

## **Federal Home Loan Bank of Indianapolis**

### **Subprime and Nontraditional Residential Mortgage Policy**

#### **Purpose and Intent**

The Federal Home Loan Bank of Indianapolis (“FHLBI”) supports the expansion of fair and equitable home ownership opportunities. While the FHLBI does not originate mortgages, it does accept residential mortgage loans as collateral to support advances, and it purchases such whole loans and mortgage-backed securities (“MBS”) for its portfolio from time to time. The FHLBI recognizes that some of these portfolios could contain loans which would be considered subprime or nontraditional mortgages, depending on the definition of such loans.

The Bank recognizes that, in the process of serving its members and facilitating their mortgage lending activities, it must accept a small level of credit risk. It also recognizes, however, that subprime residential loans possess a higher risk profile than conforming loans. Because the market value of subprime loans may deteriorate more rapidly under economic stress than conforming loans, such loans are more vulnerable to losses. Nontraditional loans also possess a higher risk profile.

This policy was developed in response to Federal Housing Finance Board’s Office of Supervision Advisory Bulletin 2007-AB-01 and establishes appropriate limits and mitigating controls for the Bank’s credit risk exposure to subprime and nontraditional residential mortgage loans in its member services products: Mortgage Purchase Program (“MPP”) and member collateral. This policy defines subprime and nontraditional residential mortgage loans as it applies to the FHLBI’s MBS portfolio, but all limitations, restrictions, and reporting requirements regarding the MBS portfolio are contained in the Risk Management Policy.

#### **Board and Management Reporting**

Members identified as subprime or nontraditional mortgage lenders will be reported to management and the Board on a semi-annual basis.

#### **Definitions**

The FHLBI recognizes that there is no industry accepted standard definition of a “subprime” or “nontraditional” mortgage; however, for purposes of this policy, the FHLBI will adopt the following definitions:

### Subprime Mortgage

Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

In an effort to avoid incorrectly identifying a prime loan as a subprime loan, a loan will be considered subprime under the following two conditions: First, absent additional mitigating or compensating factors, residential mortgage loans made to borrowers with FICO scores below 620. Second, absent additional mitigating or compensating factors, residential mortgage loans made to borrowers with FICO scores between 620 and 660 that include risk layering and adverse credit histories. Risk layering characteristics would include: debt-to-income ratios of 50% or greater, limited credit histories, and “reduced” or “stated” income documentation. Adverse credit histories include payment delinquencies, bankruptcies, charge offs or judgments.

### Nontraditional Mortgage

Residential mortgage products that allow borrowers to defer payment of principal or interest, such as interest-only mortgages, payment-option mortgages, and negative amortization mortgages are considered nontraditional.

### **Mortgage Purchase Program**

The FHLBI’s MPP was approved by the Federal Housing Finance Board (“FHFB”) to be an ‘A’ paper or prime mortgage loan program. The underwriting requirements of MPP have not diminished since inception of the program.

The FHLBI MPP was designed to manage credit risk for conventional loans largely through use of a Nationally Recognized Statistical Rating Organization (“NRSRO”) credit rating model. This model captures various risk characteristics to measure the expected credit risk in the portfolio of conventional loans purchased by FHLBI. The risk of loss to the FHLBI is minimized through a layered credit enhancement structure. Borrower equity, private mortgage insurance (“PMI”) (as applicable), the Lender Risk Account (“LRA”), and supplemental mortgage insurance (“SMI”) are in place prior to the FHLBI having exposure to credit loss risk.

Nontraditional and subprime conventional loans (as defined above) are not purchased by the FHLBI MPP. The MPP permits the purchase of FHA loans with low FICO scores only to the extent that such loans are insured by the FHA. Conventional loans acquired by MPP with FICO scores of 620 to 660 are not considered subprime due to other factors specific to the MPP. These factors

include: a maximum LTV of 95%, AUS (Automated Underwriting System) standard approval (no expanded criteria permitted), and a fixed rate / fixed term product. The minimum AUS approval for MPP is 'Approve / Eligible' (DU) and 'Accept / Eligible' (LP). AUS approvals below that level, such as 'Refer' or 'Caution' do not qualify for purchase under the MPP.

Participation in MPP requires sellers to implement (or maintain) their own quality assurance ("QA") program to verify their compliance with investor underwriting and documentation requirements. FHLBI performs a periodic review of the seller's QA program to confirm the seller's compliance

## **Member Collateral**

### **Mortgage Whole Loans**

Management will diligently strive to identify members who are pledging as collateral to the FHLBI pools of residential loans that are substantially comprised of subprime and/or nontraditional residential mortgages. Members whose collateral portfolios contain a minimal number of individual loans with subprime characteristics made as exceptions to prime risk selection criteria, prime loans that have developed credit problems, community development loans, and/or other such circumstances will not be considered subprime mortgage lenders. Procedures for identifying and monitoring subprime and nontraditional lenders will be maintained in the Collateral Procedures Manual.

Members pledging residential mortgage loans that have subprime mortgages exceeding 25% of their total pledged residential mortgage collateral will be identified as subprime residential mortgage lenders. Exceptions must be approved by the FHLBI Member Credit Committee and the ERM Committee.

Members pledging residential mortgage loans that have nontraditional mortgages exceeding 25% of their total pledged residential mortgage collateral will be identified as nontraditional residential mortgage lenders. Exceptions must be approved by the FHLBI Member Credit Committee and the ERM Committee.

### **MBS as collateral for advances:**

The types of mortgage loans securing MBS and CMOs have broadened and, with greater frequency, include subprime loans and nontraditional mortgage products such as payment-option ARMS, reverse mortgages, and interest-only mortgages. Securities backed by subprime loans and nontraditional mortgage products can carry additional credit risk and reputational risk.

In order to reduce the likelihood of exposing itself to additional credit and reputation risk, the FHLBI will, through a sample, perform a quarterly review of collateral securing advances backed by non-agency or private MBS and CMOs. Procedures for monitoring these types of pledged securities will be maintained in

the Collateral Procedures Manual.

### Requirements / Limitations

Members that have been identified as a subprime or nontraditional mortgage lender are subject to the following requirements:

1. Must execute standard Advances Pledge and Security Agreement (“APSA”), which places a lien on essentially all of the member's assets. Not eligible for specific lien-only agreement.
2. Must submit to comprehensive UCC-1 filing on all of the member's loans, receivables, and other financial assets, which legally perfects our interest in this collateral.,
3. Must operate under specific listings or physical possession collateral arrangement unless otherwise approved by the Member Credit Committee and reported to the ERM Committee.
4. Subject to full, on-site risk reviews of residential mortgage collateral on an annual basis.
5. The member will be placed on the Credit Watch List and will be fully analyzed by our underwriting department for financial condition and trends on a quarterly basis. The member's examination reports will be reviewed and summarized as the reports are made available by the member's primary federal regulator.

### **Member Compliance**

Periodic confirmation will be required from members subject to federal or state regulatory oversight that the member is complying with nontraditional residential mortgage and subprime mortgage lending guidance.

### **Effective Date**

This policy shall become effective on October 1, 2007.

This policy was first approved by the Federal Home Loan Bank of Indianapolis Board of Directors on June 14, 2007, effective June 30, 2007, and was amended on September 17, 2007.