Introduction

In December 1996, the Finance Board authorized the Federal Home Loan Bank (FHLBank) of Chicago's Mortgage Partnership Finance ® (MPF) program. Authorized on a pilot basis, the MPF program was the first mortgage purchase program. In 1999, with the adoption of Resolution Number 1999-50, as modified by Resolution Number 1999-66, the Finance Board broadened the FHLBanks' authority and to emphasize that the mortgage programs must involve credit risk-sharing with FHLBank System members or housing associates. It was the view of the Finance Board that the expansion of the mortgage programs would provide the FHLBanks with a vehicle to reduce the amount of non-mission related investments financed by GSE borrowings.

In July 2000, the Finance Board adopted Part 955 to its regulations governing Acquired Member Asset (AMA) activities, which codified many of the parameters for AMA programs that were previously set forth by Finance Board resolution and established new requirements. With the adoption of Part 955, the previously-approved mortgage programs moved from pilot to permanent status.

To date, two separate mortgage programs have been authorized under Part 955 – the MPF program and the Mortgage Purchase Program (MPP). Since the FHLBank of Chicago was first approved to offer MPF to its members on a pilot basis, all of the FHLBanks have received Finance Board approval to offer MPF and/or MPP to their members. Members may participate in the MPF and MPP programs through various products with differing credit risk-sharing structures.

Except for the FHLBank of Chicago's Shared Funding® (Shared Funding) Program, an MPF product, the AMA products are structured such that the FHLBanks acquire, either through a purchase or funding transaction, whole, single-family mortgage loans from their members. Products exist for both conventional and government- guaranteed or-insured loans. The risks associated with the mortgages are such that the FHLBank manages the interest-rate risk and the member manages a substantial portion of the risks associated with originating the mortgage, including a substantial portion of the credit risk. Part 955 requires that the member provide a credit enhancement sufficient to enhance the credit quality of the assets to an equivalent of an instrument rated at least investment grade. The member may provide this credit enhancement through various means.

Shared Funding currently is the only AMA product under which the FHLBank may acquire interests in whole loans.

Regulatory Environment

The primary authorities governing, or relevant to, AMA activities of the FHLBanks are set forth below. The discussion does not address the application of authorities other than the FHLBank Act and the regulations, interpretations and issuances of the Finance Board to the FHLBanks. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

1) ***Rules and Regulations of the Federal Housing Finance Board, which include the following parts and sections relevant to AMA activities:***

Part 955, setting forth requirements for FHLBank participation in AMA programs and activities. The regulation's four main elements are as follows:

a) Three-part test to determine AMA eligibility;
b) Regulatory reporting requirements;
c) Administrative transactions between FHLBanks; and
d) Risk-based capital requirements for AMA.

Part 917 of the Finance Board regulations addresses powers and responsibilities of FHLBank boards of directors and senior management. In particular, Section 917.3, Risk Management, Section 917.4, Bank Member Products Policy, Section 917, Strategic Business Plan, and Section 917.6, Internal Control System, are pertinent.

Part 980, defining and setting forth the procedural requirements regarding FHLBank's new business activities. With respect to AMA, a new business activity is considered one in which the FHLBank is involved in either managing a risk or undertaking operations that it has not previously or regularly managed. The new business activity regulation prohibits FHLBanks from undertaking a new business activity without first complying with the requirements of the regulation.

2) ***Advisory Bulletins of the Federal Housing Finance Board*** that provide supervisory guidance relating to the topic of AMA activities are the following:

Advisory Bulletin 01-1, dated January 24, 2001, provides that an FHLBank acquiring AMA must seek to collect and have in place a system that is capable of accepting all data elements specified in Section 955.4 and Appendix A thereto.

Advisory Bulletin 01-2, dated January 24, 2001, provides that an FHLBank must maintain a security interest in collateral that is sufficient to fully secure the member's retained credit enhancement, over and above the collateral that is necessary to support any advance or other obligation of the member to the FHLBank.

Advisory Bulletin 01-6, dated June 13, 2001, provides the format under which the FHLBank must submit quarterly aggregate data, as required under Section 955.4.

Advisory Bulletin 01-7, dated August 8, 2001, provides the format under which the FHLBanks must submit year-to-date and program-to-date loan-level data.

Advisory Bulletin 01-8, dated October 4, 2001, provides guidance to the FHLBanks in establishing procedures to address the periodic review, classification and reporting of problem assets.

Advisory Bulletins 02-03, dated February 13, 2002 and 03-2, dated February 10, 2003, provides guidance on specific attributes to be considered by FHLBanks in the formation of their business continuity plans and the establishment of bilateral agreements with other FHLBanks.

Advisory Bulletin 03-6, dated May 9, 2003, addresses the FHLBanks' use of nationally recognized statistical rating organization (NRSRO) models for loans that may be secured by real property located in Georgia and originated between October 1, 2002, and March 7, 2003. The Advisory Bulletin instructs the FHLBanks to implement procedures to screen out these Georgia loans prior to purchase.

Advisory Bulletin 03-12, dated December 3, 2003, provides that each FHLBank should establish policies that include criteria to determine individual exposure limits to each SMI provider based on an independent credit analysis of the provider.

Advisory Bulletin 04-01, dated March 10, 2004, provides guidance on the evaluation of an organization providing services to an FHLBank whose activities could affect the FHLBank's financial condition. This includes the performance of an assessment of the service organization's internal controls, including the procurement of a service auditor's report in accordance with Statement of Auditing Standards No. 70, Reports on the Processing of Transactions by Service Organizations (SAS 70), or the performance of alternative methods necessary to gain confidence on the service organization's internal controls.

Advisory Bulletin 04-4, dated August 12, 2004, affirms that the pool size adjustment factor in LEVELS must always be used to calculate the credit enhancement for the pool, regardless of the size of the pool. In addition, the Advisory Bulletin provides that for pools to which the pool size adjustment factor was not properly applied, the FHLBank must recalculate the credit enhancement and allocate additional capital as necessary.

Advisory Bulletin 05-5, dated May 18, 2005, provides guidance on the risk management responsibilities of the FHLBank's board of directors, senior management and risk management function.

Advisory Bulletin 05-08, dated August 25, 2005, provides guidance on establishing anti-predatory lending policies to govern the FHLBank's purchasing of mortgages and calculating the level of advances that can be made to its members.

Advisory Bulletin 07-01, dated April 12, 2007, which establishes regulatory expectations for the FHLBanks to adopt and implement policies and risk management practices that establish appropriate risk limits for, and appropriate mitigation of, credit exposure on nontraditional and subprime mortgage loans.

3) ***Regulatory Interpretations of the Federal Housing Finance Board are the following:***

   Regulatory Interpretation 2000-25, dated November 17, 2000, addresses some of the factors that should be considered in determining if assets meet the valid business purpose requirement of Part 955. The Regulatory Interpretation specifies that a member must have meaningful influence over or control of the assets being acquired by the FHLBank. Assets will not be considered eligible as AMA if they are merely passed from a nonmember through a member to an FHLBank without the same or equivalent degree of scrutiny as would have been the case if the member had originated the asset itself.

   Regulatory Interpretation 2002-02, dated March 6, 2002, provides that under Part 955, a Participating Financial Institution (PFI) may sell the servicing rights associated with a mortgage loan to a PFI other than the PFI responsible for the credit enhancement.

   Regulatory Interpretation 2002-03, dated March 6, 2002, provides that an FHLBank may obtain pool insurance to supplement the credit enhancements provided by the member. Within the context of the credit enhancement structure, the pool insurance must follow the more credit enhancement components such as the first loss account and the supplemental mortgage insurance.

   Regulatory Interpretation 2005-05, dated October 21, 2005, provides that Part 955 does not allow an FHLBank to sell or transfer either the mortgage loans or the related PFI-provided credit enhancement obligation while continuing to hold the other piece of the transaction.

4) ***New Business Activity Approval Letter-FHLBank of Chicago Shared Funding Program:*** By letter dated December 4, 2002, from the Finance Board's Office of General Counsel, agency staff approved the FHLBank of Chicago's new business activity request regarding Shared Funding. This approval applied only to Shared Funding transactions as described in the FHLBank of Chicago's submissions and imposed certain conditions on the FHLBank and product.

5) ***Statements of Financial Accounting Standards (collectively, Statements of Financial Accounting Standards or individually, SFAS) adopted by the Financial Accounting Standards Board*** establish standards of financial accounting and reporting governing the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Accountants. Specific Statements of Financial Accounting Standards applicable to AMA activities include, but are not limited to the following:

   a) SFAS 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases, prescribes accounting standards for nonrefundable fees and costs associated with loans, commitments to lend, and purchases of one or more loans or group of loans. In addition, the statement prescribes permissible accounting treatment for direct fees and costs associated with leasing.

b) SFAS 114, as amended by SFAS 118, Accounting by Creditors for Impairment of a Loan, requires a creditor to recognize loan impairment through the creation of a credit loss reserve and a charge to bad debt expense. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. This statement is applicable to advances and to AMA.

c) SFAS 133, Accounting for Derivative Instruments and Hedging Activities, prescribes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities.

FHLBank Environment

AMA Programs

Two AMA programs have been authorized by the Finance Board – Mortgage Partnership Finance (MPF) and Mortgage Purchase Program (MPP). In order to offer MPF and/or MPP to its members, each FHLBank underwent an application process with the Finance Board. This application process included a safety and soundness examination to verify that the FHLBanks had in place adequate policies, procedures, and controls to manage the risks presented by these programs.

For MPF, the FHLBank of Chicago serves as "MPF Provider," providing operational support to all of the other MPF-Banks as permitted under Section 955.5(a). The services the FHLBank of Chicago provides include program development, pricing, legal services, marketing, quality control, accounting, processing, development of underwriting and other processing guides, policies, and procedures, and maintenance of the MPF website. The FHLBank of Chicago annually obtains a Type II SAS 70 report from its external auditor covering its MPF program that documents and tests the design and operational effectiveness of internal controls the institution has established in connection with the program.

In contrast, each MPP-Bank conducts its own back-office operations and operates independently from the other MPP-Banks. Unlike the MPF-Banks, each MPP-Bank has autonomy over its own processes, including pricing and execution.

The MPF-Banks and MPP-Banks maintain written guides that govern their respective administration of the AMA programs. The guides, at a minimum, govern origination, underwriting and servicing. Collectively, these materials are generally referred to as "FHLBank Guides."

The AMA programs are designed, pursuant Part 955, such that the FHLBanks manage the interest rate and prepayment risks while the FHLBanks share credit risk with members and housing associates. With the exception of certain AMA programs approved by the Finance Board at the time of Part 955's adoption, members or housing associates bear the direct economic consequences of actual credit losses on an asset or asset pool either (i) from the first dollar of loss up to the amount of expected losses or (ii) immediately following expected losses, but in an amount at least equal to expected credit losses. In either case, a member's or housing associate's direct loss obligation precedes the application of any loan-level or pool-level insurance.

How the member assumes responsibility for the credit risk varies depending upon the structure of the AMA product. Although MPF and MPP offer different products with different risk-sharing structures, there is consistency in basic AMA program elements. Following are some of the common elements found in both the MPF and MPP programs.

a) *Participating Financial Institution*. A PFI is a member or housing associate that has been approved to participate in the AMA programs. Both MPF and MPP use this term in common.

b) *PFI agreements.* An agreement between the FHLBank and PFI establishing the terms under which the PFI will deliver loans to the FHLBank and/or perform the servicing function. Under MPF, these agreements are known as "PFI Agreements." Under MPP, these agreements are known as "Mortgage Selling and Servicing Master Agreements."

c) *Master Servicer.* The MPF Provider (on behalf of the MPF-Banks) and each MPP-Bank have retained servicing firms to act as "Master Servicer." The duties of the Master Servicer include the supervision, monitoring, and oversight of the servicing of the mortgage loans and the performance of each "Servicer" of its duties and obligations pursuant to the FHLBanks' requirements. Both MPF and MPP use this term in common.

d) *Servicer.* Under both MPF and MPP, Servicers are required to be PFIs. The duties of Servicers include the collecting of funds from borrowers, preparing monthly accounting reports, reconciling cash flows, providing mortgage loan documents to a "Custodian," ensuring insurance is in force, and performing loss mitigation functions. Both MPF and MPP use this term in common.

e) *Custodial agreements.* An agreement that establishes the rights and obligations of the Custodian. Under MPF, the custody agreement is between a Custodian and the MPF Provider. Under MPP, the custodial agreement is between the Custodian and the PFI.

f) *Custodian.* An institution that verifies and maintains documents in connection with mortgage loans, including original notes and assignment of mortgages.

Under MPF, the term "Custodian" is used. Under MPP, the term "Document Custodian" is used.

g) *Master commitments.* Under both MPF and MPP, the FHLBank and PFI sign master commitment agreements that provide the terms under which the PFI may deliver loans to the FHLBank. Under MPF, these agreements are known as "Master Commitment Agreements." Under MPP, these agreements are known as "Master Commitment Contracts."

h) *Delivery commitments.* Delivery commitment agreements are entered into between the FHLBank and PFI. These commitments legally obligate the PFI to deliver loans with certain characteristics to the FHLBank within a specified period of time. Under MPF, these agreements are known as "Delivery Commitment Agreements." Under MPP, these agreements are known as "Mandatory Delivery Contracts."

i) *Accounts designed to absorb expected credit losses*. Under MPF, this account is known as the "First Loss Account" (FLA). Under MPP, the account is known as the "Lender Risk Account" (LRA).

MPF Products

When a member is approved as a PFI under MPF, it immediately enters into a Master Commitment Agreement with the FHLBank. This agreement defines and specifies the funding terms, product type, credit enhancement and servicing fees, First Loss Account, and maximum credit enhancement. When the PFI is prepared to deliver loans under the Master Commitment Agreement, it enters into a Delivery Commitment Agreement with the FHLBank. Once signed, the PFI is legally obligated to deliver the loans to the FHLBank. If the PFI fails to deliver the loans, the FHLBank, depending on the provisions of the Delivery Commitment Agreement, may assess the PFI a pair-off fee.

For each Master Commitment Agreement, the FHLBank allocates an amount to a specific First Loss Account, to be used to fund losses realized on mortgage loans allocated to the applicable master commitment. Any realized loss remaining after the application to the First Loss Account will be applied to the PFI's credit enhancement obligation for the applicable master commitment. Any remaining realized loss remaining after applications to both the First Loss Account and the PFI's credit enhancement obligation will be allocated directly to the FHLBank. Credit enhancement obligations must be secured in parallel with the Finance Board's requirements for securing advances.

The following provides a brief summary of each of the six different MPF products. Depending on the product, PFIs have the option either to sell closed loans to the FHLBank or to originate "flow" loans as agent for the FHLBank. For flow loans, the PFI performs its usual origination function; however, the FHLBank funds the loans at the time of closing. Since the FHLBank funds the loans, the PFI never books the loan as an asset on its balance sheet; the flow loans are an asset of the FHLBank immediately upon closing. The flow loan program is available only under the MPF 100 program described below.

a) *Original MPF.* Under Original MPF, the first layer of losses (following the application of any primary mortgage insurance) is applied to an FHLBank-funded FLA in an amount specified in the master commitment agreement. The PFI then provides a second layer credit enhancement obligation for each master commitment sized to bring the master commitment to "AA" or equivalent rating. Loan losses that exceed the second layer are then absorbed by the FHLBank. For providing the credit enhancement obligation, the member typically is paid a fixed monthly credit enhancement fee specified in the master commitment agreement. Only closed loans may be sold to the FHLBank under this product.

b) *MPF 100*. Under MPF 100, the first layer of losses (following the application of any primary mortgage insurance) is applied by the FHLBank to the FLA in the amount of 100 basis points of the aggregate principal balance of the MPF Loans funded under the master commitment. The PFI then provides a second layer credit enhancement sized to bring the master commitment to "AA" or equivalent rating. Unless otherwise agreed, the PFI's minimum credit enhancement obligation is 20 basis points based on the delivered amount. Loan losses beyond the first and second layers are absorbed by the FHLBank. For providing the credit enhancement obligation, the member is paid a monthly credit enhancement specified in the master commitment agreement. The PFI's monthly credit enhancement fee becomes performance based after the first two or three years, because it is reduced by losses charge to the FLA. Only flow loans may be acquired by the FHLBank under this product.

c) *MPF 125.* Under MPF 125, the first layer of losses (following the application of any primary mortgage insurance) is applied by the FHLBank to the FLA in the amount of 100 basis points of the aggregate principal balance of the MPF Loans funded under the master commitment. The PFI then provides a second layer credit enhancement obligation sized to bring the master commitment to "AA" or equivalent rating. Loan losses beyond the first and second layers are absorbed by the FHLBank. Unless otherwise agreed, the PFI's minimum credit enhancement obligation is 25 basis points based on the delivered amount. The member receives a monthly performance-based credit enhancement fee specified in the master commitment agreement for providing the credit enhancement obligation. Only closed loans may be sold to the FHLBank under this product.

d) *MPF Plus.* Under MPF Plus, the first layer of losses (following the application of any primary mortgage insurance) is applied by the FHLBank to the FLA sized to equal to a specified percentage of the loans in the pool as of the sale date. The member procures additional credit enhancement in the form of a Supplemental Mortgage Insurance (SMI) policy to cover the second layer of losses which exceeds the deductible such as the amount equal to the FLA of the SMI policy. Losses on the pool of loans not covered by the FLA and the SMI coverage are paid by the PFI, up to the amount of the PFI's credit enhancement obligation, if any, for the master commitment. The total credit enhancement for the pool of loans in a master commitment is set so as to achieve a credit level equivalent to an instrument rated at least "AA" or its equivalent. The PFI is paid a fixed and a performance-based credit enhancement fee specified in the master commitment agreement for providing the credit enhancement obligation. The fixed credit enhancement fee is paid monthly beginning the month after delivery. The performance-based fee accrues and is paid monthly commencing with the 13th month following delivery of the loans and is reduced by losses charged to the FLA. The FHLBank absorbs all losses in excess of the member's credit enhancement obligation. Only closed loans may be sold to the FHLBank under this product. The minimum size of a MPF Plus delivery commitment is $100 million.

e) *Original MPF for Federal Housing Authority/Veterans Administration Loans.* Under Original MPF for Federal Housing Authority (FHA) or Veterans Administration (VA) Loans, the PFI provides and maintains FHA mortgage insurance or VA guaranty for all loans. The PFI is responsible for compliance with all FHA/VA requirements and for obtaining the benefit of the FHA insurance or VA guaranty with respect to defaulted loans. The PFI is responsible for "unreimbursed servicing expenses" such as those amounts not reimbursed by the FHA or VA with respect to defaulted loans, in the same manner and to the same extent as is customary for Ginnie Mae loan servicers. Expenses that are neither covered by FHA insurance/VA guaranty nor included in the unreimbursed servicing expenses are the obligation of the FHLBank. The servicing fee for FHA insured/VA guaranteed loans is 44 basis points annualized. The PFI is paid a monthly government loan fee of 2 basis points annualized. Only closed loans may be sold to the FHLBank under this product.

f) *Shared Funding Program.* Under Shared Funding, PFIs sell MPF-eligible loans to an FHLBank of Chicago member (Depositor). The FHLBank of Chicago acts as agent for the Depositor in the sale of these loans. The Depositor will concurrently sell those loans to a special purpose third-party trust that it has organized for the purpose of securitizing the mortgages into collateralized mortgage obligations (CMOs). The trust issues two certificates – an A Certificate and B Certificate. The A Certificate represents the senior investment-grade securities and the B Certificate represents the credit support tranches. The Depositor will initially acquire both the A and B Certificate CMOs and then subsequently sell all of the A Certificate CMOs to the FHLBank of Chicago. The Depositor may either hold the B Certificate CMOs in its own portfolio or sell all or a portion of them to other investors, which may or may not be FHLBank members. The FHLBank of Chicago may sell its interests in its acquired A Certificate CMOs, but only to other FHLBanks or to members of the FHLBank. All certificates issued by the trust will receive a public credit rating from an NRSRO.

MPP Products

Similar to MPF, the two primary agreements that must be in place in order for a PFI to sell loans to an FHLBank under MPP are the Master Commitment Contract and the Mandatory Delivery Contract. The Master Commitment Contract establishes the expected composition and dollar amount of the portfolio of mortgages to be sold to the FHLBank. The Master Commitment Contract also establishes the amount that must be funded to the LRA and the premiums payable to the SMI provider. Once the Master Commitment Contract is in place, the PFI may establish a Mandatory Delivery Contract that will be allocated against the Master Commitment Contract. If the PFI fails to deliver the balance of loans specified in the Mandatory Delivery Contract, the FHLBank will assess the PFI a pair-off fee in accordance with the terms of Mandatory Delivery Contract.

Under MPP, PFIs are able to sell closed loans to the FHLBank under two products – a conventional loan product and an FHA loan product. Both of the MPP products are very similarly structured to two of the MPF products. First, the MPP conventional loan product is similar in many respects to the MPF Plus product. The two are similar in that MPP-Conventional and MPF Plus both rely on SMI to cover a portion of the credit losses (after expected losses). Additionally, the MPP-FHA product is conceptually very similar to the Original MPF for FHA/VA Loans product.

For conventional loans sold under MPP, the first layer of credit losses (following the application of any primary mortgage insurance) is allocated to a LRA, which is established by the FHLBank on behalf of the PFI for each master commitment. The LRA covers expected losses and is funded by the PFI either up-front as a portion of the purchase proceeds ("Fixed LRA") or though a portion of the interest paid by the borrower ("Spread LRA"). In general, the amount deposited into the LRA is approximately 30 to 50 basis points of the original loan balance. The PFI is eligible to receive LRA payments net of losses pursuant to the Master Commitment Contract; generally payments begin in the sixth year and end in the eleventh year.

In addition to the expected losses covered by the LRA, the PFI is required to purchase SMI as an additional credit enhancement with the FHLBank listed as the insured. The coverage provided by the combination of the LRA and the SMI is considered sufficient loss protection to raise the asset to the equivalent of an instrument rated at least at the "AA" or equivalent level.

The MPP-FHA product does not require a LRA or SMI in order to meet the requirements of Part 955 because of the presence of government insurance. For loans sold to the FHLBank under this product, the PFI is required to meet the requirements established by the FHA.

FHLBank Responsibility by Functional Area

A brief overview of the basic functions performed by the FHLBanks with respect to operations of the AMA programs follows below. Although specific responsibilities may be divided among different staff at different FHLBanks, the functional responsibilities related to the AMA programs is generally consistent across the FHLBanks.

Marketing. The FHLBank's marketing department provides technical support on the details of the AMA program during the sales and marketing process. Once a member indicates its interest in participating in the program, the marketing department provides the member with the program application instructions and assists the member through the application process. The marketing department is generally responsible for collecting and maintaining all required application documentation and approving the application.

Credit. Generally, the FHLBank's credit department is responsible for reviewing the creditworthiness of each PFI. The credit department also monitors loan delinquency levels, evaluate the adequacy of the loan loss reserve account and makes recommendations for changes in the reserve. In the case of MPF, the MPF Provider, the FHLBank of Chicago, also reviews the member applications.

Collateral. The FHLBank's collateral department is generally responsible for monitoring the PFI's collateral levels in relation to the PFI's credit enhancement exposures and delivery commitment exposures.

Information Technology (IT). The FHLBank's IT department is generally responsible for supporting the information processing and data and voice technology needs of the FHLBanks and the PFIs. In the case of an MPF-Bank, the IT department is responsible for processing the nightly posting files from the FHLBank of Chicago to the general ledger and internal reporting systems.

Accounting. The FHLBank's accounting department is responsible for establishing and maintaining the books and records of the FHLBank in accordance with Generally Accepted Accounting Principles. For an MPF-Bank, the accounting department is responsible for balancing and reconciling the MPF-related accounts to ensure that all data entries, including principal and interest accruals and payments, from the FHLBank of Chicago are posted completely to the general ledger as well as preparing adjustments and MPF recurring entries.

The accounting department is also responsible for the communication of allowance for loan and lease loss methodology approved by the FHLBank's credit committee for application by the credit departments, reclassification of nonperforming loans, analysis and assessment of the reasonableness of premium/discount amortization/accretion adjustments, the approval and recordation of charge-offs in the general ledger and any reversal thereof to record gain/loss from the sale of associated real estate owned.

Together with staff responsible for mortgage portfolio management, credit, collateral, member financial risk, the accounting staff also reviews the Type II SAS 70 report annually obtained by the FHLBank of Chicago from its external auditor covering the design and effectiveness of the internal controls it has established for its MPF program.

Mortgage Finance. The FHLBank's mortgage finance department is responsible for the acquisition of mortgage loans, including the execution of purchase transactions, the evaluation of delivery commitments, and the analysis of mortgage markets. At the FHLBank of Chicago, in its capacity as MPF Provider, and at the MPP-Banks, this function includes the oversight of the AMA pricing model and intra-day price schedule updating. The MPF Provider receives the notice of the delivery commitments from the PFIs and then notifies the MPF-Banks, so they can arrange financing. At MPF-Banks, the mortgage finance departments are responsible for monitoring and validating pricing of MPF products and monitoring and evaluating PFI's delivery commitments to identify potential hedging needs.

Risks Associated with AMA

An FHLBank's primary risks relating to AMA activities are set forth below.

1) Lack of Sound Corporate Governance (Board of Directors and Senior Management Oversight)

a) Key risks and controls are not adequately identified, assessed, and monitored.
b) Information technology is not aligned with the FHLBank's goals and strategies.
c) Exceptions to AMA policies are not properly reviewed and reported to senior management and the board of directors.
d) The FHLBank's financial performance and compliance with established goals, policies, procedures, accounting and regulatory requirements are not properly reviewed and monitored due to inadequate, inaccurate and/or untimely reporting to the board of directors and senior management.
e) Internal control weaknesses potentially affecting financial reporting have not been adequately identified, assessed and disclosed.
f) Duties, responsibilities, and staff expertise, including segregation of operational and control functions, are not adequately defined.
g) Delegations of authority from the board of directors to the chief executive officer to the respective FHLBank personnel are not adequately reviewed and maintained.
h) Background criminal and credit investigations are not performed on personnel prior to their retention. Periodic credit investigations are not performed, and mandatory leave policies have not been established.
i) Duties, responsibilities, and liabilities are not adequately addressed with vendors.
j) Losses due to errors and fraud are not effectively mitigated through insurance or other means.
k) A business continuity plan has not been developed or adequately tested.

l) Audit coverage and testing is limited; auditors are inexperienced or lack the technical expertise.

2) Operational Risk

a) New PFIs and new master commitments are not properly administered.
b) Deficiencies exist in internal controls or information systems.
c) Failure to execute master commitments or lack of compliance with loan delivery processes.
d) Delivery commitments and loans are not recorded accurately, completely, or in the correct period.
e) Loan payments are not calculated and/or recorded accurately, completely, or in the correct period.
f) Unauthorized/untrained users enter transactions.
g) Service providers with which the FHLBank has contracted do not adequately perform their duties and responsibilities.
h) Loan information is not accurately recorded to the general ledger.
i) Amortization of book value adjustments is not accurate.
j) Data cannot be readily recreated and/or required tasks readily performed in the event of a disaster or personnel turnover.
k) Non-compliance with record retention requirements.
l) Review of SAS 70 controls and testing is inadequate.
m) Agreements between the FHLBank and counterparties may be unenforceable or may not clearly set out the rights, duties and obligations of the parties, including the remedies available to the FHLBank in the event that a counterparty does not adequately perform its duties and satisfy its obligations thereunder.
n) Foreclosure by an FHLBank or Servicer on a mortgage loan that has not been repurchased by a PFI results in an unreimbursed liability to the FHLBank for failure to comply with applicable state law governing foreclosures, third-party injury on the property acquired through foreclosure, or the presence of environmental hazards on such property.
o) Inadequate staffing of FHLBank departments and functional areas critical to AMA activities with experienced personnel results in the compromise of key internal processes relating to the successful conduct of AMA activities.
p) Failure by the FHLBank to comply with regulatory requirements and its own internal policies relating to the conduct of AMA activities results in supervisory action, financial loss or reputational diminishment adversely affects the ability of the institution to continue to conduct AMA activities.
q) Placement by a governmental authority of a PFI or other key counterparty into conservatorship, receivership, or liquidation adversely affects the ability of an FHLBank to exercise its rights and remedies under the agreement.
r) Changes in the economy diminish the business outlook for FHLBank member institutions and reduce the demand for mortgages.
s) Industry consolidation involving member institutions that results in a reduction in FHLBank membership and reduces the demand for AMA products.
t) A change in law, judicial decision or other event curtails the ability of an

FHLBank to conduct AMA activities.

u) Increased competition from other housing GSEs and wholesale lenders results in loss of AMA business to competitors.
v) Mortgage loans are acquired from non-PFIs.
w) Lack of compliance with internal controls, policies, procedures, and specific requirements of insurance policies, resulting in rejection of claims by insurers and incurrence of losses.

3) Credit Risk

a) Mortgage loans are acquired either as whole loans or interests in whole loans that do not comply with the FHLBank's underwriting guidelines and do not meet the investment grade ratings requirements.
b) FHLBank acquires loans that do not comply with the master commitment agreement.
c) Delivery commitments and loans are not properly valued.
d) Credit enhancement obligations are not adequately satisfied or secured.
e) The FHLBank's security interest in the mortgage collateral is not perfected, resulting in establishment of superior lien status by a competing creditor that perfects its security interest in the mortgage collateral.
f) Condition and performance of PFIs is not adequately monitored to assess their continuing ability to satisfy their credit enhancement obligations.
g) PFIs do not fulfill requirements under default reporting standards or delinquent loans may be undetected.
h) Mortgage insurance providers are not adequately monitored to assess their continuing ability to satisfy their obligations.
i) Foreclosure by an FHLBank or Servicer on a mortgage loan that has not been repurchased by the PFI results in unreimbursed loss to the institution where the outstanding principal and interest due on the property exceeds the proceeds realized from the subsequent sale of the property.
j) FHLBank maintains inadequate allowance for loan losses to satisfy losses.
k) Inadequate processes to screen loans deemed to be predatory

4) Market Risk

The purchase and funding of AMA assets presents the FHLBanks with interest rate and accounting risks that need to be prudently managed, as addressed in the Interest Rate Risk Management and Financial Reporting Operations sections of the examination manual.

Specific Risk Controls Relating to the AMA Function

An FHLBank's controls relating to AMA activities are set forth below.

1) Quality Control

The FHLBank should maintain an effective quality control function, either internally or through an outside vendor, to evaluate the processes related to the acquisition and administration of AMA. The quality control function should ensure that the FHLBank's execution of AMA transactions mitigates the inherent risks. Each FHLBank should have in place controls to assure that loans satisfy the program requirements.

2) Business Continuity

The FHLBank should have written procedures for operations at its designated hot-site. All AMA production applications, including upgrades, should be installed and available at the off-site location. Testing of applications should be conducted periodically to ascertain reliability. The FHLBank should require all critical AMA counterparties to maintain an adequate disaster recovery plan and to test such plan periodically.

3) PFI Approval and Continued Monitoring

The FHLBanks should have in place adequate controls to ensure that all members requesting PFI approval are reviewed for program eligibility, including creditworthiness and documentation standards. Once approved, PFIs should be periodically monitored to ensure continued compliance with all AMA program requirements.

4) Agreements with AMA Counterparties

All relationships with AMA counterparties such as PFIs, Master Servicers, Servicers, and Custodians should be clearly documented in enforceable written agreements whose terms and provisions respond to risks presented by AMA processes, provide reasonable means of managing those risks, and clearly define the rights, duties and responsibilities of the parties, including the remedies of each FHLBank in the event that its counterparty does not adequately perform its duties and responsibilities. All such agreements should be reviewed by the FHLBank's legal counsel.

Examination Guidance

A work program for AMA accompanies this narrative. What follows below are illustrative examples of attributes that should be considered by the examiner in completing the analyses required in that work program. In determining the extent of review and testing to be conducted in completing each analysis called for in the work program, the examiner should take into account his or her assessment of the quality and effectiveness of corporate governance, risk management, internal controls and audit coverage relating to the institution's AMA activities.

1) ***Organizational structure***

   a) Department organization and reporting structure;
   b) Identification of key personnel;
   c) Primary duties, responsibilities and technical expertise of personnel;
   d) Segregation of duties;
   e) Cross-training of personnel;
   f) Coordination with other departments such as risk management, information technology, marketing, accounting, credit, collateral and mortgage finance;
   g) Significant changes in the foregoing since the last examination; and
   h) Delegations of authority.

2) ***Establishment of risk tolerances and development of key policies and oversight by the board of directors. Evaluate the adequacy of senior management and the risk management function as to the risks arising from the institution's AMA activities, which may include the following:***

   a) Development or expansion of AMA products offered by the FHLBank and projected impact on financial condition of FHLBank;
   b) Risk management processes and funding requirements to compensate for additional risk;
   c) Actions taken to mitigate risk, and to control and correct deviations from risk mitigation plans;
   d) Agreements for AMA transactions clearly identify and allocate between the FHLBank and its counterparties;
   e) Periodic monitoring and reporting of key operating procedures, controls and deviations; and.
   f) Changes to the FHLBank's AMA policies and procedures and MPF or MPP Guidelines.

3) ***Key FHLBank and departmental policies and procedures, which may include those relating to the following:***

   a) Risk management;
   b) Member products policy;
   c) PFI approval and monitoring;
   d) Quality control;
   e) Mortgage insurance monitoring;
   f) Asset classification and performance monitoring;
   g) Credit policy;
   h) Financial risk management;
   i) Business continuity and recovery;
   j) Loan acquisition that address PFI eligibility, loan documents, underwriting, credit enhancement, pricing, and agreements with counterparties;
   k) Assets administration such as master servicer and servicer, document custody operations; and third party quality control;

l) Capital requirements;
m) Information security;
n) Fraud prevention;
o) Background and credit investigations;
p) Whistleblower provisions of SARBOX; and
q) Business conduct and ethics.

4) Risk assessment under Part 917 and internal control evaluation under SARBOX

a) Effectiveness of the annual risk assessment under Part 917 that identifies the key risks arising from and controls established by the institution over AMA activities and includes quantitative and qualitative evaluations; and
b) Effectiveness of evaluations conducted pursuant to SARBOX that identify the key risks and controls pertaining to financial reporting and evaluate potential fraud, and procedures implemented to periodically attest to the adequacy of the control environment.

5) Testing performed by external and internal auditors and outside consultants

a) Evaluate the adequacy of the scope and testing performed by external and internal auditors, and third party quality control firms; and
b) Evaluate the adequacy of the scope and testing performed by outside consultants.

6) Information technology and controls

Identify and assess the automated and manual systems and applicable controls utilized by AMA operations for processing transactions, including:

a) Authorized users;
b) Financial modeling systems, including pricing models;
c) Loan origination system (LOS);
d) Loan acquisition system (LAS), including tracking SMI and LRA;
e) eMPF transactional website;
f) Treasury pricing model (TPM);
g) Loss allocation model (LAM);
h) Utilization of spreadsheets;
i) Use of LEVELS to calculate credit enhancement;
j) Calculation of capital requirements;
k) Tracking delinquencies and foreclosures; and
l) Business continuity and recovery.

7) Identification and evaluation of controls and significant changes to the activity or function

a) Evaluate workflow and processes as well as controls, including the level and direction of risk and the quality of risk management; and

b) Evaluate any significant changes that have been implemented since the last examination or are being considered that may affect the control environment such as management, systems, key personnel, regulatory requirements and processing.

8) Testing

Conduct testing as appropriate. The scope of testing should be based on the preliminary review of governance, risk management, internal controls and audit coverage. Specific examples include, but are not limited to, the following:

a) Restrictions exist upon access to the pricing models or, in their absence, compensating controls to ensure proper authorization of transactions such as dual control, limitations upon system access or function capabilities, and managerial review;

b) Loan acquisition process is consistent with Finance Board regulations and AMA program requirements;

c) Credit enhancement calculated by LEVELS is appropriate;

d) Loan servicing and collection efforts are in accordance with industry standards and sub-servicing agreement between master servicer and sub-servicer;

e) Changes to loan characteristics, such as FICO score, PFI, loan-to-value, geographic location, occupancy, and exceptions to underwriting guidelines, that do not require an adjustment or amendment to the governing master loan commitment;

f) Service organization’s internal controls, such as the obtainment of the external auditor’s SAS 70 report, are adequate;

g) Acquisition and administration of assets complies with Finance Board regulations and AMA requirements;

h) Document custody operations comply with AMA program requirements;

i) PFI status is granted only to members and housing associates;

j) Reconciliation of AMA accounts are reconciled;

k) Classification of specific AMA loan(s) or loan pools is consistent with the institution’s internal loan classification system (if significant weaknesses are identified with the FHLBank’s risk identification, loan classification policies and procedures, and credit and collateral monitoring, consider performing an adverse classification review);

l) AMA loss mitigation is adequate ;

m) FHLBank maintains appropriate amount of capital against its mortgage loans;

n) Background and credit investigations are conducted, and fraud prevention procedures are adequate and are adhered to;

o) Policies, procedures and methodologies for premium amortization and grouping of loan pools is in compliance with the requirements of SFAS 91 (coordinate review with examiner or analyst assigned to review Financial Reporting Operations); and

p) Record retention procedures that pertain to automated and manual records have been established.

9) Assessment of Risks

Summarize the results of the activity or function examined in a separate memorandum. The memorandum must articulate the risks and the management of those risks. It should also clearly and specifically describe the basis and analysis for the assessment. The memorandum should discuss the type(s) of risk (market, credit, operational); the level of the risk (low, moderate, high); the direction of the risk (stable, decreasing, increasing); and the quality of risk management (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

10) Items requiring follow-up at the next on-site visitation

Identify key issues that have been communicated to management (written or oral) that require follow-up during the next on-site visitation.