FHLBI Shareholder Symposium

FHLBI's Mortgage Purchase Program:

Understanding the Value of Your Lender Risk Account

August 30, 2016

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Agenda

Welcome

- Updates on Mortgage Purchase Program (MPP)
- MPP Advantage program
  - Components of the various contracts
- Lender Risk Account (LRA)
  - Unique accounting characteristics to consider
- Other accounting matters
  - Derivatives and servicing

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MPP Advantage - Components of the contracts

There are three contracts in the program to fully understand:

- Selling & Servicing Master Agreement ("Master Agreement")
- Master Commitment Contract *
- Mortgage Purchase Program Mandatory Delivery Contracts *

There is also a Mortgage Purchase Guide to help you become an expert.

In all cases, the financial institution (you) = "seller"

* These contracts have specific accounting ramifications

MPP Advantage - Components of the contracts

Master Commitment Contract (MCC)

- Best efforts contract (not a derivative)
- Establishes an overall dollar commitment and “fill-up period”
- Loans sold may be aggregated with other sellers into pools (could have stand alone)
- The seller will service – fee set at 25bps
- Establishes general mortgage quality guidelines (FICO scores, terms, LTV, property types, etc.)
- Establishes the Lender Risk Account (shared risk; see pool above)
- Credit enhancement management is the responsibility of the FHLBI

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MPP Advantage - Components of the contracts

Mandatory Delivery Contract (MDC)

- Used to deliver individual contracts to the pools, filling up the MCC
- Represents a mandatory commitment (this is a *derivative*)

These derivatives have historically been the topic of much discussion-

- Some of our clients hedge informally
- Some hedge with intentional focus on maximizing the gains on transactions
    - Pair-off fees are planned and settled
    - Departments/individuals responsible on a daily basis

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Lender Risk Account (LRA)

LRA

- Established on behalf of the seller to provide first loss coverage (after any private mortgage insurance) for expected losses.

There are different types of LRAs. It is currently a “Fixed LRA” under the MPP Advantage program. Legacy portfolios could be under the “Spread LRA” program.

Major terms/components of the LRA:

- Assets of the seller held by the FHLBI. If losses occur, LRA funds for individual member are used first to cover before affecting the pool.
- Any excess LRA balances are returned to the seller based on a release schedule and loan performance.

Lender Risk Account (LRA)

Common LRA Questions:

- Is the LRA an asset? When do I get it back?
- Can there be losses in excess of the LRA?
- How do I account for the LRA?

Additional considerations:

- Shared risk

Before we get into the accounting matters, let's talk about the math a little!

Lender Risk Account (LRA)

Release schedule: $100,000 mortgage

LRA established at $1,200

(1.20% of the principal)

- Release to seller happens after year 5
- There is a fee paid to FHLBI at the time of release

LRA Potential Cash Flow

(assuming 0% losses)

Year after Contract Fill-up	Total LRA Retention %	Total LRA Balance	Total Potential LRA Release	Cumulative Potential LRA Release
0	100.0%	$ 1,200	$ -	$ -
1	100.0%	$ 1,200	$ -	$ -
2	100.0%	$ 1,200	$ -	$ -
3	100.0%	$ 1,200	$ -	$ -
4	100.0%	$ 1,200	$ -	$ -
5	93.8%	$ 1,125	$ 73	$ 73
6	87.5%	$ 1,050	$ 73	$ 146
7	79.2%	$ 950	$ 97	$ 243
8	75.0%	$ 900	$ 49	$ 291
9	68.8%	$ 825	$ 73	$ 364
10	64.6%	$ 775	$ 49	$ 412
11	58.3%	$ 700	$ 73	$ 485
12	55.4%	$ 665	$ 34	$ 519
13	52.5%	$ 630	$ 34	$ 553
14	49.6%	$ 595	$ 34	$ 587
15	46.7%	$ 560	$ 34	$ 621
16	43.8%	$ 525	$ 34	$ 655
17	40.8%	$ 490	$ 34	$ 689
18	37.9%	$ 455	$ 34	$ 723
19	35.0%	$ 420	$ 34	$ 757
20	29.2%	$ 350	$ 68	$ 825
21	26.3%	$ 315	$ 34	$ 858
22	23.3%	$ 280	$ 34	$ 892
23	14.6%	$ 175	$ 102	$ 994
24	11.7%	$ 140	$ 34	$ 1,028
25	8.8%	$ 105	$ 34	$ 1,062
26	0.0%	$ -	$ 102	$ 1,164
		Totals	**$ 1,164**	

Lender Risk Account (LRA)

Estimated losses (same example)

- The loss history of the entire pool will impact the LRA. The tables below depict the day 1 present value of cash flows under a range of loss assumptions (assuming a 4.5% cost of capital).

	Potential Cumulative Losses						
	0.00%	**0.10%**	**0.20%**	**0.30%**	**0.40%**	**0.50%**	**0.60%**
Cumulative LRA Release	$1,164	$1,067	$970	$873	$776	$679	$582
PV of LRA cash flow	$630	$574	$518	$461	$406	$350	$295
PV as % of Pool	0.63%	0.57%	0.52%	0.46%	0.41%	0.35%	0.29%

	Potential Cumulative Losses						
	0.70%	**0.80%**	**0.90%**	**1.00%**	**1.10%**	**1.20%**	**1.30%**
Cumulative LRA Release	$485	$388	$291	$194	$97	$0	$0
PV of LRA cash flow	$240	$185	$132	$82	$36	$0	$0
PV as % of Pool	0.24%	0.19%	0.13%	0.08%	0.04%	0.00%	0.00%

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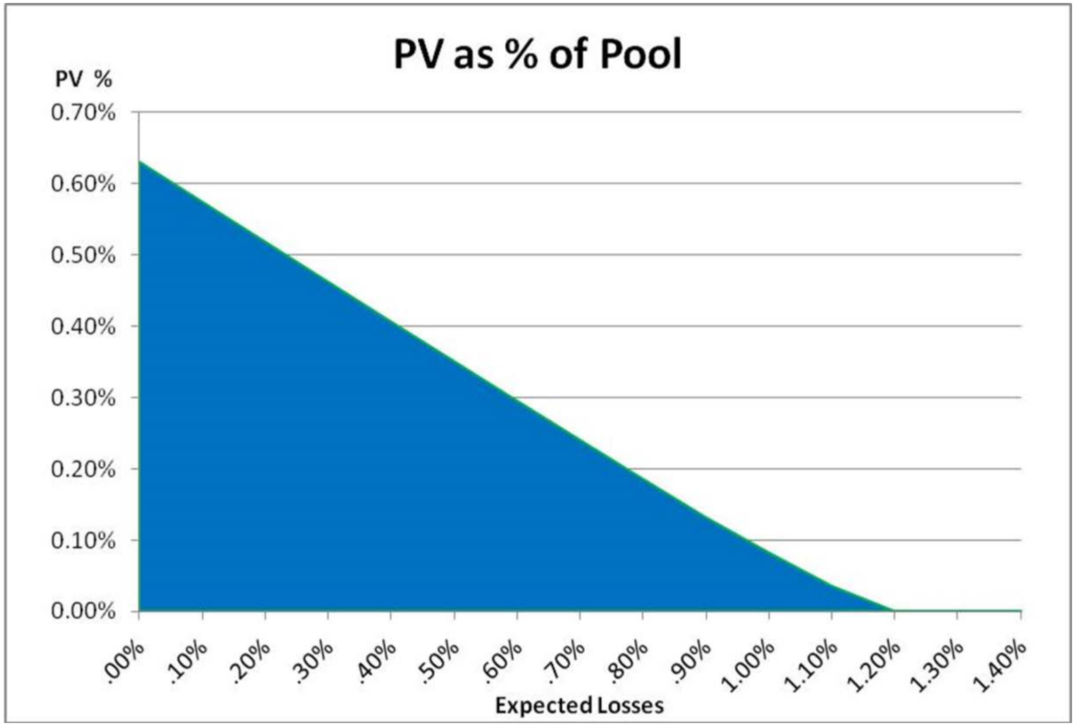
Lender Risk Account (LRA)

Consideration of the present value of cash flows and the loss estimates



Lender Risk Account (LRA)

Objective of the LRA from an accounting perspective

If the LRA represents an over-funding of the expected losses, then the present value of future cash flows should be considered an asset

- Recommendations
    - Monitor funded balances in the LRA and establish expectations for losses each period, similar to what you'd do on repurchase reserves. This will probably result in different 'tranches' – perhaps by year
    - Communicate with the FHBLI and track actual losses over similar periods
    - Review actual vs expected and update the analysis of the funded LRA balance vs. expected losses and adjust the general ledger to account

Lender Risk Account (LRA)

Getting back to some of the major questions:

In reviewing the MCC, the Seller must bear responsibility for expected losses on the mortgages sold to the FHLBI.

Q: So, should I record a liability for the repurchase reserve?

A: Possibly, for underwriting or servicing issues (rep and warrant violations)

Q: Ok, the question is how much?

A: Depends! *(I knew you'd like that).*

The liability should be established based on the expected losses.

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Other accounting matters

Typical mortgage banking derivatives

Interest Rate Lock Commitment (IRLC) – Meets definition of derivatives. These items must be measured at fair value each reporting period.

Forward sales commitments – Agreement to deliver loans that meet certain criteria to the secondary market within a specified time period

- *Best efforts terms are* NOT derivatives (but are financial instruments)
- *Mandatory terms* – meet the definition of derivative. These items must be measured at fair value each reporting period. MPP Advantage program is mandatory.

Critical reminder: Derivatives **MUST** be accounted for at fair value. Financial instruments **MAY** be accounted for at fair value.

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Other accounting matters

Accounting for mortgage derivatives

Interest Rate Lock Commitment (IRLC) – This should be considered separately from any contract to delivery to the secondary market and accounted for at fair value.

Example calculation of fair value at a point in time =

(Notional amount x (spot rate gain + servicing release premium – origination costs) x pull through rate) / 100

Mandatorily Deliverable – These contracts have a ‘pair off fee’ component. The fair value of these contracts can be estimated based on the pair off fee *that would be required* if the contract were cancelled. This can be an asset or liability.

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Other accounting matters

Accounting for servicing activities

The mortgage servicing right is an asset that should be accounted for at the time the loan is sold.

Guess what – There is another option! Fair value method or amortization method. They both start at the same value on day 1. Day 2 has some changes.

- Under the fair value method, the changes will be reflected in the income statement. Eventually, it will go to zero
- Under the amortization method, there is an amortization period (based on policy) to reduce the asset. Eventually, it will go to zero.

There is a need to monitor the fair value under both methods for ongoing review for possible impairment.

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Thank you!

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About Plante Moran

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