

COMMON MISCONCEPTIONS WHEN SELLING MORTGAGES

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Many institutions sell the mortgage loans they originate with the servicing rights released because they believe it is the best price. Wilary Winn believes that in many cases, the best all-in price comes from selling the loan servicing retained under the Federal Home Loan Bank's Mortgage Partnership Finance® (MPF®) Program.

By Douglas Winn, Wilary Winn LLC

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Wilary Winn believes an institution can and should recognize both the value of the servicing it retains and the value of the credit enhancement fees the MPF Program provides. Both amounts should be recorded at the time of sale providing current income. In addition, we believe retaining the servicing allows institutions to maintain their relationship with their customers thus providing better long term profitability.

DESCRIPTION OF THE MPF® PROGRAM

The MPF Program, offered by the Federal Home Loan Bank of Topeka (FHLBank Topeka), provides an alternative to selling loans to Fannie Mae, Freddie Mac or other secondary market participants. Institutions participating in the Program (PFIs) sell fixed-rate residential mortgage loans they originate to FHLBank Topeka.

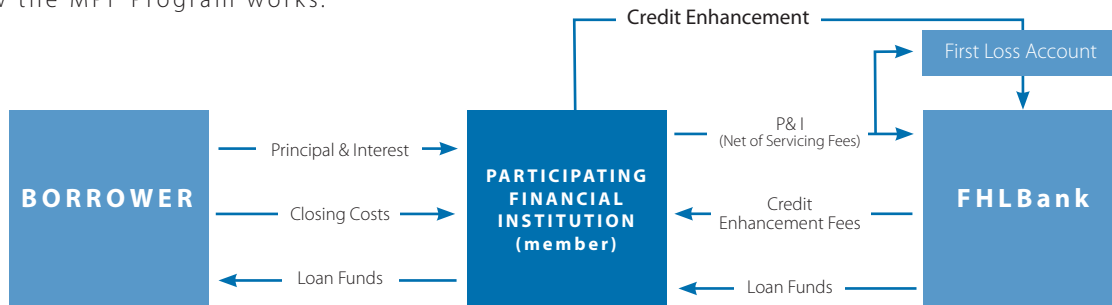
The MPF Program is best understood by viewing a fixed-rate mortgage as a bundle of risks and rewards that can be split into their component parts. Each risk and its related reward is assigned to the institution best situated to manage it. For example, experience has demonstrated that local lenders know their customers best. As a result, under the MPF Program the mortgage lender originator has the primary responsibility for managing the credit risk (the risk that the homebuyer will be unable to repay the loan) of the loans it originates. Similarly, under the MPF Program the local lender handles all functions involving the customer relationship.

By contrast, FHLBank Topeka is responsible for managing the interest-rate risk, prepayment risk and liquidity risk of the long term fixed-rate mortgage loans because of its expertise at properly hedging such interest rate risks and its ability as a GSE to raise low-cost, long-term funds in the global capital markets.



MPF® Program Flow Chart

The following diagram represents a simplified and general version of how the MPF Program works.



CREDIT ENHANCEMENT

The credit risks of MPF loans are managed by structuring the possible losses into several layers. As is customary for conventional mortgage loans sold to Fannie Mae or Freddie Mac, private mortgage insurance (PMI) is required for MPF loans with down payments of less than 20 percent of the original purchase price. Losses beyond the PMI layer and the borrower's equity are absorbed by a "first loss" account (FLA) established by FHLBank Topeka. If "second losses" beyond this first layer are incurred, the losses (not to exceed a specific maximum) are absorbed through credit enhancement provided by the PFI. The credit enhancement layer ensures that the lender retains a credit stake in the loans it originates. For managing this risk, PFIs receive monthly "credit enhancement fees" from FHLBank Topeka.

Although FHLBank Topeka offers several MPF product alternatives, this article, for the sake of simplicity, focuses on the Original MPF product.

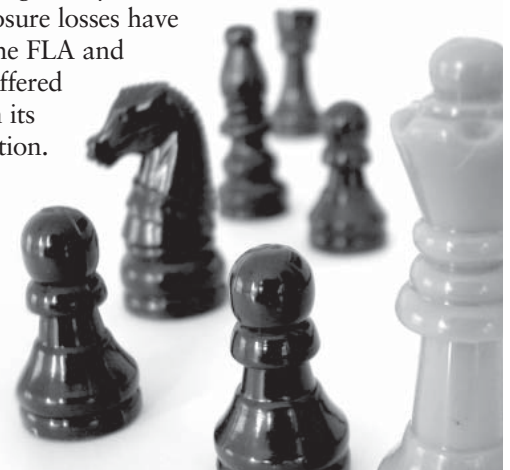
ORIGINAL MPF®

Under the Original MPF product, the first layer of foreclosures losses arising from loans sold which are in excess of the amount covered by PMI coverage is paid by FHLBank Topeka up to the balance in the FLA. The FLA accumulates monthly at the rate of 4 basis points per year. The PFI then provides a second loss CE Obligation for each Master Commitment based on

In return for bearing a portion of the credit risk, an institution receives monthly fees on the outstanding balance of the loans at a rate equal to 10 basis points annually. We estimate that in today's market the present value of this fee equates to approximately \$475 for a \$125,000 30-year fixed rate loan.

the underlying quality of the loans sold. This second loss obligation generally averages around 2.5 percent of the loans sold under the commitment. Foreclosure losses beyond the first and second layers are absorbed by FHLBank Topeka. We note here that since the inception of the Program by FHLBank Topeka, all foreclosure losses have been covered by the FLA and that no PFI has suffered a loss arising from its second loss obligation.

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FIVE COMMON SERVICING MISCONCEPTIONS WHEN SELLING MORTGAGES

1. Selling mortgages servicing released provides more current income than selling servicing retained. **FALSE**

Selling loans servicing released provides immediate income and cash flow from the purchaser. However, when selling loans servicing retained an institution can and should record the value of the servicing asset, which also provides immediate income.

In addition, by selling loans under the MPF® Program an institution can generally generate upfront income by capitalizing the credit enhancement fee. Wilary Winn believes it is appropriate to capitalize this asset, as do the regulators. However, there are dissenting opinions, so check with your accountants before making your decision.

Pricing Components	FHLBank Topeka	Servicing Aggregator
Cash Price	100.22%	99.59%
Servicing	1.07%	1.25%
CE Fee	0.37%	0.00%
Credit Obligation	0.00%	0.00%
	101.66%	100.84%

Below is an example where we compare selling a \$125,000 30-year loan with a 6.375% interest rate servicing retained to FHLBank Topeka vs. selling the same loan servicing released to a large aggregator of servicing rights.

2. The 25 basis point servicing fee is the only source of income related to retained servicing. **FALSE**

In addition to the servicing and credit enhancement

income mentioned above, an institution that retains the right to collect late fees and other ancillary income from the borrower. Purchasers of servicing often include the benefits of cross-selling in their bids – whether the income arises from getting the borrower to open a demand or time deposit account, purchase insurance, make an investment, or obtain a loan. In our opinion, the mortgage application contained within the loan file contains the most comprehensive and detailed information available to be to effectively cross-sell. We believe institutions should consider the loss of cross selling opportunities or worse still the loss of a customer in their economic comparison analysis.

3. Smaller servicing portfolios are cost-prohibitive. **FALSE**

Wilary Winn believes that one of the age old myths in mortgage banking is that an institution must have scale in order to profitably service loans. We have found that our clients with smaller portfolios efficiently service loans by keeping it simple – they service for one or two investors; use the same remittance option; maximize the number of borrowers who pay electronically; originate high quality loans; and determine if escrowing the loan voluntarily (investors require that high LTV loans be escrowed) makes sense in the institution's geographic area.

Institutions that do not want to service their mortgages in-house may wish to consider contracting the function to an MPF approved sub-servicer.

4. Selling the servicing rights provides for a simple loan officer commission structure. **FALSE**

Many institutions include the price received for selling the servicing right into the loan officer commission calculation. The same can be done with servicing rights that are retained. We have clients that simply add the capitalized servicing asset to the sales price in order to calculate commissions. We provide our clients with a schedule of booking rates that allows them to calculate the value of the retained servicing right based on the loan size, loan term and whether or not the loan is escrowed. They use the schedule determine the amount to record for the mortgage servicing right for their gain on sale and commission calculations.

5. An institution cannot sell loans servicing released to FHLBank Topeka.

FALSE

Although the majority of loans sold to FHLBank Topeka are sold servicing retained, an institution can sell its loan servicing released under the MPF Program. FHLBank Topeka has a contract with Colonial National Mortgage to purchase servicing rights for loans sold into the MPF Program. We note that Colonial's prices are often less than other servicing released bidders in the marketplace. We believe this in part due to their commitment under the Program to not cross-sell.

Institutions that elect to sell to the MPF Program servicing released do not give up their credit enhancement position. They continue to receive credit enhancement fees from FHLBank Topeka and continue to be responsible for their credit enhancement obligation.

WONDERING HOW TO GET STARTED?

First, we recommend that an institution compare the economics of the Program to other alternatives. We have found the MPF Program to generally be more favorable.

Second, we recommend that an institution consider the accounting and regulatory requirements of the Program. Wilary Winn can provide you with a complimentary Accounting and Regulatory Guidance manual designed to help you with implementation.

Third, we recommend that you develop analytics to provide you with the proper amounts to record for the mortgage servicing rights assets, credit enhancement fees receivable and credit enhancement obligation liabilities. In this regard, we are pleased to report that we have commenced a pilot Program with FHLBank Topeka under which FHLBank Topeka will provide us directly with data on loans sold by a PFI to the Bank (e.g. loan amount, term, interest rate). We will in turn combine this data with information we obtain from the marketplace (e.g. expected prepayment speeds, market servicing costs, market required discount rates) and determine the value of the assets and liabilities at the loan level using our proprietary cash flow engine. We will then provide an institution that elects to participate in the Program with a monthly (or quarterly depending on loan volume) MPF portfolio value report, the necessary accounting entries to record the loan sales and a file that calculates the ongoing monthly amortization at the loan level.

It goes without saying, but we will say it anyway to the people responsible for the accounting, our calculations and reports meet all of the requirements of FAS #140, FAS #156, and FAS #157.

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