This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to SupervisoryJournal@fdic.gov.

Guidance on Accounting for the Mortgage Partnership Finance Program

The Federal Home Loan Bank (FHLB) of Chicago created the Mortgage Partnership Finance (MPF) program in 1997 to provide its member institutions with an alternative to holding fixed-rate residential mortgage loans in their loan portfolios or selling them in the secondary market. Institutions that participate in the MPF program originate loans that are purchased or funded by the FHLBs, but the institutions receive fees for managing the credit risk of the loans and servicing them. The FHLBs manage the interest rate and prepayment risks of the mortgages they acquire, thereby also taking on the liquidity risk arising from holding the loans in their portfolios. The MPF program now offers several product structures, and eight more FHLBs have joined the program.

The interest of depository institutions in the MPF program has grown steadily during the past seven years. As of June 30, 2004, the FHLB of Chicago reported that the number of institutions participating in the MPF program was approaching 800, up more than 40 percent from a year earlier, with another 100 in the process of joining. Since 1997, the program has funded more than $145 billion in residential mortgages throughout the United States. The vast majority of participants in the program are community institutions.

Differences in the features of the various MPF products and the growing number of institutions joining the program continue to prompt questions from bankers and examiners about the proper accounting and reporting treatment for these products. Although the program information available from the FHLBs describes the MPF products and their regulatory capital implications, guidance on accounting has been sparse. In this article we will summarize the MPF products and attempt to answer these accounting questions.

How the Mortgage Partnership Finance Program Works

An institution participating in the MPF program enters into a Master Commitment agreement with the FHLB of which it is a member. This agreement specifies the dollar amount of loans to be delivered under the commitment and details the terms and conditions, including the credit enhancements, that govern these loans. The FHLB provides the long-term funding for MPF loans.

Credit risk is shared between the participating institution and the FHLB by structuring the potential loss exposure into several layers. The initial layer of losses (after any private mortgage insurance coverage) on loans delivered under a Master Commitment is absorbed by a

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1 Most institutions that participate in the MPF program are insured banks and savings associations. A small percentage are credit unions and insurance companies.

2 The FHLBs of Atlanta, Boston, Chicago, Dallas, Des Moines, New York, Pittsburgh, San Francisco, and Topeka participate in the MPF program. The FHLB of Seattle has developed a separate Mortgage Purchase Program (MPP) that differs from the MPF program discussed in this article. The FHLBs of Atlanta, Cincinnati, and Indianapolis also participate in the MPP.

3 Product descriptions and term sheets for the various MPF products are available at www.fhlbmpf.com.
“first loss” account (FLA) established by the FHLB. If losses extend beyond this account, they are absorbed by a second loss credit enhancement provided by the institution. If the first and second loss credit enhancements are exhausted, the FHLB is in a third loss position and absorbs any further losses. The size of the institution’s second loss credit enhancement is the difference between the size of the FLA and the size of the overall amount of enhancement needed to achieve an “AA” rating from a rating agency on the FHLB’s third loss position on the loans.

An institution receives credit enhancement fees, generally paid by the FHLB on a monthly basis, for sharing and continuing to manage the credit risk of the MPF loans. The size of these fees is based on the unpaid principal balance of the loans delivered under the Master Commitment and, for certain MPF products, is adjusted for loan losses absorbed by the FHLB’s FLA. In effect, these fees compensate the institution for providing the second loss credit enhancement.

Institutions participate in the MPF program either by originating loans on a “flow” basis or by selling closed loans to the FHLB. For the single flow loan product (designated MPF 100), the institution acts as an originating agent for the FHLB, for which it may receive agent fees in addition to the loan origination fees paid by the borrower. The institution closes the loan in the name of the FHLB, which provides the funding for the mortgage at closing and legally owns the loan from the moment it is created. The loan is never carried on the agent institution’s balance sheet.

The closed loan products offered by the FHLBs include Original MPF, MPF 125, and MPF Plus. For all three products, an institution originates residential mortgages, closes the loans in its own name, and sells them to the FHLB in a manner similar to a secondary market sale to Fannie Mae or Freddie Mac. The chart below illustrates the typical cash flows for a loan sold to the FHLB in the MPF closed loan products.

For both flow loans and closed loans, participating institutions are paid specified servicing fees (typically 25 basis points for conventional loans) for servicing MPF loans. The option of selling rather than retaining servicing has recently been created for closed loans.

**Accounting and Reporting Considerations**

The proper accounting and financial reporting for the various MPF products is dictated by the type of product. For example, in the case of the MPF 100 flow loan product, an institution is not selling loans to an FHLB but rather is acting as its originating agent. Therefore, the criteria for sale accounting, as

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4 The FHLBs also offer Original MPF for Federal Housing Administration/Veterans Administration (FHA/VA) loans, a closed loan product for these U.S. government–guaranteed/insured loans. However, this product does not require the institution selling the FHA/VA loans to an FHLB to undertake a second loss credit enhancement obligation.
outlined in Financial Accounting Standards Board (FASB) Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140), do not apply. In contrast, the MPF closed loan products involve loan sales to an FHLB, and the institution must account for these transactions in accordance with FAS 140. The institution would remove the assets that have been sold from its balance sheet, continue to carry on its balance sheet any servicing assets retained, recognize any assets obtained and liabilities incurred at fair value, and recognize any gain or loss on the sale in earnings.

Credit Enhancement

The second loss credit enhancement obligation undertaken by an institution in all the MPF products represents a guarantee that must be accounted for in accordance with FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45), which was issued in November 2002. FIN 45 requires a guarantor “to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee.” In this regard, FIN 45 distinguishes between guarantees issued “in a stand-alone arm’s-length transaction with an unrelated party” and those “issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset).”

An institution’s second loss credit enhancement for the MPF 100 flow loan product falls within the standalone category because the institution acts as the FHLB’s origination agent, and no asset sale takes place. In this situation, FIN 45 provides that “the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor.” For the MPF 100 product, the “premium” that will compensate the institution for undertaking the second loss credit enhancement obligation is the sum of two components: the fair value of the credit enhancement fees receivable from the FHLB over the life of the mortgage loans delivered under the Master Commitment plus the fair value of the servicing asset, the measurement of which is discussed below. The fair value of the credit enhancement fees receivable would need to be estimated using expected present value measurement techniques. Thus, the institution must estimate the amount and timing of the cash flows to be received as credit enhancement fees. The amount of these fees is a function of the remaining unpaid principal balance of the mortgage loans in a Master Commitment, which means that the institution must estimate the prepayment rate on these loans. In addition, for performance-based credit enhancement fees, the loan losses that will be incurred on the loans in the Master Commitment must be estimated. The institution must also determine an appropriate discount rate for the present value calculation.

On the other hand, the guarantee provided for the MPF closed loan products represents a recourse obligation that results from the FAS 140 asset sale to the FHLB. To estimate the fair value of this guarantee (the recourse obligation), FIN 45 states that the guarantor “should consider what premium would be required by the guarantor to issue the same guarantee in a stand-alone arm’s-length transaction with an unrelated party.” Under FAS 140, this fair value estimate typically is described as the amount that a willing (unrelated) party would charge the guarantor to assume the recourse obligation. The fair value also would be calculated using present value measurement techniques, but would take into account the estimated amount and timing of the payments to the FHLB under the recourse obligation for those loan losses in excess of the FLA that are expected to occur over the life of
the loans in the Master Commitment, up to the maximum amount of the second loss obligation. The institution also must estimate the fair value of the credit enhancement fees receivable asset, as described above.

However, these two fair value estimates may differ because, under FIN 45, they are separate elements of a multiple element transaction that also includes cash sale proceeds for the loans delivered to the FHLB and servicing. In essence, the fair value of the credit enhancement fees receivable for closed loan MPF products may be viewed as part of the proceeds of the sale. The fair value of the recourse obligation should be treated as a reduction of the proceeds. Both the asset for the fees receivable and the liability for the credit enhancement obligation should initially be recorded at their fair values. When applying sale accounting to the closed loan MPF products, these fair values will enter into the institution’s measurement of the gain or loss on the sale under FAS 140.

After the asset for credit enhancement fees receivable initially has been recorded at its fair value (which becomes its cost basis), the ongoing accounting for this asset, regardless of whether it arose from a flow loan or a closed loan MPF product, is governed by the provision of FAS 140 on financial assets subject to prepayment. Because the mortgage loans in the Master Commitment contractually can be prepaid and the credit enhancement fees receivable are a function of the principal amount outstanding on the mortgages, the receivable could be settled in such a way that the institution would not recover all of its recorded investment. As a result, FAS 140 requires this receivable to “be subsequently measured like investments in debt securities classified as available-for-sale or trading” under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

As for the liability for an institution’s second loss credit enhancement obligation, FIN 45 “does not describe in detail how the guarantor’s liability...would be measured subsequent to its initial recognition.” However, FIN 45 notes that this liability “would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee.” Because of the long-term nature of the second loss credit enhancement obligation for all MPF products and the decreasing likelihood that an institution will be called upon to reimburse the FHLB for losses that exceed the amount in the FLA as the loans become more seasoned, it would be reasonable for the institution to use a systematic and rational amortization method to reduce the liability over the life of the credit enhancement.

One element of the accounting for the second loss credit enhancement obligation after its initial recognition remains. By entering into this guarantee obligation, the institution takes on a contingent obligation to make future payments to the FHLB if loan losses exceed the FHLB’s FLA. At the inception of this guarantee, it would normally not be probable that the institution would be called on to make payments to the FHLB to cover credit losses in excess of the FLA. However, for each Master Commitment, the institution would need to reevaluate this contingent obligation regularly in accordance with FASB Statement No. 5, Accounting for Contingencies. If available information about the performance of these loans indicates that it is probable that the institution will have to reimburse the FHLB for losses in excess of the FLA, and the amount of the loss can be reasonably estimated, the institution must accrue the estimated loss. This loss would be charged to earnings and an offsetting liability would be recorded for the institution’s obligation to the FHLB. As payments are made to the FHLB, the liability would be reduced.
When an institution services the mortgages it has delivered to the FHLB, it must also consider the accounting for the servicing under FAS 140. For the MPF closed loan products, it must determine whether it has retained a servicing asset or incurred a servicing liability.

Under the servicing released option for closed loan MPF products, a designated financial institution that is a large mortgage servicer stands ready concurrently to purchase the servicing rights to the mortgage loans that an institution sells to its FHLB. The premiums the designated institution will pay are specified in a pricing schedule, which is updated from time to time. An example of such a schedule is shown below. The establishment of the servicing released option with its related premiums confirms that an institution that services its MPF loans has a servicing asset. The institution must estimate the fair value of this servicing asset using a quoted market price if one is available. In this regard, the FAS 140 implementation guidance notes that an unsolicited bid from a third-party servicer that is a major market participant, such as the prices set forth on the MPF program’s servicing released pricing schedule, should be used as the basis for determining the fair value of the institution’s servicing asset “as it represents a quoted market price for its asset.” When accounting for the sale of the mortgage loans with servicing retained under FAS 140, the institution must initially measure the servicing asset at its “allocated previous carrying amount based on relative fair values.”

For the MPF 100 flow loan product, the originating institution typically retains the servicing, but the original owner of the loan is the FHLB. In essence, the FHLB is transferring the servicing to the institution, but there is no cash payment from the institution to the FHLB for the institution’s assumption of servicing responsibilities. Although the MPF servicing released option is not available for flow loans, it is reasonable to believe that, consistent with the closed loans, the institution, as originating agent, has obtained a servicing asset from the flow loans it delivers to the FHLB.

According to the FAS 140 implementation guidance, this servicing asset results from an exchange transaction and represents “consideration for goods or services provided by the transferee to the transferor of the servicing.” It would be

### Servicing Released Premium (SRP) Schedule

<table>
<thead>
<tr>
<th>Conventional Loans</th>
<th>Assures 25 basis points (bps) Servicing Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan Amount</strong></td>
<td><strong>30/20-Year Fixed</strong></td>
</tr>
<tr>
<td>$200,000–conforming limit</td>
<td>1.500</td>
</tr>
<tr>
<td>$100,000–$199,999</td>
<td>1.375</td>
</tr>
<tr>
<td>$50,000–$99,999</td>
<td>1.125</td>
</tr>
<tr>
<td>$0–$49,999</td>
<td>0.375</td>
</tr>
</tbody>
</table>

The SRP will be reduced by 25 bps (0.25%) if the loan does not escrow for both taxes and insurance.

**Escrow account can not be waived if**
- Loan amount is less than $50,000, or
- Loan-to-value ratio is greater than 80%, or
- Any borrower’s credit score is less than 620.

**Processing fee:** $100
**Tax service fee:** $89

### Volume Incentive

**5 bps (0.05%) bonus:**
For all loans delivered in a given month if loans boarded for that month are ≥ $5M and < $10M.

**10 bps (0.10%) bonus:**
For all loans delivered in a given month if loans boarded for that month are ≥ $10M.

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See Question 81 of the FAS 140 implementation guidance.
See Question 98 of the FAS 140 implementation guidance.
reasonable to conclude that this consideration is additional compensation to an institution for undertaking the second loss credit enhancement obligation. Thus, as discussed above, the fair value of the second loss credit enhancement guarantee for the MPF 100 flow loan product has two components: the fair value of the premium receivable from credit enhancement fees and the fair value of the servicing asset. When estimating the latter fair value, however, the servicing released pricing schedule for closed loans would not represent a quoted market price because it does not apply to the MPF 100 product. Nevertheless, the pricing schedule would be one of the factors the institution should consider when estimating the initial fair value of its servicing asset.

After a servicing asset has been recognized on the balance sheet, FAS 140 provides that it must be amortized in proportion to, and over the period of, estimated net servicing income (i.e., servicing revenue in excess of servicing cost). A servicing asset must be evaluated for impairment quarterly based on its fair value.

Examination Considerations

The FHLB of Chicago’s literature describes the MPF program as “combining the credit expertise of a local lender with the funding and hedging advantages of a FHLB,” which means that “lenders can retain the credit risk and customer relationship of their loans while shifting the interest rate and prepayment risks to the FHLB.” Although the interest rate and prepayment risks arising from holding mortgage loans in portfolio have been shifted for the most part, these risks are inherent in the credit enhancement fees receivable and servicing assets carried on an institution’s balance sheet.

Examiners should ensure that the credit risk management process of an institution that participates in the MPF program adequately addresses the credit exposure arising from the second loss credit enhancement provided on the loans delivered to the FHLB and from any performance-based credit enhancement fees receivable. A prudent risk management process includes effective senior management and board oversight; comprehensive policies and procedures, including appropriate limits; and an effective ongoing system of risk assessment, management, monitoring, and internal control, including appropriate coverage by the internal audit and compliance functions.

In addition, while the MPF program is not per se a securitization activity, it is nonetheless similar because a participating institution provides a credit enhancement to the FHLB and may retain the responsibility for servicing the mortgages. Thus, many of the standards applicable to retained interests that are outlined in the December 1999 Interagency Guidance on Asset Securitization Activities would be relevant to the second loss credit enhancement guarantee and the related credit enhancement fees receivable.7 The guidance on risk management activities, including valuation, in the February 2003 Interagency Advisory on Mortgage Banking would be pertinent to servicing assets.8

An institution significantly involved in the MPF program should ensure that its accounting policies governing the resulting assets and liabilities are applied consistently and include approved valuation methods and procedures for the formal approval of changes to these methods. Moreover, management should employ reasonable and conservative valuation assumptions and cash flow

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projections and maintain verifiable, objective documentation of fair value estimates used in the accounting for enhancement-related assets and liabilities and servicing assets. When deficiencies are identified, examiners should seek management’s commitment to institute appropriate corrective action.

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