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CRA MORTGAGE BACKED SECURITIES & CHIP THE CRA CMO

PRUDENT INVESTMENT OPPORTUNITIES



2004 COMMUNITY REINVESTMENT
CONFERENCE

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Group (SS&TG)

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Freddie's Affordable Goals*

OUR INTERESTS ARE SIMILAR

- 2004 50% LMI Borrowers
- 2004 31% Underserved Areas

* Set by HUD

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CRA CHALLENGES

- Banks' Declining Share of Mortgage Pie Limits Impact of CRA on LMI Lending
- Mortgage Company Loan Officer Compensation Structure Hinders LMI Lending
- Too Many "A" Credit LMI Borrowers Pay High Interest Rates From Sub Prime Lenders
- Banks' Investment Objectives Limit CRA Investments in Affordable Housing

COMPLIANCE BENEFITS of CRA MBS & CMO

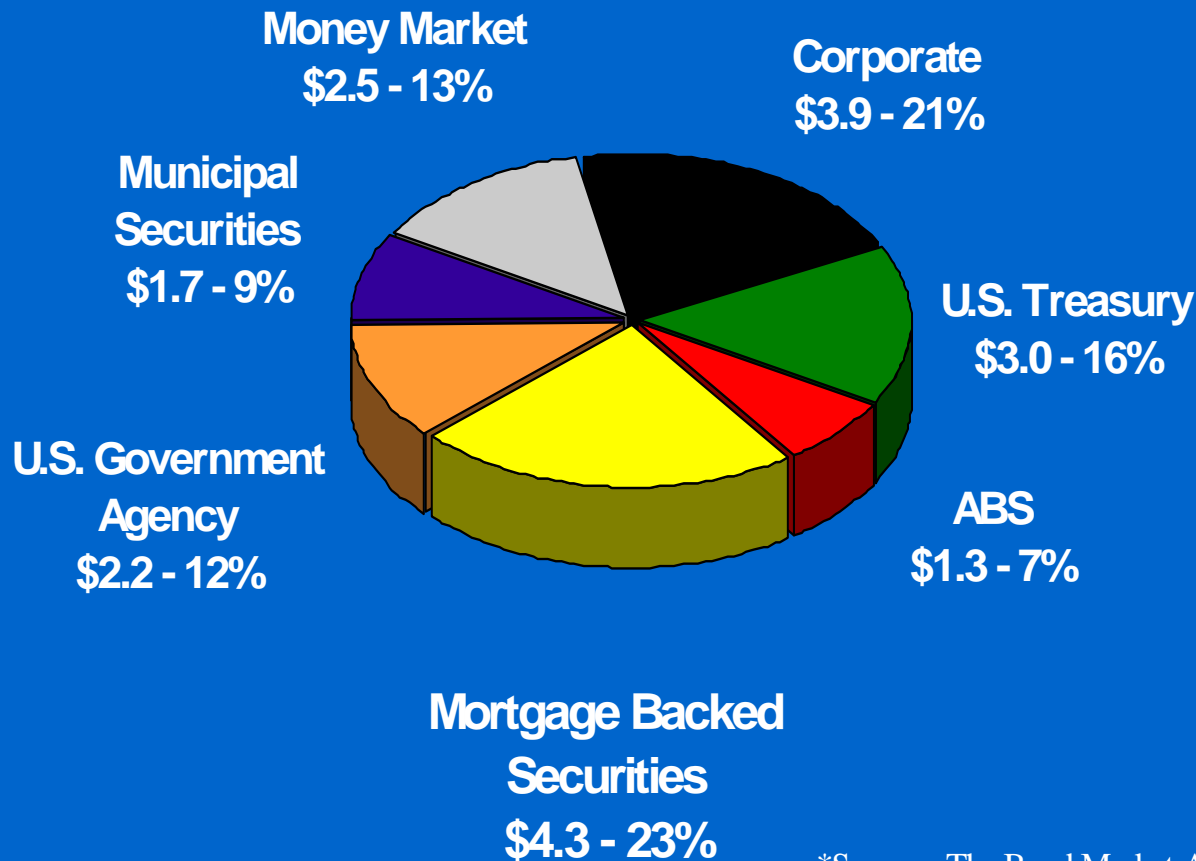
If Premium Paid to Mortgage Originators, Then

- Can Increase Supply of Financing for Affordable Housing
- Can Help “A” Credit Borrowers Avoid Sub Prime Mortgages

U.S. Fixed Income Market

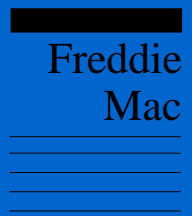
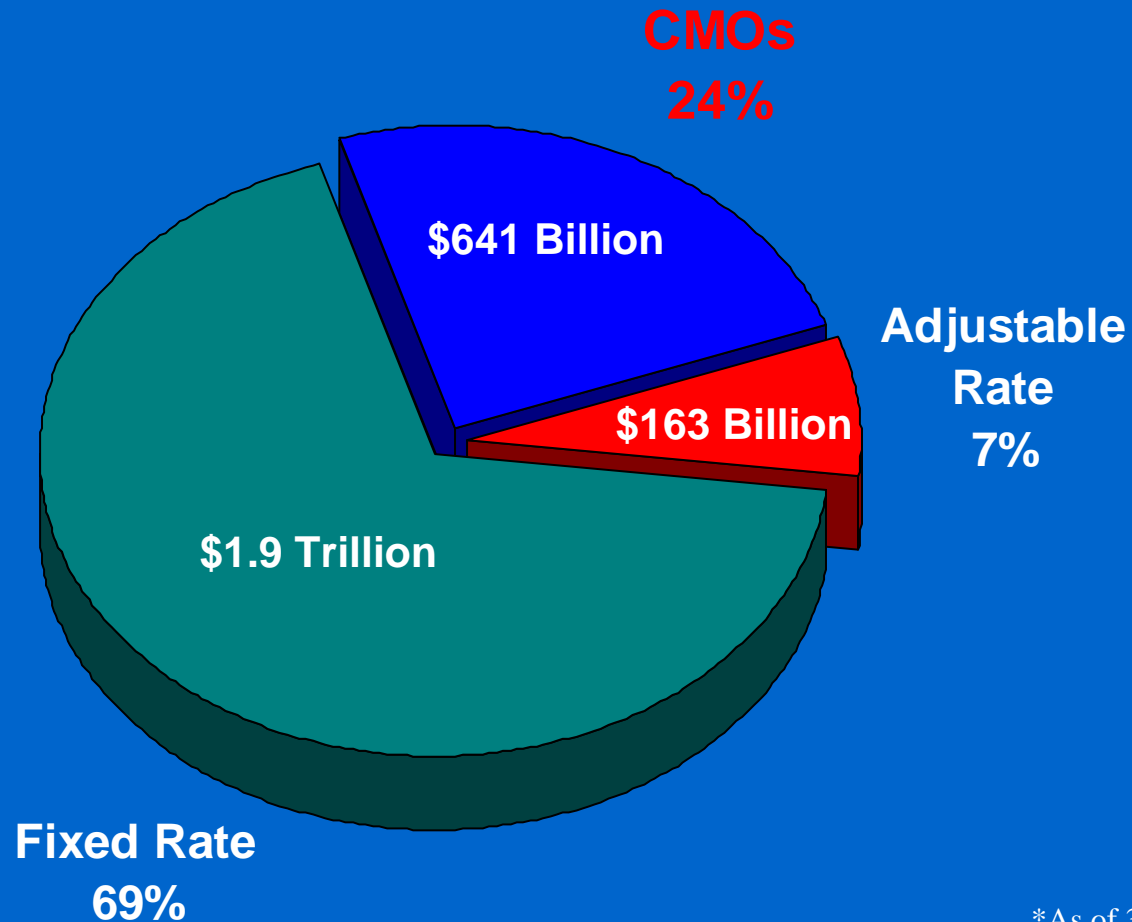
Outstanding Bond Debt as of March 31, 2002*

Total = \$19 Trillion



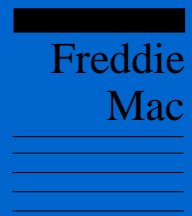
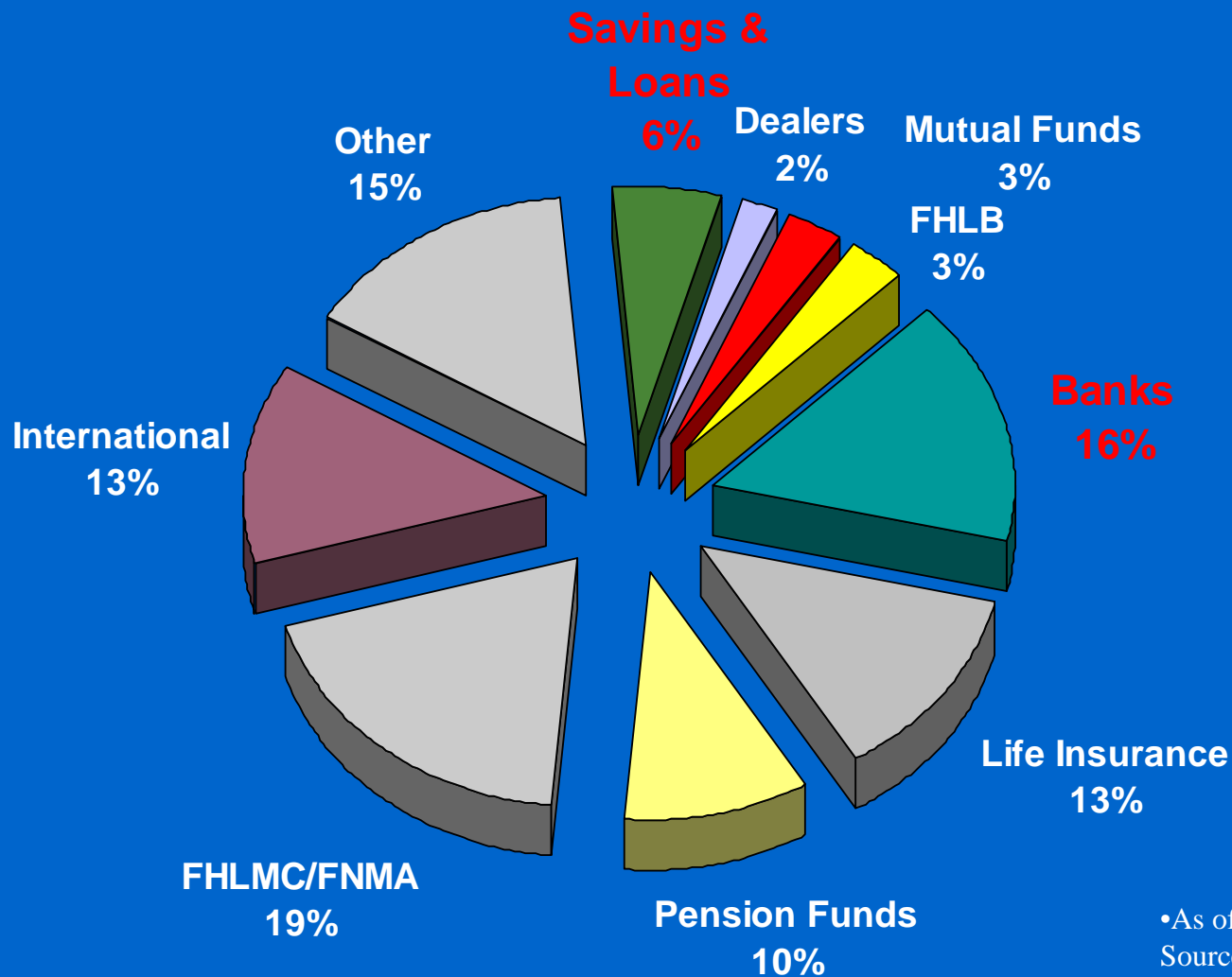
*Source: The Bond Market Association estimates

Mortgage Securities Outstanding*



*As of 3/31/02
Source: Inside MBS & ABS

Mortgage Security Investor Base*



•As of Mid-Year 2000
Source: Inside MBS & ABS

Bank Objectives

CRA + P&L = Freddie Mac

Lending

↑ LMI Borrowers

↓ Credit Risk

↑ LMI Tracts

↓ Interest Rate Risk

↑ LTD Ratio

↓ Cost

↑ AA%

↑ Innovative

↑ Amount

↓ Risk

↑ Innovative

↓ Cost

Conforming

Whole

Loans

Targeted

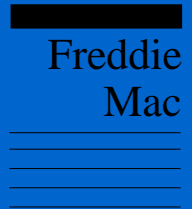
MBS &

CRA CMOs

Investment

Bank Investment Issues

- Risk versus Return
 - Credit Risk
 - Interest Rate Risk
 - Yield
- Capital Management
- Liquidity



CREDIT RISK?

- **Agency (Freddie/ Fannie/Ginnie) MBS/CMO have the timely payment of principal and interest guaranteed. Agency unsecured debt is rated AAA and MBS/CMO are further backed by the mortgaged properties.**



Yield Benefits

- **MBS have traditionally provided returns that exceed those of most other fixed-income securities of comparable quality. Thus, MBS often produce higher yields than Treasury and corporate bonds of comparable maturity and credit quality.**



Capital Management Benefits

- **Reduced Capital Requirements**

Only 20% risk-based capital

- **Active Repurchase Market**

Can earn \$ by lending via repo agreement

Liquidity Benefits

- Agency MBS are extremely liquid. Investors can easily buy, sell or borrow against MBS. The liquidity of MBS is enhanced by the relative homogeneity of the assets, compared with corporate bonds (different issuers, industries and credit) or municipal bonds (state issued, Authority issued, revenue bond, etc.).

Investment Test: CRA CMO/MBS Benefits

- Compare With Other CRA Qualified Investments (Some Munis, Grants, Low Income Housing Tax Credits, Low Yield Deposits, CRA Mutual Funds):
 - Slam Dunk CRA Qualification
 - Credit Risk/ Guarantee
 - Attractive Yields
 - Enhanced Capital Management
 - Excellent Liquidity
 - Low Transaction Costs – No Management Fees
 - Saves Bank Personnel Resources

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What Makes A MBS “Qualified” for CRA?

- Targeted by Borrower Income
- Regulatory Opinion Letters

MBS Characteristics

- Geography - Degree of Customization
 - AA or Larger
- LMI Borrower %
 - 51% → 100%
- LMI Tract?
- Pooling - 15 or 30 Year

CRA MBS LOAN LEVEL DISCLOSURE

The information set forth below was provided to Freddie Mac's Securities Sales and Trading Group ("SS&TG") by the originator of the mortgage loans. The originator has represented to SS&TG that the mortgages were pooled based on certain criteria set forth in the Community Reinvestment Act ("CRA"). Investors in these securities should perform their own due diligence to ensure that the securities backed by these mortgages fulfill their CRA requirements.

FG7.0

CRA Pool Offering

Address	City	State	ZIP	County	Census	MSA	MSA Name	UPB	Area Median Income	% of Area median income
6866 WYMAN WAY	WESTMINS	CO	80030	Adams County, CO	98.05	2080	Denver, CO	180,000	62,100	75.68%
1127 MILKY WAY	DENVER	CO	80260	Adams County, CO	93.18	2080	Denver, CO	99,000	62,100	78.90%
358 S 24TH AVE	BRIGHTON	CO	80601	Adams County, CO	85.14	2080	Denver, CO	160,000	62,100	74.07%
9487 PELON DR	NORTHGLE	CO	80260	Adams County, CO	83.04	2080	Denver, CO	147,250	62,100	51.53%
11997 E FORD DR	AURORA	CO	80012	Arapahoe County, CO	70.16	2080	Denver, CO	104,850	62,100	45.09%
2720 W ARCHER PL	DENVER	CO	80219	Denver County, CO	10	2080	Denver, CO	94,000	62,100	51.53%
3636 VALLEJO ST	DENVER	CO	80211	Denver County, CO	4.02	2080	Denver, CO	210,400	62,100	56.36%
1310 LAZY LN	COLORADO	CO	80906	El Paso County, CO	25	1720	Colorado Springs, CO	208,000	51,300	74.07%
4732 S SWADLEY ST	MORRISON	CO	80466	Jefferson County, CO	120.17	2080	Denver, CO	153,000	62,100	64.41%
7375 S ALKIRE ST	LITTLETO	CO	80127	Jefferson County, CO	120.22	2080	Denver, CO	113,200	62,100	57.97%
12131 WEST ATLANTIC DRIV	LAKEWOOD	CO	80228	Jefferson County, CO	117.18	2080	Denver, CO	160,000	62,100	46.70%
2905 NEIL DR	FORT COL	CO	80526	Larimer County, CO	11.04	2670	Fort Collins-Loveland, CO	105,600	56,300	72.82%
Grand Total			12					1,735,300		

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CRA Investment Concerns of Medium Size Banks

- Modest Assessment Area Size Limits
Opportunities
- Modest Capacity and Sophistication Level May
Limit Opportunities

Section 228.23 Investment Test

- Scope of Test. The Investment Test Evaluates a Bank's Record of Helping to Meet the Credit Needs of Its Assessment Area(s) Through Qualified Investments That Benefit Its Assessment Area(s) Or a Broader Statewide or Regional Area That Includes the Bank's Assessment Area(s).

Source: CRA Regulations

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New Regulatory Guidance

- “In addition, a retail institution that, considering its performance context, has adequately addressed the community development needs of its assessment area(s) will receive consideration for...community development activities ...located somewhere within a broader statewide or regional area Examiners will consider these activities even if they will not benefit the institution’s assessment area(s).”

Source: FFIEC CRA Q&A

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MBS INVESTMENTS ARE NOT PERFECT

- Bank Funding is Short Term (e.g., CDs and Money Market) – But, CRA MBS are Long Term Investments
- **MBS Prepayments are not Predictable**

Thus, Banks' Investment Objectives May Limit
CRA MBS Investments in Affordable Housing

CMO Investments Are Closer To Perfect

**CMOs Compartmentalize
Prepayment Risk of CRA MBS and Can
Offer Shorter Term Investments**

CMOs Structure Mortgage Borrowers Payments into
Multiple Cash Flow Streams, which are put into
Bond Classes called Tranches

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CMOs ARE ATTRACTIVE TO INVESTORS

- Initial Payment Streams (Tranches)
Appeal to Thrifts Seeking Short-Term Investments
- Longer Term Streams Generally Appeal to Pension Funds and Life Insurance Companies
- Credit Risk? – Same Guarantee of Timely Payment of Principal and Interest as MBS

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Custom Tailored Housing Investment Program (CHIP)

CHIP: The CRA CMO

- **All the Benefits of CRA MBS, plus**
- **Custom Tailored Investment Profile**
Banks Choose Their Tranche to Define
the Geography and Duration They
Desire

CRA CMO COMPLIANCE BENEFITS GO FURTHER THAN CRA MBS

- Leverage Additional Investments
- Shorter Investment than MBS so **Banks Can Invest More**
- **Innovative** and **Complex** Structure
- Not Routinely Provided by Private Investors
- Opportunity to Play a Leadership Role in Community Development

CRA CMO DEVELOPMENT

- First CMOs issued in 1983 by Freddie Mac
- 1997 Freddie Mac guarantees first CMO with LMI Collateral, underwritten by Bear Stearns & First Union – nonconforming loans, no geographic targeting

CRA MBS ALSO HELP SMALL BANKS

Compared with whole loan purchases:

- Safer – No Credit Risk
- More Liquid
- Lower Risk Based Capital Requirements
- Lower Transaction Costs/ Much less time consuming than whole loan purchases – No File Review

CRA MBS ALSO HELP SMALL BANKS

SECTION .26--Small institution performance standards

§__.26(a) Performance criteria

§__.26(a) - 1: May examiners consider lending-related qualified investments, when evaluating a small institution?

A1. **Yes. Examiners can consider "lending-related activities,"** and **lending-related qualified investments, when evaluating the first four performance criteria of the small institution performance test.** Although lending-related activities are specifically mentioned in the regulation in connection with only the first three criteria (i.e., loan-to-deposit ratio, percentage of loans in the institution's assessment area, and lending to borrowers of different incomes and businesses of different sizes), examiners can also consider these activities when

they evaluate the fourth criteria -- geographic distribution

CRA MBS ALSO HELP SMALL BANKS

§__.26(a) - 5: Under the **small institution** performance standards, **how will qualified investments be considered** for purposes of determining whether a small institution receives a satisfactory CRA rating?

- A5. The small institution performance standards focus on lending and other lending-related activities. Therefore, **examiners will consider only lending-related qualified investments for the purposes of determining whether the small institution receives a satisfactory CRA rating.**

Source: FFIEC CRA Q&A



CONSIDERATIONS IN CHOOSING A PARTNER

- Do They Actually Own the Bonds?
- Are You Getting the Best Price?
- Do You Have to Sign a Contract in Advance?
- Will Loans Fall Out?
- Will They Make a Market/ Can You Recoup Some of Your Premium if You Sell the Bonds?
- Are There Other Ways in Which the Relationship Will Add Value to Your Bank?



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· **CRA MORTGAGE BACKED
SECURITIES & CHIP – The
CRA CMO**

PRUDENT INVESTMENT OPPORTUNITIES

For More Information. . .

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