Federal Housing Finance Board
1777 F Street, N.W. Washington, D.C. 20006
Telephone: (202) 408-2500
Facsimile: (202) 408-1435
www.fhfb.gov

DRAFT

Mr. Charles L. Thiemann
President
Federal Home Loan Bank of Cincinnati
Post Office Box 598
Cincinnati, Ohio 45201-0598

Mr. Martin L. Heger
President
Federal Home Loan Bank of Indianapolis
Post Office Box 60
Indianapolis, Indiana 46206-0060

Mr. Norman B. Rice
President
Federal Home Loan Bank of Seattle
1501 Fourth Avenue, 19th Floor
Seattle, Washington 98101-1693

Gentlemen:

Thank you for your proposal regarding the Mortgage Purchase Program (MPP), to be offered by the Federal Home Loan Banks (FHLBank) of Cincinnati, Indianapolis, and Seattle. Federal Housing Finance Board (Finance Board) staff have completed a preliminary review of your proposal.

As described in your proposal, under MPP, members would underwrite and process mortgages using standards and paperwork similar to that currently used by Fannie Mae and Freddie Mac. The FHLBank would then purchase the mortgages, paying a higher price for the loan than the member would otherwise receive in the secondary market. The credit risk of the mortgage would be divided into three layers. The first layer of credit loss (to the extent not covered by any primary mortgage insurance required by conventional underwriting standards) would be absorbed by the member (through a lender risk account) and the second loss layer would be covered by mortgage insurance purchased by the FHLBank (insuring loans to a 60 percent loan-to-value level). All additional losses would be absorbed the FHLBank.

We are encouraged by the innovative idea put forth in your proposal and appreciate your efforts to address the operational issues you have identified in the Mortgage Partnership Finance™ (MPF) pilot program model. However, I believe your proposal would benefit from further development to achieve a program that better aligns the risks inherent in mortgage lending between the institutions best suited to manage those risks, i.e., allowing the FHLBanks to take advantage of their capital market expertise and member institutions to bear the credit risk. Although the first tier loss coverage described in your proposal is designed to insulate the FHLBank from credit losses, the FHLBank would in fact bear the risk of non-performance by the mortgage insurance company.

I agree with the suggestion in your letter that a meeting to discuss your proposal would be useful. Prior to our meeting, I encourage you to work with Finance Board staff in preparing a written supplement to your proposal that addresses the following matters.

- Side-by-side financial information, including data and a discussion, comparing the relative effects on the member and the FHLBank of MPP with: (a) MPF and (b) selling loans to the secondary market;

- Loss protection afforded the FHLBanks by MPP's proposed structure should be more fully and specifically addressed;

- Capital and accounting treatment of the lender risk account, as well as details regarding the ten year paydown schedule, should be discussed more thoroughly;

- A variation of the proposal that would involve arrangements between a member and insurance company (as a means to leave the credit risk with the member) should be considered and analyzed;

- The FHLBanks' use of Loan Prospector, Desktop Underwriter, and other scoring models as part of the program;

- The capacity of the FHLBanks and their members to include nonconforming (other than jumbo) loans as part of the program; and

- The FHLBanks' efforts to determine market demand for the product.

Finance Board staff should have the opportunity to review and comment on this supplement prior to our meeting. Please contact Scott Smith of the Office of Policy, Research and Analysis at (202) 408-2991 to coordinate this effort and to schedule our meeting. I look forward to meeting with you at your earliest convenience after the supplement has been submitted.

Sincerely,

DRAFT

Bruce A. Morrison
Chairman