Federal Housing Finance Agency
Office of Inspector General

FHFA's Oversight of the MPF Xtra Program

Evaluation Survey Report • ESR-2014-007 • April 22, 2014

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

April 22, 2014

TO: Fred Graham, Deputy Director, Division of Federal Home Loan Bank Regulation
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FROM: Richard Parker, Deputy Inspector General for Evaluations

SUBJECT: FHFA's Oversight of the Federal Home Loan Banks' Mortgage Partnership Finance (MPF) Xtra Program (ESR-2014-007)

Summary of this Memorandum

This memorandum closes our survey of the Federal Housing Finance Agency's (FHFA) oversight of the Mortgage Partnership Finance (MPF) Xtra program as administered by the Federal Home Loan Bank of Chicago (FHLBank of Chicago).

We conclude that FHFA's oversight of the MPF Xtra program is not ripe for evaluation at this time. Although there are unresolved issues related to FHLBank of Chicago's quality assurance processes, it appears that FHFA has been overseeing the FHLBank's efforts to remediate them. Accordingly, we will monitor developments in the MPF Xtra program and initiate future work on this topic as necessary.

Background

The twelve FHLBanks that comprise the FHLBank System[1] make secured loans, called advances, to their members.[2] Members, which are both owners and customers of their

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[1] The Federal Home Loan Bank (FHLBank) System was created by the FHLBank Act of 1932 to support mortgage lending and community investment. The FHLBank System is comprised of 12 regional banks and the FHLBank System's fiscal agent, the Office of Finance. The 12 FHLBanks are jointly and severally liable for each other's consolidated obligations. In the event of default, FHFA can "allocate the outstanding liability among one or more of the remaining [FHLBanks] on a pro rata basis or on any other basis that the FHFA may determine." FHLBank of Chicago, *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 25 (Mar. 13, 2014). For a description of the FHLBank System and its operations see OIG, *Semiannual Report to the Congress: April 1, 2013, through September 30, 2013*, at 45 (Oct. 31, 2013) (online at: http://www.fhfaoig.gov/Content/Files/SixthSemiannualReport_0.pdf).

[2] In total, the FHLBanks have about 7,500 members. Members of the FHLBanks include banks, thrifts, credit unions, insurance companies, or community development financial institutions.

FHLBanks, must purchase the FHLBanks' capital stock to obtain credit in the form of secured loans and letters of credit.

MPF – The Umbrella Program

In 1997, the Federal Home Finance Board (FHFB)[3] approved the creation of the Mortgage Partnership Finance (MPF) Program. The purpose of the Program is to create partnerships between FHLBanks and their small and mid-sized members by which the members gain greater access to the secondary mortgage market. The FHLBanks provide this access through sub-programs made available to the members under the MPF Program.[4]

The MPF Program is designed to allocate the risks associated with home mortgage finance between the member and its FHLBank. It is premised on the idea that members have expertise in lending and managing credit risk[5] and the FHLBanks have expertise in managing interest rate and prepayment risk.[6] Essentially, an FHLBank purchases loans from its members and takes on the associated prepayment and interest rate risks. The FHLBank manages the loans by hedging the interest rate and prepayment risks. The member, which has sold its loans to the FHLBank, continues to receive income from originating and servicing the loans and, thus, retains the servicing risk.[7] Both the FHLBank and the member share the risk of loss.

MPF Xtra

In October 2008, FHFA announced the MPF Xtra program. Under it, the FHLBank of Chicago purchases conforming fixed rate residential mortgages from participating members across the FHLBank System and concurrently sells them to the Federal National Mortgage Association (Fannie Mae).[8] Thus, MPF Xtra provides small- and mid-size members with greater access to the secondary mortgage market, the corresponding liquidity, and several additional advantages. These additional advantages distinguish MPF Xtra from the other MPF sub-programs.

Under MPF Xtra, the members – called Participating Financial Institutions (PFIs) – transfer to Fannie Mae the interest rate, prepayment, and credit risks associated with the loans they sell, but

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[3] FHFB was the regulator of the FHLBanks until the Housing and Economic Recovery Act of 2008 (HERA) replaced it with FHFA.

[4] These programs include the Original MPF, MPF 100, MPF 125, MPF Plus, MPF Government, and MPF Xtra. We surveyed FHFA's oversight of the FHLBank of Chicago's administration of MPF Xtra – a newer MPF program.

[5] Credit risk refers to the risk that a borrower will default on a mortgage.

[6] Interest rate risk refers to the risk that changes in interest rates may adversely affect an institution's financial condition. Prepayment risk refers to the risk that mortgages will be paid off early resulting in less interest income for the holders of the debt.

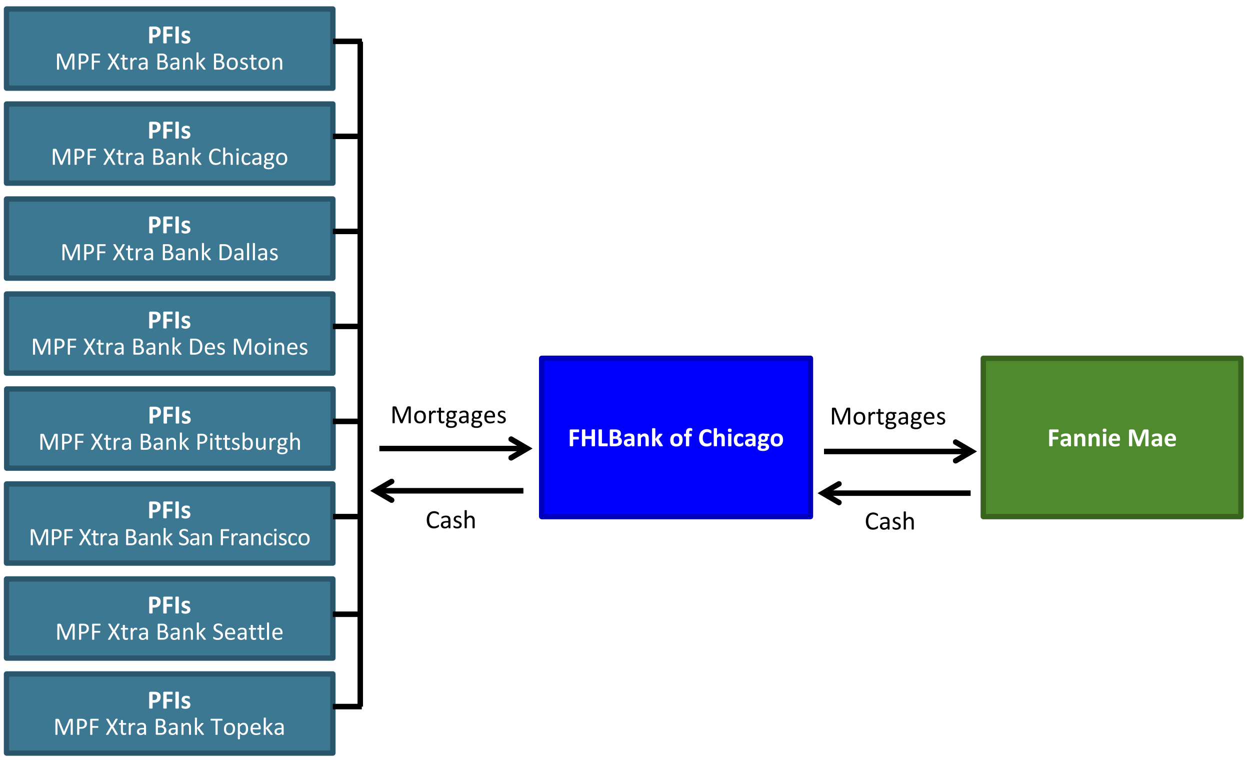
[7] The MPF Program permits members to choose a service release option under which they may sell their servicing rights to another member.

[8] Fannie Mae is currently the only investor in the MPF Xtra program. Officials of the FHLBank of Chicago told us that it is working with the Federal Home Loan Mortgage Corporation (Freddie Mac) to assess the feasibility of Freddie Mac becoming an investor in the MPF Xtra program.

generally retain the servicing rights and the fees they generate.[9] Since the PFIs do not retain credit risk associated with the loans sold under MPF Xtra they are not subject to any risk-based capital or credit risk collateral requirements. Moreover, there are no leverage capital requirements for PFIs that are depository institutions.

As illustrated in Figure 1, the MPF Xtra program works as follows: PFIs from each MPF Xtra Bank[10] originate and sell fixed rate, conforming loans directly to the FHLBank of Chicago.[11] The FHLBank of Chicago immediately sells these MPF Xtra loans to Fannie Mae.[12] The FHLBank of Chicago earns fees for its services.

FIGURE 1. MPF Xtra Transaction



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[9] Smaller members that sell loans to Fannie Mae normally do so through third party loan aggregators. The aggregators may require the members to surrender their servicing rights as a condition of the transaction.

[10] FHLBanks that FHFA has authorized to participate in MPF Xtra are called MPF Xtra Banks. Among other things, they certify their members to participate in MPF Xtra pursuant to guidelines established under the MPF Xtra program.

[11] The PFIs sell MPF Xtra loans directly to FHLBank of Chicago regardless of whether or not the PFI is a member institution of the FHLBank of Chicago. Further, the FHLBank of Chicago's own PFIs sell MPF Xtra loans to it just as the PFIs of other MPF Xtra Banks sell loans to it. Thus, the FHLBank of Chicago is represented on both the left and right hand sides of Figure 1.

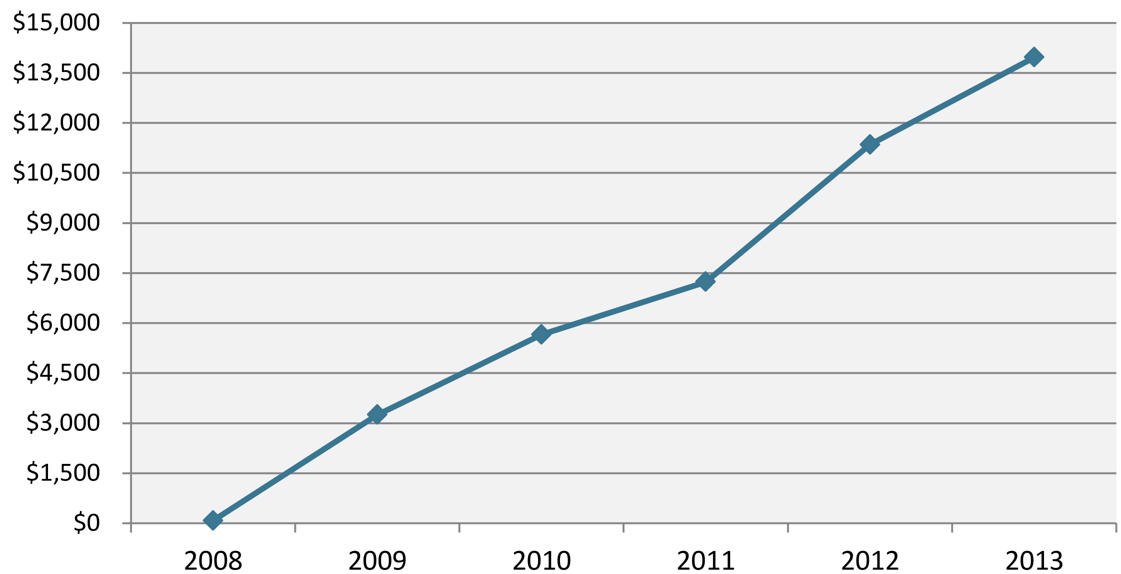
[12] The FHLBank of Chicago sells the MPF Xtra loans to Fannie Mae for cash. Thereafter, Fannie Mae may securitize the mortgages and sell the resulting mortgage-backed securities to investors.

The FHLBank of Chicago is responsible for the representations and warranties associated with the mortgages that it sells to Fannie Mae under the MPF Xtra program.[13] If Fannie Mae determines that a representation or warranty was breached, then it can require the FHLBank of Chicago to repurchase the MPF Xtra loan. The FHLBank of Chicago may, in turn, require the PFI to repurchase the mortgage from it. If the PFI has failed, however, then the MPF Xtra Bank of which the PFI is a member assumes the fallen PFI's repurchase obligation. In its 2013 Annual Report, the FHLBank of Chicago estimated that its mortgage repurchase liability to Fannie Mae for MPF Xtra loans as of December 31, 2013 was less than $1 million.[14]

MPF Xtra Loan Volume

The number of MPF Xtra Banks participating in the MPF Xtra program has increased since it began in 2008. As of January 2014, there were eight MPF Xtra Banks offering MPF Xtra, three of which joined in 2013.[15] The MPF Xtra program has been a growing business for the FHLBank of Chicago. As depicted in Figure 2, the growth is due to an increase in the volume of MPF Xtra loans.

FIGURE 2. Total Aggregate Outstanding Unpaid Principal Balance of MPF Xtra Loans ($ millions)



Source: FHLBank of Chicago.

[13] Representations and warranties are assurances that lenders make to the Enterprises about the quality of loans being purchased or guaranteed by the Enterprises. If an Enterprise determines that a loan does not meet the criteria that the lender claimed the loan met, then the Enterprise may issue a request to the lender to repurchase the loan.

[14] *See* FHLBank of Chicago, *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 74 (Mar. 13, 2014).

[15] The FHLBanks of Chicago, Boston, Des Moines, Pittsburgh, Topeka, Seattle, San Francisco, and Dallas offer MPF Xtra to their members.

FHFA officials consider MPF Xtra to be a small FHLBank program even though MPF Xtra loan volume has increased substantially since the program began in 2008. In 2013 the MPF Xtra program represented 20% of the FHLBank of Chicago's member-focused business of approximately $71 billion, up from 18% in 2012 and 12% in 2011.[16] MPF Xtra loans represent only one to two percent of Fannie Mae's single-family loan acquisitions. So, although MPF Xtra has grown steadily, the small size of the program relative to the FHLBank's and Fannie Mae's other business lines indicates that it presents minimal risk to the FHLBank and Fannie Mae.

FHFA Mandates Improved Quality Assurance Process

In 2012, FHFA conducted its annual examination of the FHLBank of Chicago. During the credit risk portion of the examination, FHFA identified a number of issues related to the quality assurance process for the entire MPF Program.[17] Based on its examination, FHFA directed the FHLBank of Chicago to enhance and standardize its quality assurance process. Thereafter, the FHLBank:

- Consolidated risk management operations under a single division at the FHLBank of Chicago, called Risk Management and Strategic Initiatives.
- Revised its sampling methodology in January 2014 by increasing the sampling minimum for MPF Xtra loans to 10% for all PFIs to meet the minimum quality assurance standards set by Fannie Mae.
- Increased the frequency of its quality assurance reviews to sample loans on a monthly cycle rather than sampling in arrears on an annual cycle.

In addition, the FHLBank of Chicago is engaged in the development of an MPF Risk Framework. The framework outlines the processes for identifying, assessing, and mitigating risks associated with the purchase and sale of loans under the entire MPF Program. It is organized around 11 core issues.[18]

The MPF Risk Framework is intended to provide written guidelines by which regular assessments may be made in the major risk management areas. It is also intended to provide a

[16] In addition to the MPF Xtra program, the FHLBank of Chicago's member-focused business activities include other MPF programs, advances, and standby letters of credit. The FHLBank of Chicago's total member-focused business for 2012 and 2011 was $62 billion and $61 billion, respectively.

[17] For example, FHFA found problems with the threshold analysis used to determine the sample size of loans to be reviewed for each PFI. The methodology was designed to automatically decrease the sample size for PFIs that had a nominal incidence of loan defects. FHFA, however, found that a similar policy did not exist to automatically increase the sample size for PFIs that had a high incidence of loan defects. Additionally, FHFA found no instances where the sample size was increased for a PFI with a high loan defect rate.

[18] The core issues are: (1) Market Research; (2) Quality Control Sampling Methodology; (3) Quality Control Standards and Process for Documentation; (4) Quality Control Standards and Process for Judgment/Remediation; (5) Quality Control Standards and Process for Reporting; (6) Quality Control Standards and Process for Vendor Management; (7) PFI Standards; (8) PFI Rating Methodology; (9) Servicing; (10) PFI Training; and (11) Governance.

platform upon which risk management groups may work collaboratively to improve performance reporting, tracking, and PFI support. For example, future onsite training will be customized for each PFI in that it will be directed toward the resolution of issues identified during recent quality control assessments of the institution.

Officials from the FHLBank of Chicago regularly meet with FHFA to discuss their progress in implementing the MPF Risk Framework, and FHFA expects it to be fully operational by July 2014.

Conclusion

Although there are unresolved issues related to the FHLBank of Chicago's quality assurance process, we found that FHFA has been actively overseeing the FHLBank of Chicago's remediation efforts. Thus, we conclude that FHFA's oversight of the MPF Xtra program is not ripe for evaluation at this time. We will monitor developments in the MPF Xtra program and initiate future work on this topic as necessary.

Scope and Methodology

The purpose of this memorandum was to assess FHFA's oversight of the MPF Xtra program.

To achieve this objective, we reviewed publicly available information regarding the MPF Xtra program. We interviewed FHFA officials and FHLBank of Chicago management officials. We also obtained and reviewed documents and data from FHFA, the FHLBank of Chicago, and Fannie Mae. These included risk assessments, contracts, and loan defect rate data. Using publicly available data, we calculated the MPF Xtra program as a percent of the FHLBank of Chicago's total member-focused business; and we also calculated the percent of MPF Xtra loans that make up Fannie Mae's single-family loan acquisitions. We did not independently test the reliability of the data.

Our work was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform a survey that results in evidence sufficient to support reasonably the conclusions made herein. We believe that the conclusions contained in this memorandum meet this standard.

The performance period for this survey was from September 2013 to March 2014.

This survey was led by Investigative Counsels Adrienne Freeman and Alexa Strear. Assistance was provided by David P. Bloch, Director, Division of Mortgage, Investments, and Risk Analysis; and Angela Choy, Director, Division of Fraud Prevention and Program Management.

We appreciate the cooperation of FHFA, the FHLBank of Chicago, and Fannie Mae staff, as well as the assistance of all those who contributed to the preparation of this report. It has been distributed to Congress, the Office of Management and Budget, and others and will be posted on OIG's website, www.fhfaoig.gov.

cc: Melvin L. Watt, Director
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