Subprime and Nontraditional Residential Mortgage Policy

September 16, 2022

Policy Information

Document Title:	**Subprime and Nontraditional Residential Mortgage Policy**
Document Owner:	**Senior Director of Underwriting & Collateral Operations**
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Chief Risk Officer Non-Objection Required:	**Yes**
Board-Level Approver:	**Board of Directors (Finance/Budget Committee)**
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CONTENTS

1. INTRODUCTION

The Federal Home Loan Bank of Indianapolis (Bank) is required to establish 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. The Bank has established this *Subprime and Nontraditional Residential Mortgage Policy* (Policy) to achieve these objectives.

1.1. THE RISK MANAGEMENT PROGRAM

This Policy is an integral part of the Bank's Risk Management Program, as described in the *Enterprise Risk Management Policy* (ERMP). This Policy constitutes a "Program Policy" within the ERMP.

1.2. SCOPE

This Policy applies to residential mortgage loans and mortgage-backed pledged to it as collateral, residential mortgage-backed securities acquired for its portfolio, and residential mortgage loans purchased by it under the Mortgage Purchase Program .

1.3. RELATED DOCUMENTS

Enterprise Risk Management Policy

Anti-Predatory Lending Policy

Risk Appetite Statement

Credit Policy

Mortgage Purchase Program Policy

Risk Appetite Statement Metrics

1.4. ROLES/RESPONSIBILITIES

Table 1. Subprime and Nontraditional Residential Mortgage Policy Roles and Responsibilities

Department/Officer/Working Group/Committee/Other	Brief Summary of Responsibilities
Board of Directors (Board)	Establishes the Bank's risk appetite in the Risk Appetite Statement (RAS); establishes risk limits in the ERMP; adopts and amends this Policy.
Finance/Budget Committee of the Board of Directors (Finance/Budget Committee)	Reviews and recommends amendments to this Policy to the Board of the Directors
Member Services Committee	Reviews and recommends amendments to this Policy to the Finance Committee.
Chief Risk Officer (CRO)	Reviews proposed amendments to this Policy; the CRO's non-objection is required to recommend amendments to the Policy.
Underwriting & Collateral Operations department	Owner of this Policy. Responsible for compliance with the Policy.
MPP department	Responsible for compliance with the Policy.

1.5. EXCEPTIONS

No exception to this Policy is permissible that may violate any requirement of applicable law, regulation, RAS, or ERMP.

Subject to the foregoing requirement, a business line manager may present a request for exception to a requirement of this Policy to the Chief Financial Officer (CFO), CRO, and Chief Business Operations Officer (CBOO). The request will include:

- Full disclosure of all material circumstances justifying the request;
- Full disclosure of identified feasible alternatives (if any) available to the Bank that may not involve exceeding a limit set forth in this Policy; and
- Management's reasoning why the request is justified.

Management will use its reasonable judgment in preparing the request; for example, a *bona fide* emergency may leave the Bank with insufficient time or resources to prepare a complete written analysis, and may permit only an oral disclosure. Requestors should prepare reasonable records of such requests as soon as may be done within the safe and sound operation of the Bank.

If the CRO and either the CFO or CBOO agree to the request, they may then propose the request to the CEO. If the request is not unanimous, the dissenting officer will explain the basis of his or her objection to the CEO.

The CEO may approve, condition, or deny the request in her or his discretion.

The manager requesting the exception will report each such exception to ERM, if granted, in a timely manner. ERM will monitor all such exceptions.

1.6. NON-COMPLIANCE

If a Bank employee, contractor, or officer detects non-compliance of this Policy, he or she will report it to his or her supervisor for remediation. The detecting employee, contractor, or officer or his or her supervisor will also report the non-compliance to Compliance Risk Management.

Non-compliance with this Policy may subject a person to discipline in accordance with the Bank's *Code of Conduct* and management judgment.

1.7. DISTRIBUTION OF POLICY

The Bank is required to post this Policy on its public Web site and make copies of this Policy available to Members to comply with the requirements of 2007-AB-01. The Board designates the Appendix as the "Policy" for purposes of posting on the Bank's website and Member Link for distribution of this Policy to Members.

2. POLICY

The statement of this Policy is set forth in the Appendix hereto.

3. AMENDMENTS

The Board may amend this Policy at any time.

4. APPROVAL AND REVIEW CYCLE

This Policy, as amended, is effective as of September 16, 2022. The Finance Committee will review this Policy, recommend any changes, and recommend Board approval at least once per calendar year.

5. RELEVANT AUTHORITIES AND REFERENCES

The following non-exhaustive list of authorities provide additional guidance relevant to this Policy.

Regulations:

- 12 C.F.R. Part 1239, *Responsibilities of Boards of Directors, Corporate Practices, and Corporate Governance*

Advisory Bulletins:

- 2007-AB-01, *Nontraditional and Subprime Residential Mortgage Loans*
- 2008-AB-02**,** *Application of Guidance on Nontraditional and Subprime Residential Mortgage Loans to Specific FHLBank Assets*
- 2010-AB-01, *Clarification of 2008-AB-02: Application of Guidance on Nontraditional and Subprime Residential Mortgage Loans to Specific FHLBank Assets*
- Federal Housing Finance Agency Questions and Answers concerning:
  (i) Advisory Bulletin 2007-AB-01: *Nontraditional and Subprime Residential Mortgage Loans*
  (ii) Advisory Bulletin 2008-AB-02: *Application of Guidance on Nontraditional and Subprime Residential Mortgage Loans to Specific FHLBank Assets*
  (iii) Advisory Bulletin 2010-AB-01: *Clarification to Advisory Bulletin 2008-AB-02*

6. DOCUMENT CHANGE RECORD

Management may update the information set forth in this § 6 at any time.

Version	Date	Description	Revised by
1.0	10/21/2016	Revised to reflect new policy template.	Board of Directors
1.1	07/22/2017	Updates to organizational roles, as well as general clean-up and consistency updates. Added missing Policy Exceptions language. Standalone FHFA terminology updated.	Credit Risk Director Policy Management CRO Board – Finance
1.2	06/28/2018	Content reviewed for annual maintenance. Owner of this Policy has been added as a responsibility of Credit Services. Additional applicable Advisory Bulletins have been added to Section 5, Relevant Authorities and References. Outdated language has been removed from the definition of *MBS as Collateral for Advances* in the Public Appendix. Use of “FHLBI” modified to match Bank rebranding/nomenclature direction from Corporate Communications. No other content changes made with exception of minor clean-up and re-marking of Policy versioning and dates.	Credit Risk Director Policy Management Compliance CRO Member Services Committee Board of Directors

1.3	09/20/2019	Update to reflect changes to an officer title and organizational roles	Credit Risk Director Policy Management Compliance CRCO Member Services Committee Board of Directors
1.4	9/17/2020	Update to reflect officer title/organizational change Updated Violations/Non-Compliance language to be consistent with other policies	Credit Risk Director Policy Management Member Services Committee Board of Directors
1.5	9/10/2021	Updated to reflect annual Finance Committee review and Board approval.	Credit Risk Director Policy Management Member Services Committee Board of Directors
1.6	9/16/2022	Updated to reflect officer title and departmental name change Updated “Noncompliance” and “Relevant Authorities and References” language to be consistent with other policies Updated Distribution of Policy language for added clarity	Senior Director of Underwriting & Collateral Operations Member Services Committee Finance/Budget Committee Board of Directors

The *Public Appendix* (Public version) of this Policy follows this section.

SUBPRIME AND NONTRADITIONAL RESIDENTIAL MORTGAGE POLICY STATEMENT

The Federal Home Loan Bank of Indianapolis (the "Bank") supports the expansion of fair and equitable home ownership opportunities. While the Bank 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 Bank 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 Agency'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 Bank's private label MBS portfolio, but all limitations, restrictions, and reporting requirements regarding the MBS portfolio are contained in other Bank policies.

Board and Management Reporting

In aggregate, member levels of estimated subprime or nontraditional mortgages pledged as collateral will be reported to management and the Board on a semi-annual basis.

Definitions

The Federal Home Loan Bank of Indianapolis (the "Bank") recognizes that there is no industry-accepted standard definition of a "subprime" or "nontraditional" mortgage. A mortgage or loan that is insured or guaranteed by the United States or any agency thereof, or otherwise is backed by the full faith and credit of the United States, and such insurance, guarantee, or other backing is for the direct benefit of the holder of the mortgage or loan, will NOT be considered subprime or nontraditional. For purposes of this Policy, the Bank 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:

1) Absent additional mitigating or compensating factors, residential mortgage loans made to borrowers with FICO scores below 620.
2) 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 (MPP)

The Bank's 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 the Bank. The risk of loss to the Bank 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) (as applicable) are in place prior to the Bank having exposure to risk of credit loss.

Nontraditional and subprime conventional loans (as defined above) are not purchased by the Bank's 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. The Bank 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 the amount of subprime and/or nontraditional residential mortgage loans pledged as collateral by each member. Procedures for identifying and monitoring pledged subprime and nontraditional mortgage loans will be maintained in the *Collateral Procedures Manual*.

Members pledging residential mortgage loans that have subprime or nontraditional mortgage loan concentrations exceeding baseline levels established in the Bank's overcollateralization methodology will have overcollateralization requirements increased to reflect the higher credit and liquidity risk associated with the concentration amounts. Subprime and nontraditional whole mortgage loans that are 30 days or more delinquent are ineligible collateral. The Bank's risk limits for subprime or nontraditional collateral will be maintained at the Member level and managed through increased overcollateralization requirements from analysis of on-site audit findings and/or monthly loan level reporting.

MBS as Collateral for Advances

The types of mortgage loans securing MBS and CMOs 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 Bank will, through a sample, perform a quarterly review of collateral securing advances backed by non-agency or private-label MBS and CMOs. In addition, members pledging private-label MBS or CMOs issued or acquired after July 10, 2007 will be required to obtain an enforceable representation and warranty from the issuer that the underlying residential mortgages included in the loan pools comply with interagency guidance (issued in 2006 and 2007 by federal banking agencies) or must be determined by the Bank that the underlying loans conform to interagency guidance. Furthermore, the member must certify receipt of and/or provide a copy of such representation and warranty to the Bank. Private-label MBS or CMO tranches backed by nontraditional and subprime collateral that have an interruption of actual cash flows are ineligible collateral. Procedures for monitoring these types of pledged securities will be maintained in the *Collateral Procedures Manual*. *Requirements/Limitations*

Members pledging residential loan portfolios with subprime or nontraditional mortgage loans concentration amounts exceeding 40% are subject to the following requirements:

- 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.
- 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.
- The member will be placed on the Credit Monitoring or Credit Watch List. If the member has credit products outstanding during the quarter, the member will be analyzed by our underwriting department for financial condition and trends on a quarterly basis. The member's examination reports may also be reviewed and summarized if the reports are made available by the member's regulator.
- Members are initially capped at a concentration limit of 50%. Any exception to the 50% limit must be approved by the Bank’s Member Services Committee at its next regularly scheduled meeting. If the Member Services Committee does not approve the exception, the member is limited to advances with a maximum term of six months until it complies with the limitation.

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 for loans originated or acquired after July 10, 2007.