



REGULATORY INTERPRETATION 2002-RI-02

Date: March 6, 2002

Subject: Whether the Definition of “Acquired Member Assets” Includes Loans For Which the Servicing Rights Have Been Sold to a Participating Financial Institution Other Than the One Responsible For the Credit Enhancement

Request Summary:

A Federal Home Loan Bank (FHLBank) has requested a regulatory interpretation confirming that the Federal Housing Finance Board’s (Finance Board) Acquired Member Asset (AMA) regulation, 12 C.F.R. part 955, recognizes as AMA those Mortgage Partnership Finance (MPF) mortgage loans for which the responsibility for the required credit enhancement is retained by the Participating Financial Institution (PFI) that sold the loan to the FHLBank, but for which the servicing rights have been transferred to another PFI.

Conclusion:

So long as a mortgage loan acquired by a FHLBank from a member or housing associate as part of an AMA program continues to meet the credit risk-sharing and other requirements set forth in the AMA regulation, 12 C.F.R. part 955, the sale of the servicing rights associated with that loan to a PFI other than the PFI responsible for the credit enhancement would not violate the AMA regulation.

Background:

The FHLBank argues that the ability of small and mid-size members to sell servicing rights to other PFIs while retaining the credit enhancement on loans transferred to the FHLBank through an AMA program is essential in order to allow these members to maximize both the value of their servicing rights and the total credit enhancement fees received.

Under MPF, when a PFI sells a mortgage loan to an FHLBank, or originates a loan on behalf of an FHLBank, it retains a contractual obligation to administer the servicing of the mortgage loans in exchange for a fee, as well as a responsibility to credit enhance the mortgage loan (or, more accurately, the pool of which the loan is a part) to the extent required by Finance Board regulation and FHLBank policy. The FHLBank explains that these and similar mortgage servicing rights are considered to be assets of the institution holding the rights and represent a significant portion of the balance sheets of many institutions, including many FHLBank

members. The FHLBank explains that the value attributed to servicing rights is their “fair market value,” which is based, in part, on the liquidity of the asset. The FHLBank argues that by requiring the credit enhancement obligation to transfer simultaneously with the servicing rights, the liquidity and, therefore, the value of the servicing rights is diminished.

Discussion:

The Finance Board’s AMA regulation sets forth three criteria that must be met in order for a particular asset to be eligible for sale or transfer to an FHLBank as AMA. First, the asset must be either a whole loan of a type that is eligible to secure FHLBank advances, or another type listed in section 955.2(a) of the AMA regulation. *See* 12 C.F.R. § 955.2(a). Second, the asset must: be acquired by the FHLBank from a member or housing associate, another FHLBank, or, in certain circumstances, from a member or housing associate of another FHLBank; and have been originated, or held for a valid business purpose, by an FHLBank System member or housing associate prior to acquisition by the FHLBank. *See* 12 C.F.R. § 955.2(b).

Finally, with certain exceptions that are not relevant to this regulatory interpretation, the transaction through which the asset is transferred to the FHLBank must satisfy the credit risk sharing requirements set forth in section 955.3 of the regulation. *See* 12 C.F.R. § 955.2(c). Section 955.3(a) of the AMA regulation (12 C.F.R. § 955.3(a)) requires, in part, that:

a FHLBank shall determine the total credit enhancement necessary to enhance the asset or pool of assets to a credit quality that is equivalent to that of an instrument having at least the fourth highest credit rating from [a Nationally Recognized Statistical Rating Organization (NRSRO)], or such higher credit rating as the FHLBank may require. The FHLBank shall make this determination for each AMA product using a methodology that is confirmed in writing by an NRSRO to be comparable to a methodology that the NRSRO would use in determining credit enhancement levels when conducting a rating review of the asset or pool of assets in a securitization transaction.

Based upon the calculation required under section 955.3(a), section 955.3(b) (12 C.F.R. § 955.3(b)) requires that any FHLBank acquiring AMA:

implement, and have in place at all times, a credit risk-sharing structure for each AMA product under which a member or housing associate of the FHLBank or, with the approval of both FHLBanks, a member or housing associate of another FHLBank, provides a sufficient credit enhancement from the first dollar of credit loss for each asset or pool of assets such that the acquiring FHLBank’s exposure to credit risk for the life of the asset or pool of assets is no greater than that of an asset rated in the fourth highest credit rating category, as determined pursuant to paragraph (a) of this section, or such higher rating as the acquiring FHLBank may require.

Thus, under the regulation, the FHLBank has a continuing obligation to make certain that the credit risk-sharing requirements set forth in section 955.3 of the regulation are met on an ongoing basis and for the life of the asset.

While the regulation itself addresses neither the sale, nor any other aspect, of servicing of AMA loans, the preamble to the final rule establishing the AMA regulation contains a brief reference to the issue. *See* 65 Fed. Reg. 43977-78 (July 17, 2000). There, the Finance Board stated:

Six comments were received advocating a provision in part 955 that would give members participating in AMA programs the ability to transfer credit enhancement obligations and the servicing of AMA loans to other members in the same or other FHLBank districts. The final rule does not explicitly address, nor does it restrict, such transfers, though they may only be undertaken with the concurrence of the FHLBank of which the transferee is a member. In addition, such transfers must be accompanied by a similar undertaking by the transferee of the incentive requirements in 955.3(b)(2).

It is unclear whether, by referring to “such transfers,” this portion of the preamble was intended to address only the simultaneous transfer of the credit enhancement obligation and servicing rights to the same party, or also the separate transfer of one without the other. However, this portion of the preamble does not purport to address the sale of servicing in a comprehensive fashion, but merely responds to specific comments regarding the simultaneous transfer of credit enhancement obligations and servicing rights that were raised during the comment period for the proposed AMA rule. At any rate, because the AMA regulation is silent as to both the simultaneous and separate transfers of servicing rights and associated credit enhancement obligations, the regulation does not directly prohibit or restrict either type of transfer. However, although the regulation does not directly restrict the transfer of servicing rights, the AMA assets for which servicing rights have been transferred must continue to meet all requirements of the AMA regulation, all other applicable Finance Board regulations and all other guidelines established by the Finance Board for that AMA program after any transfer occurs.

In other words, transfers of servicing rights must be implemented in a manner that will minimize the possibility of a violation of the AMA regulation or other Finance Board regulations or AMA guidelines. Most importantly, the credit enhancement obligation must continue to be held by a member or housing associate of the FHLBank System, the credit enhancement must be sufficient to raise the asset to investment grade throughout the life of the asset, and the credit risk sharing structure must otherwise continue to meet the specific requirements of section 955.3(b). The FHLBank should ensure the continuing accuracy of the credit enhancement calculations made under section 955.3(a) by having in place guidelines for PFIs that will engage in the servicing of MPF assets and permitting the transfer of servicing only to PFIs that meet the MPF loan servicer criteria. Such servicing guidelines should include a requirement that any institution to which servicing rights are transferred be explicitly accepted by a Nationally Recognized Statistical Rating Organization (NRSRO) as conforming with its requirements for servicing proficiency, or which the FHLBank can demonstrate conclusively meets the NRSRO’s proficiency requirements. The sale of MPF servicing rights to a servicer that does not meet these standards would call into question the adequacy of the credit enhancement calculations, as currently made by the FHLBank, and would be a matter for increased scrutiny by the Finance Board’s Office of Supervision.

In addition, the FHLBank should undertake steps to ensure that the “member nexus” requirement of section 955.2(b)(1) of the regulation is met. The FHLBank should formally approve the request for transfer of servicing and should maintain adequate documentation to support compliance with regulatory requirements. For example, in general, it would be adequate for a PFI that sells MPF servicing to warrant both to the FHLBank and the purchaser of the MPF servicing rights that it originated the loans or acquired them from an affiliate.

Accordingly, so long as a mortgage loan acquired by a FHLBank from a member or housing associate as part of an AMA program meets the requirements of section 955.2 of the Finance Board’s regulations, and continues to meet the credit risk-sharing and other requirements set forth in the AMA regulation, 12 C.F.R. part 955, the sale of the servicing rights associated with that loan to a PFI other than the PFI responsible for the credit enhancement would not violate the AMA regulation. In the final analysis, the FHLBank is responsible for maintaining documentation that is adequate to support compliance with regulatory requirements.

A Regulatory Interpretation applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. part 907.