMI policy is generally written with a deductible that equals the amount of the FLA. Losses on the pool of loans not covered by the FLA and the SMI coverage are paid by the PFI, up to the amount of the PFI's credit enhancement obligation, if any, under the master commitment. The total credit enhancement for the pool of loans in a master commitment is set so as to achieve a credit level of "AA" or equivalent rating. The FHLBank pays the PFI a fixed and a performance-based credit enhancement fee specified in the master commitment agreement for providing the credit enhancement obligation. The fixed credit enhancement fee is paid monthly beginning the month after delivery. The performance-based fee accrues and is paid monthly commencing with the 13th month following delivery of the loans and is reduced by losses charged to the FLA. The FHLBank absorbs all losses in excess of the member's credit enhancement obligation. Only closed loans may be sold to the FHLBank under this product. The minimum size of a MPF Plus delivery commitment is $100 million.

5) *Original MPF for Federal Housing Authority/Veterans Administration Loans.* Under Original MPF for Federal Housing Administration (FHA) or Veterans Administration (VA) Loans, the PFI provides and maintains FHA mortgage insurance or VA guaranty for all loans. The PFI is responsible for compliance with all FHA/VA requirements and for obtaining the benefit of the FHA insurance or VA guaranty with respect to defaulted loans. The PFI is responsible for "unreimbursed servicing expenses" such as those amounts not reimbursed by the FHA or VA with respect to defaulted loans, in the same manner and to the same extent as is customary for Ginnie Mae loan servicers. Expenses that are neither covered by FHA insurance/VA guaranty nor included in the unreimbursed servicing expenses are the obligation of the FHLBank. The servicing fee for FHA insured/VA guaranteed loans is 44 basis points annualized. The PFI is paid a monthly government loan fee of two basis points annualized. Only closed loans may be sold to the FHLBank under this product.

6) *Shared Funding Program.* Under Shared Funding, PFIs sell MPF-eligible loans to a FHLBank of Chicago member (Depositor). The FHLBank of Chicago acts as agent for the Depositor in the sale of these loans. The Depositor will concurrently

sell those loans to a special purpose third-party trust that has been organized for the purpose of securitizing the mortgages into CMOs. The trust issues two certificates: an A Certificate and B Certificate. The A Certificate represents the senior investment-grade securities and the B Certificate represents the credit support tranches. The Depositor will initially acquire both the A and B Certificate CMOs and then subsequently sell all of the A Certificate CMOs to the FHLBank of Chicago. The Depositor may either hold the B Certificate CMOs in its own portfolio or sell all or a portion of them to other investors, which may or may not be FHLBank members. The FHLBank of Chicago may sell its interests in its acquired A Certificate CMOs, but only to other FHLBanks or to members of the FHLBank. All certificates issued by the trust will receive a public credit rating from an Nationally Recognized Statistical Rating Organization (NRSRO). Shared Funding is not an active program; only two Shared Funding transactions have occurred, both in 2003.

7) *MPF Xtra.* The MPF Xtra product allows PFIs to sell residential conforming fixed rate mortgages to the FHLBank of Chicago, which concurrently sells them to Fannie Mae on a nonrecourse basis. The mortgage loans are not assets of the FHLBank and are not reflected as assets on the balance sheet. Credit and market risk are transferred to Fannie Mae at the time of sale. The FHLBank of Chicago, as MPF provider, purchases the loans from the PFIs and sells the loans to Fannie Mae. The PFI receives the same price received from Fannie Mae less a fixed amount to cover marketing and operational costs and allow for a small profit to the FHLBank. Unlike the existing MPF products, the MPF Xtra product does not use the credit enhancement features of the Original MPF, MPF 100, MPF 125, or MPF Plus products.

MPP Products

Similar to MPF, the two primary agreements that must be in place in order for a PFI to sell loans to an FHLBank under MPP are the Master Commitment Contract and the Mandatory Delivery Contract. The Master Commitment Contract establishes the expected composition and dollar amount of the portfolio of mortgages to be sold to the FHLBank. The Master Commitment Contract also establishes the amount that must be funded to the LRA and the premiums payable to the SMI provider. Once the Master Commitment Contract is in place, the PFI may establish a Mandatory Delivery Contract that will be allocated against the Master Commitment Contract. If the PFI fails to deliver the balance of loans specified in the Mandatory Delivery Contract, the FHLBank will assess the PFI a pair-off fee in accordance with the terms of Mandatory Delivery Contract.

Under MPP, PFIs are able to sell closed loans to the FHLBank under two products: a conventional loan product and an FHA loan product. Both of the MPP products are very similarly structured to two of the MPF products. First, the MPP conventional loan product is similar in many respects to the MPF Plus product. The two are similar in that MPP-Conventional and MPF Plus both rely on SMI to cover a portion of the credit losses (after expected losses). Additionally, the MPP-FHA product is conceptually very similar to the Original MPF for FHA/VA Loans product.

For conventional loans sold under MPP, the first layer of credit losses (following the application of any primary mortgage insurance) is allocated to a LRA, which is established by the FHLBank on behalf of the PFI for each master commitment. The LRA covers expected losses and is funded by the PFI either up-front as a portion of the purchase proceeds ("Fixed LRA") or through a portion of the interest paid by the borrower ("Spread LRA"). In general, the amount deposited into the LRA is approximately 30 to 50 basis points of the original loan balance. The PFI is eligible to receive LRA refund payments net of losses pursuant to the Master Commitment Contract; generally, payments begin in the sixth year and end in the eleventh year.

For those programs that use SMI as a credit enhancement, the PFI was required to purchase SMI as an additional credit enhancement with the FHLBank listed as the insured. The coverage provided by the combination of the LRA and the SMI is considered sufficient loss protection to raise the asset to the equivalent of an instrument rated at least at the "AA" or equivalent level. However, in 2010, with no SMI providers rated "AA" or above, FHFA approved two FHLBanks to offer a new MPP product that relies on an enhanced LRA that brings the asset to a "BBB" level in lieu of SMI.

The MPP-FHA product does not require an LRA or SMI in order to meet the requirements of 12 CFR Part 955 because of the presence of government insurance. For loans sold to the FHLBank under this product, the PFI is required to meet the requirements established by the FHA.

Risks Associated with AMA Programs

The AMA programs subject the FHLBanks to various risks. The primary risks associated with these activities are credit, operational, and interest rate risk. The credit risks are tied to the credit quality of the mortgages (*e.g.*, delinquencies/defaults), as well as the financial condition of the PFIs. In addition, the FHLBank has credit risk exposure tied to the claims-paying ability of the mortgage insurer. Operational risks can arise from administering a program that involves participation from several business units (*e.g.*, credit, legal, accounting, information technology, and MPF/MPP) and third party vendors.

FHLBanks generally assume interest rate risk in the funding of mortgage related assets, such as AMA. Borrowers are able to prepay their mortgage loans at any time without penalty and, consequently, FHLBanks face the risk that they will experience a return of principal earlier than anticipated and be left to invest that principal at lower yields. Because prepayments on mortgages tend to accelerate when mortgage interest rates drop, acquired member assets display "negative convexity." In other words, the rate of price increase for mortgage assets declines as interest rate fall, depending on the underlying coupon(s) and the level of current market rates. As interest rates rise, prepayments tend to slow, creating extension risk, which is the risk that the expected maturity of the mortgage assets will lengthen in duration. The risk and returns in this business line must represent prudent interest rate risk management.

The FHLBanks must also be aware of risks associated with the use of the Mortgage Electronic Registration System ® (MERS). MERS is an electronic registry designed to track servicing rights and ownership of mortgages. Under AMA guidance for foreclosure, if MERS is the mortgagee of record, the servicer must prepare a mortgage assignment from MERS to the servicer. The assignment from MERS to the servicer must be recorded before foreclosure begins. Examiners should determine whether FHLBanks use tri-party agreements (Electronic Tracking Agreement ETA) to strengthen security interest in mortgage loan collateral registered with MERS. Without such agreements, a FHLBank's interest in some or all of a common member's registered loans may be ambiguous to MERS. An alternative for the FHLBank would be to pursue a written acknowledgment from MERS of access and control of all pledged member collateral at failure.

Examination Workprogram

The workprogram for the AMA examination module is detailed below. If this module is included in the examination scope, the examiner must perform worksteps sufficient in coverage to document the basis for conclusions on the quantity of risk and quality of risk management pertaining to this area. Transaction testing is mandatory and the examiner must evidence sufficient worksteps from Section 4, *Testing,* to support the findings and conclusions from this examination module.

In determining the extent of review and testing to be conducted in completing each examination, the examiner should take into account applicable FHFA off-site monitoring or analysis reports, such as analyses of the quality and effectiveness of corporate governance practices, financial condition and performance, economic and housing industry conditions, internal controls, and audit coverage relating to the institution's AMA activities.

NOTE: Text that appears in *italics* referenced in a workstep represents illustrative guidance and serves as suggestions for specific inquiry.

1. Scope of Examination Work Performed

1) Review past reports of examination and workpapers for outstanding issues or previous problems related to AMA.

2) Review applicable FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring, related to AMA.

3) Assess the status of any outstanding examinations findings (*e.g.*, Matters Requiring Attention or Violations) pertaining to AMA.

4) Review internal audit or quality assurance reports for outstanding issues relating to AMA.

5) Review minutes of meetings of the board of directors and relevant board and management committees for any issues regarding AMA.

6) Identify and evaluate the FHLBank's strategy for AMA. *(What are the risks and benefits of that business model?)*

7) Assess whether the business model used by the FHLBank for AMA is consistent with the FHLBank's broader strategic objectives and the needs of its members.

8) Identify and evaluate the FHLBank's pricing strategy for mortgage purchases. (*Does this strategy fully account for program costs and cost of funds? Does the strategy achieve the objectives stated for the FHLBank's AMA program?)*

9) Review the FHLBank's strategic business plan for compliance with 12 CFR Section 917.5(a) of the Finance Board regulations as it relates to AMA.

10) Evaluate any significant changes related to AMA that have been implemented since the last examination or are being considered that may affect the FHLBank's risk profile.

11) Review [for and address] any applicable portions of FHFA issued Advisory Bulletins or other examination guidance (Supervisory Directives or Examiner Practices Bulletins).

Summarize the work performed in the examination of the FHLBank's AMA program. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

2. Description of Risks

1) Review and evaluate the FHLBank's Risk Management Policy (RMP), or similar policy, to determine and identify what, if any, risk limits are established and how they are monitored. (*Are the established limits reasonable and appropriate? Are controls established adequate? Do the established limits appropriately mitigate potential risk to the FHLBank?)*

2) Review the Member Products Policy and evaluate the FHLBank's requirements for underwriting, collateralization, fees and pricing. *(Is the pricing sufficient to cover costs and to account for risk?)*

3) Assess policies and risk management practices the FHLBank implemented as part of its credit risk management program that establishes appropriate risk limits for, and appropriate mitigation of, credit exposure on nontraditional and subprime mortgage loans. (*Are established limits reasonable to mitigate potential risk exposure to the extent there are any nontraditional or subprime mortgages in the portfolio?)*

4) Review departmental policies and procedures. (*Are policies and procedures current, relevant, sufficiently detailed, and consistent with the FHLBank's policies and regulations? Do the policies provide adequate guidance in controlling risk to the institution? Do policies and procedures clearly define responsibility for adhering to established parameters? Are on-going reporting requirements established and reasonable to adequately monitor potential risk to the institution resulting from the AMA portfolio?)*

5) Review and evaluate the FHLBank's practices for managing risk through the use of credit enhancements. Evaluate the extent to which the FHLBank monitors PFIs to assess their ability to satisfy their credit enhancement obligations. (*Is the calculation adequate to control credit risk?)*

6) Evaluate the method used to determine the amount of Allowance for Loan Losses allocated to the AMA portfolio. *(Has the external auditor reviewed the reserves of the allocation methodology? Does the loan loss reserve calculation consider all potential risks to the FHLBank?)*

7) Determine if PFIs provide collateralization of their credit enhancement requirements. (*Evaluate and conclude on the adequacy of the collateral.)*

8) Evaluate the Supplemental Quality Control program implemented by the FHLBank. (*Does the program assess all potential risks to the institution resulting from the AMA program?)*

9) Determine if the FHLBank has established procedures to address risks associated with foreclosure of a mortgage that has not been repurchased by the PFI. *(Do the established procedures provide appropriate guidance to limit the loss exposure to the FHLBank? Have procedures established practices for recourse against the PFI if the quality of the mortgage purchased does not adhere to appropriate standards?)*

10) Determine if the FHLBank's foreclosure procedures when MERS is involved complies with AMA guidance and are followed.

11) Determine if the FHLBank has procedures to assess and monitor its risk exposure to mortgage insurance providers. (*Evaluate and conclude on the adequacy of the FHLBank's efforts to identify potential concerns with mortgage insurance providers.*

12) Determine if the FHLBank has any limits in place for mortgage insurer exposure. (*If so, evaluate the process for determining the limits and how the limits are monitored and reported.)*

13) Determine if the FHLBank has established procedures in the event of a PFI failure. (*Are procedures adequate to protect the FHLBank from loss?)*

14) Determine if the FHLBank has established specific limits for third party originations. (*Are the limits reasonable? Do the limits provide appropriate protection to the FHLBank from potential loss?)*

15) Determine if the FHLBank has established policies and procedures for monitoring third party vendors. *(What operational or other risks are posed by the FHLBank's third party vendor relationships? Has the FHLBank taken appropriate action to mitigate those risks through policy and procedural development and through contractual relationships with third party vendors?)*

3. Risk Management

Risk Identification Process

1) Based on worksteps performed under **Description of Risks**, assess and conclude on the adequacy of the organization's risk identification process. *(Has the FHLBank appropriately identified all areas of potential risk resulting from the AMA program? Is risk exposure monitored on an on-going basis? Does the FHLBank report on risk exposure to the appropriate parties within the organization? Has the identification of potential risk resulted in establishing appropriate controls for the AMA program?)*

2) Determine if the FHLBank has appropriately identified, monitored, and managed the credit, market, and operational risk issues related to AMA. (*Do FHLBank personnel coordinate the mitigation of such risks appropriately throughout the organization and among the divisions of the FHLBank? Coordinate examination activities with other examiners appropriately to ensure potential risk to the organization is assessed.)*

Organizational Structure

1) Identify the key personnel and their primary duties, responsibilities and technical expertise to determine if resources are effectively deployed to execute the FHLBank's AMA strategies.

2) Evaluate the staffing, segregation of duties, and cross-training of personnel to determine if resources are sufficient to execute the FHLBank's AMA strategies. (*Does staff have appropriate training and experience to carry-out their responsibilities within the organization? What steps has the FHLBank taken to address identified deficiencies in staff expertise? Are such steps appropriate?)*

3) Evaluate coordination between departments such as risk management, information technology, treasury and cash management, and accounting to determine if AMA

products are processed in an efficient and effective manner. (*Do different departments within the organization coordinate efforts to limit the risk exposure to the FHLBank resulting from the AMA program? How are these efforts coordinated? Does FHLBank staff make specific funding and hedging decisions related to AMA? How have such actions mitigated risk to the organization?)*

4) Evaluate the board of directors' committee structure and delegated authorities to determine if they are effective in helping the full board to understand the level of risk in the AMA portfolio. (*Do board committees report pertinent information to the full board appropriately? Do board and committee minutes reflect an understanding of pertinent issues related to the AMA program?)*

5) Evaluate management committees and delegated authorities to determine if they are effective in identifying and reporting the level and trends of risk in the AMA portfolio. *(Are there specific levels and trends of risk (or potential risk) which were not identified by FHLBank personnel or were not considered by management? If so, has management taken action to prevent the recurrence of such events in the future?)*

Policy and Procedure Development

1) Evaluate the FHLBank's pricing practices for consistency with Section 7(j) of the FHLBank Act. (*Have there been instances where pricing has not been consistently provided to all AMA providers? Has FHLBank personnel identified such instances? Have they taken appropriate corrective action?)*

2) Review any new AMA products offered by the FHLBank. (*Are internal controls sufficient to ensure compliance with applicable policies, regulations and risk limits? What new risks are presented to the FHLBank as a result of these new AMA products? Have appropriate policy and procedural controls been established to address these additional risks?)*

Risk Metrics

1) Evaluate any risk metrics established related to AMA. (*Do risk metrics appropriately considered all aspects of potential risk to the organization? Do these risk metrics consider potential credit, operational and market risks?)*

2) Determine if risk metrics are consistent with the risk appetite of the organization and sound risk management practices. (*Do risk parameters established for AMA result in risk exposure beyond the FHLBank's overall risk appetite?)*

3) Evaluate the adequacy of the board and management's efforts to ensure compliance with risk limits and performance metrics. (*Is information reported to the board and*

management accurate and comprehensive? What actions have been taken when risk limits and performance metrics are not met by the FHLBank?)

Reporting

1) Determine if management identifies all potential risks to the FHLBank resulting from AMA activities and monitors these risks. (*Is reporting adequate? Is information communicated in a comprehensive and meaningful fashion?)*

2) Determine if internal control weaknesses that could potentially affect financial reporting have been identified, assessed, and reported by FHLBank staff. (*Determine if the FHLBank has taken appropriate action to correct such weaknesses.)*

3) Review regularly produced reports related to AMA. *(Does on-going reporting evaluate the Bank's compliance with established risk metrics? Does information contained in delinquent loan reports from PFIs get used appropriately to evaluate potential risk?)*

   a) Consult with the examiner responsible for completing the Financial Reporting examination module to assess the accuracy of general ledger entries associated with AMA. (*Consider, for example, recordings of delivery commitments and loans; loan payments; and amortization of book value adjustments.)*

4) Obtain and review SAS 70 reports on organizations that provide services that could affect the FHLBank's financial condition. (*Does the information identify any potential concern from third party vendors in the AMA area?)*

Internal/External Audit

1) If there are no prior findings, select internal audits related to AMA and evaluate the adequacy of the scope, testing, and work papers completed by internal audit. (*Do procedures include testing for cases of fraud? Do pertinent audits consider the effect of risks emanating from the AMA portfolio to all areas of the organization?)*

2) For internal audits completed in the AMA area since the previous examination, consult with the Office of the Chief Accountant (OCA) regarding any findings about the adequacy of scope and testing by internal audit.

3) Coordinate with OCA to determine whether or not external audit performed work for AMA risk management and whether or not OCA performed an evaluation of the adequacy of the scope and testing completed by external audit.

4) Evaluate the adequacy of the scope and testing completed by external audit and determine the status of corrective actions for findings. (*Are all areas of potential risk*

considered? If not, why not? Are reasons for not including certain areas within the scope of the audit work reasonable and supported?)

5) Evaluate the effectiveness of the evaluations conducted pursuant to SARBOX that identify the key risks and controls pertaining to financial reporting and evaluate potential fraud, and procedures implemented to periodically attest to the adequacy of the control environment.

6) Evaluate the adequacy of the objectives and scope of reviews performed by outside consultants and determine the status of management's actions regarding recommendations. (*Are actions taken in response to consultant recommendations appropriate?)*

Information Technology

1) Identify and assess the automated and manual systems and applicable controls for processing AMA transactions, including:

   a) Loan origination system (LOS);
   b) Loan acquisition system (LAS), including tracking SMI and LRA;
   c) eMPF transactional website;
   d) Treasury pricing model (TPM);
   e) Loss allocation model (LAM);
   f) Authorized users;
   g) Financial modeling systems, including pricing models;
   h) Utilization of spreadsheets;
   i) Use of LEVELS to calculate credit enhancement;
   j) Calculation of capital requirements;
   k) Tracking delinquencies and foreclosures; and
   l) Business continuity and recovery.

2) Determine if the FHLBank's information systems are aligned with its goals and strategies.

3) Determine if the FHLBank has developed and tested a business continuity plan for the AMA area. (*Are systems specific to AMA considered in the business continuity plan? Does the FHLBank have appropriate actions in place to ensure the AMA program continues to operate despite unexpected interruptions? What additional steps are needed to ensure the FHLBank's operations are not adversely affected?)*

4) Determine if the FHLBank has developed a quality assurance framework to ensure information required in the FHFA Data Reporting Manual (DRM) is accurate. *(Has FHLBank management evaluated the accuracy of information received from the PFIs? Have appropriate steps been taken to address concerns identified by*

management? If PFI data received is modified by FHLBank staff, are adjustments appropriate?) Work with the examiner responsible for completing the Financial Reporting examination module for this examination in developing conclusions in this area.

Compliance

1) Evaluate if the FHLBank has appropriately complied with pertinent regulations and regulatory guidance. (*For instances of violations, identify the cause of the violation. Determine how internal controls should be strengthened to ensure there are no future regulatory violations.)*

2) Evaluate the efforts of the board of directors and management to ensure compliance with policies and procedures related to the FHLBank's AMA program. (*Conclude on the appropriateness of these actions. Has the board and management taken appropriate steps to address instances of non-compliance?)*

3) Assess compliance with Standard 6 (Management of Asset and Investment Portfolio Growth) and Standard 7 (Investments and Acquisitions of Assets) of FHFA's Prudential Management and Operations Standards at 12 CFR section 1236. (*Has the AMA portfolio experienced significant growth? What potential risks result from growth in the AMA portfolio? Has the board and management appropriately identified these risks and taken action to mitigate the risks to the FHLBank?)*

4) Evaluate compliance with any conditions imposed as part of the approval to conduct a new business activity related to AMA. (*Has the FHLBank complied with such guidance? If not, what additional controls should be in place to ensure the FHLBank complies with conditions imposed in the future?)*

4. Testing

1) Follow-up on previous examination findings and evaluate management's efforts to implement corrective actions.

2) Determine if management effectively corrected deficiencies noted by internal audit.

3) Select a sample of AMA loans purchased. Evaluate and conclude on the FHLBank's adherence to established risk limits and performance metrics. Specific examples of areas that might be tested include, but are not limited to, the following:

   a) Determine if restrictions exist upon access to the pricing models or, in their absence, compensating controls to ensure proper authorization of transactions such as dual control, limitations on system access or function capabilities, and managerial review;

b) Determine if the credit enhancement calculated by LEVELS or other appropriate model is appropriate;
c) Determine if loan servicing and collection efforts are in accordance with industry standards and the sub-servicing agreement between master servicer and sub-servicer;
d) Review changes to loan characteristics, such as FICO score, PFI, loan-to-value, geographic location, occupancy, and exceptions to underwriting guidelines, that do not require an adjustment or amendment to the governing master loan commitment;
e) Determine if administration of assets complies with Federal Housing Finance Agency regulations and AMA requirements;
f) Determine if document custody operations comply with AMA program requirements; and
g) Determine if the classification of specific AMA loan(s) or loan pools is consistent with the institution's internal loan classification system (if significant weaknesses are identified with the FHLBank's risk identification, loan classification policies and procedures, and credit and collateral monitoring, consider performing an adverse classification review).

4) Review a sample of AMA purchases to determine if the loan acquisition process is consistent with AMA program requirements. Consider:

   a) Compliance with Master Commitment Agreement;
   b) Loan valuation;
   c) Pricing;
   d) Credit enhancements; and
   e) Perfection of security interest.

5) Select a sample of loans deemed to be ineligible and evaluate appropriateness of the FHLBank's remedial action. *(Has the FHLBank been timely in requesting remedial action from the PFI? Does the presence of ineligible loans indicate a weakness in the FHLBank's internal controls?)*

6) Select a sample of AMA loans and evaluate the accuracy of information received from PFIs on specific loans in the AMA portfolio. Determine if the information reported to FHFA through the Data Reporting Manual guidance is accurate. *(Consider changes made to data received by the FHLBank and what is ultimately reported to FHFA. Are adjustments supported and reasonable? Is data provided accurate? Do the data provide for effective oversight of potential risk in the AMA portfolio?)* Coordinate work in this area with staff from FHFA's Supervisory Information Branch).

7) Select a sample of PFI reviews to determine if the PFI's quality control process meets the AMA Program requirements. (*Determine if the FHLBank's review of PFIs includes procedures to detect and report fraud.)*

8) Select a sample of PFI Approval reviews to determine if the FHLBank has sufficiently addressed the creditworthiness of the applicant and the quality of their underwriting. *(Has the FHLBank evaluated the PFI's adherence to underwriting standards? Has the FHLBank confirmed the PFI has appropriate internal controls to ensure the quality of the mortgage loans included in the FHLBank's AMA program?)*

5. Conclusions

1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff as it relates to the regulated entity's Acquired Member Assets program. Develop a memorandum articulating the risks to the institution resulting from the AMA program and the FHLBank's management of those risks. The memorandum should clearly and articulately describe the basis of conclusions reached and summarize the analysis completed. Within the memorandum, discuss the types of risk the FHLBank is exposed to as a result of the AMA program (*e.g*., market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the FHLBank's response to previous examination findings and concerns.

3) Develop findings and prepare findings memoranda, as appropriate. Based on examination work performed, develop findings communicating concerns identified during the examination. Findings should identify the most significant risks to the institution and the potential effect to the FHLBank resulting from the concerns identified. Such documents should describe a remediation plan specifying the appropriate corrective action to address examination concerns and establish a reasonable deadline for the regulated entity to remediate the finding. Communicate preliminary findings to the EIC.

4) Develop a list of follow-up items to evaluate during the next annual examination. In addition to findings developed in the steps above, include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the FHLBank is in the process of addressing, but require follow-up work to ensure actions are completed appropriately. In addition, potential concerns should

include anticipated changes to the institution’s practices or anticipated external changes that could affect the institution’s future oversight of the AMA program.

Workprogram

1. Scope of Examination Work Performed

Workpapers must document the examination activities undertaken to evaluate potential risks related to the AMA portfolio.

2. Description of Risks

- Identify areas of concern related to the AMA portfolio
- Assess current risks and trends in the risk to the organization emanating from the AMA portfolio
- Evaluate changes within the organization or industry affecting risk
- Evaluate the entity's own risk-identification practices and conclude on their adequacy

3. Risk Management

- Assess and conclude on the adequacy of the organization's risk identification process
- Assess and conclude on the overall adequacy of internal controls, including an evaluation of:
  - The FHLBank's organizational structure
  - Policy and procedure development for this area
  - Appropriateness of risk limits and performance metrics established in this area
  - Reporting by management and the board
- Assess and conclude on the internal and external audit of risks
- Assess and conclude on the adequacy of information technology and controls related to the AMA portfolio
- Assess and conclude on the adequacy of the organization's efforts to ensure:
  - Compliance with laws, regulations and other supervisory guidance
  - Compliance with the organization's policies and procedures

4. Testing

- Complete testing, as appropriate, to assess adherence with applicable standards

5. Conclusions

- Summarize conclusions for all examination work performed related to AMA
  - Conclude on the level of risk to the organization
  - Include an assessment of the adequacy of an organization's monitoring of risk and establishment of internal controls to mitigate risk
- Conclude on responsiveness to examination findings from previous examinations
- Develop findings as appropriate
- Identify areas requiring follow-up examination activities or monitoring