



Federal Housing Finance Board

July 9, 1998

TO: James Bothwell, Director
Office of Policy

Mitchell Berns, Director
Office of Supervision

THROUGH: Deborah F. Silberman
General Counsel

FROM: Neil R. Crowley
Deputy General Counsel

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ISSUE: Whether documents prepared by the Federal Home Loan Bank of [REDACTED] (FHLBank [REDACTED] or Bank) for implementation of its Federal Housing Administration (FHA) Rent-To-Own Purchase Program (Pilot Program) comply with the Federal Housing Finance Board's (Finance Board) resolution approving the Pilot Program?

CONCLUSION:

The documents for the Pilot Program will comply with the Finance Board resolution provided the language allowing the purchase of loans prior to becoming insured by the FHA is revised to make clear that the loans must be insured at the date of purchase.

I. Background

This responds to a request from the Office of Supervision (OS) to review certain draft documents prepared by the FHLBank-[REDACTED] for implementation of its Pilot Program. See Memorandum from [REDACTED] Senior Vice President to Jim Winning, Examination Division (March 12, 1998). We have reviewed the following documents: 1) Master Loan Purchase and Servicing Agreement (MLPSA), 2) Master Loan Purchase and Sale Agreement

(PSA), 3) Loan Servicing Agreement (LSA), and 4) Lender's Manual. OS obtained these documents from the FHLBank [REDACTED] in the course of its pre-implementation examination of the Pilot Program, as required by the Finance Board. See Finance Board Resolution, No. 97-69 (November 12, 1997) (Board Resolution).

Specifically, OS requested assistance in determining whether these documents would protect the FHLBank- [REDACTED] interest as well as possible under the Pilot Program, and whether there are any significant issues that the documents do not address adequately. The only legal issue is whether the documents comply with the Board Resolution. Determining whether the documents adequately protect the FHLBank [REDACTED] interest is more of a matter for OS or the Office of Policy (OP) to decide, and we defer to those offices on that matter. Nonetheless, in order to assist OS and OP in determining whether the documents adequately protect the interest of the FHLBank- [REDACTED] we offer the comments noted below. All of the issues raised in this discussion are addressed in our redlined version of the respective document.

II. Discussion

A. Compliance with Board Resolution

By resolution dated November 21, 1997, the Finance Board approved the FHLBank- [REDACTED] Pilot Program, permitting the FHLBank Seattle to invest in certain FHA-insured mortgage loans. See Board Resolution. The Board Resolution authorizes the FHLBank [REDACTED] purchase up to \$25 million in FHA-insured residential mortgage loans originated by its members and nonmember mortgagees to affordable housing developers and local government agencies.

Prior to implementing the Pilot Program, the FHLBank [REDACTED] must 1) prove to OS's satisfaction that it has established policies, procedures and controls to manage risks associated with the proposed purchase of FHA-insured residential mortgage loans, and 2) present an updated written opinion from local counsel to the Bank that the Pilot Program is permissible under the Finance Board's Financial Management Policy. We defer to OS on the first condition; we have reviewed the updated opinion, and believe it complies with the Board Resolution

Generally, the provisions of the Pilot Program documents comply with the Board Resolution. There is, however, one provision that must be revised in order to comply fully. Specifically, Article 5, Paragraph 9 of the MLPSA and PSA provides that all loans are to be insured by the FHA within ninety (90) days of the Bank's purchase of the respective loan. As written, this provision would permit the FHLBank- [REDACTED] to purchase loans that are not FHA-insured, although they are expected to be insured later. This is not permitted under the Board Resolution, which requires that the loans be FHA-insured at the time of the Bank's purchase.

Consequently, the FHLBank- [REDACTED] must amend Article 5, Paragraph 9 in each agreement to clearly indicate that the loans will be FHA-insured upon purchase. If that change is made, the Pilot Program documents would comply with the Board Resolution. We recommend that the FHLBank- [REDACTED] be required to submit the revised documents to OS to confirm that the change has been made.

B. Advisory Comments

The remaining comments below are advisory in nature and are provided in an effort to clarify existing provisions within the documents. Because these comments do not affect the documents' compliance with the Board Resolution, we defer to the OS and OP on whether the Bank should make the suggested changes. As a general note, some of the language in the documents is broad and vague. This does not affect compliance with the Board Resolution, but Customers who wish to participate in the Pilot Program could object to such language.

1. Master Loan Purchase and Servicing Agreement. - Serves as the master agreement governing the legal relationship between the FHLBank [REDACTED] those FHLBank members that will sell certain FHA-insured Mortgage Loans (Mortgage Loans) to the Bank and service them as well.

Article 1 - Recitals

Comment: In addition to establishing the Customer as an approved seller and servicer of Mortgage Loans, the MLPISA's purpose is to transfer ownership interest in the Mortgage Loans from the Customer to the FHLBank- [REDACTED]

Article 4 - Sale of Mortgage Interests

Paragraph 3 indicates that the FHLBank- [REDACTED] purchase of Mortgage Loans will be governed by, among other things, the Bank's Advances, Security, and Deposit Agreement (Advances Agreement).

Comment: If the FHLBank [REDACTED] wants to incorporate all or part of the Advances Agreement, the paragraph should do so expressly. Making this Agreement "subject to" the Advances Agreement, which appears to be the case presently, also is acceptable and if that is what the FHLBank [REDACTED] wants, no change is necessary.

Article 5 - Eligible Loans

Paragraph 7 identifies as an eligible borrower either a public housing agency or a FHA approved nonprofit housing development organization that intends to sell the subject property to an eligible borrower under an approved "rent-to-own" program.

Comment: The Bank must include language to indicate that the "rent-to-own" program is a FHA-approved program.

Paragraph 9 must be revised to require that FHA insurance be in place as of the date of the FHLBank-Seattle's purchase, as described above.

Article 7 - Seller's Obligations. Representations and Warranties as to Mortgage Loans

Paragraph 10 identifies the Customer as the legal owner of the Mortgage Loan.

Comment: In addition to being the owner of the Mortgage Loan, the Bank should include language to ensure that the Customer has a perfected, first lien security interest in the Mortgage Loan.

Article 9 -- Indemnification

Paragraph 1 sets forth the indemnification and hold harmless requirements of the Customer. The language, however, fails to mention all potential areas of risk to the Bank.

Comment: In its request for approval of its proposed pilot program, the Bank represented that the Customer would absorb all losses associated with the Pilot Program. Accordingly, to avoid all possible risks associated with its purchase of the mortgage loan, in addition to indemnifying the Bank, and holding it harmless, the Customer should also defend the Bank against any and all claims or actions that may arise in connection with the Customer's performance of its duties under this agreement. In order to ensure full protection for the Bank, the Customer's indemnification should extend to penalties, fines, and forfeitures in addition to the items listed.

Article 11 - Breaches of Contract

Comment: Since the FHLBank- [REDACTED] will continue to own these Mortgage Loans until they are sold into the secondary market, the Bank must protect itself against any of the Customer's actions that could compromise this ownership or security interest in the Mortgage Loans. Therefore, this Article should include a provision that renders the Customer in breach of the MLPSA if its actions or omissions directly or indirectly impair the FHLBank- [REDACTED] ownership and/or security interests in the Mortgage Loans. A breach of this provision should trigger the Customer's repurchase obligation.

Article 12 - Remedies for Breach of Contract. Representations and Warranties

Comment: The Bank should insert an additional provision which, in the event of the Customer's breach, will permit the Bank to exercise other rights provided by the MLPSA and Lender's Manual, or available at law or in equity.

Article 17 - Notice

Comment: This provision should identify an individual or office to accept notice on behalf of both the Bank and the Customer.

Additional Comments/questions

In the event that there is a dispute, the FHLBank [REDACTED] may wish to include an arbitration clause or other type of alternative dispute resolution provision in this agreement. Such methods of alternative dispute resolution are often less expensive and time-consuming than resolving disputes in court,

The FHLBank [REDACTED] may wish to consider including a provision that sets forth the method and manner in which amendments may be made to this agreement.

2. Master Loan Purchase and Sale Agreement - Serves as the master agreement governing the general legal relationship between the FHLBank [REDACTED] and those FHLBank members that will sell certain FHA-insured mortgage loans to the Bank, but will not service the mortgage loans.

The PSA is identical to the MLPSA with the exception that Article 10, relative to servicing mortgages, is not contained in the PSA. Therefore, all comments to the MLPSA apply also to the PSA.

3. Loan Servicing Agreement - Serves as the master agreement governing the general legal relationship between the FHLBank- [REDACTED]; and those FHLBank members whose responsibilities are limited to servicing the FHA-insured mortgage loans that are purchased under the FHLBank's Pilot Program from other parties

Introductory Provisions

Comment: It is probably helpful if the provisions provided more information regarding the purpose of the LSA.

Article 3 - Insurance

Paragraphs 2 and 3 permit the Customer to obtain casualty insurance at the borrower's expense if the coverage is not present.

Comment: If the purchase of casualty insurance is a cost of servicing the loan, the Customer will be responsible for the purchase of casualty insurance. But, if the purchase of such insurance coverage is not a cost of servicing the loan, then the current contract language does not indicate who will be responsible ultimately for purchasing the casualty insurance. coverage.

Article 6 - Breaches of Contract

Comment: Because the [REDACTED] Bank will continue to own these Mortgage Loans until they are sold into the secondary market, the Bank must protect itself against any of the Customer's actions that could compromise this ownership or security interest in the Mortgage Loans. Therefore, this Article should include a provision that renders the Customer in breach. of the LSA if its actions or omissions directly or indirectly impair the [REDACTED] Bank's ownership and/or security interests in the Mortgage Loans. A breach of this provision should trigger the Customer's repurchase obligation.

Article 14 - Notice

Comment: This Article should identify someone or office as being responsible for receiving any Notice provided under the Agreement.

The remaining suggested revisions are reflected in our redlined version of the LSA.

4. Lender's Manual - Governs the relationship between the Bank and the Customer and forms a part of the master agreement between the two for the purchase, sale and/or servicing of the mortgage loans under the Pilot Program

Page I-1 - Maximum Funds Available

Comment: In approving the FHLBank- [REDACTED] Pilot Program subject to certain conditions, the Board Resolution limited the Bank's purchases to \$25 million in total loans outstanding at any one time.

Page I- 1 - Eligible Originators/Sellers

Comment: This section permits the Bank to purchase mortgage loans that were originated by non-members of the FHLBank system that are affiliates of the Customer. The Bank, however, would purchase the mortgage loan from the Customer, only. In this manner, the Customer would be held accountable for the mortgage loan.

Page I-2 - Eligible Borrowers

Comment: The "rent-to-own" programs must be FHA approved programs.

Page I-3 - Maximum LTV and Dollar Amounts of Individual Loans

Comment: In its request for approval of its pilot program: the FHLBank [REDACTED] represented that it would not purchase any loans that exceed the loan limit in the authorizing legislation of any of the eligible programs identified in the Lender's Manual. The provision appears to address the representation, but we recommend that OS confirm that to be the case.

Page I-4 - Repurchase Criteria

Comment: The Bank should also have the option of requiring repurchase of the mortgage loan if the Customer breaches any provision of the Lender's Manual.

In addition, since the FHLBank [REDACTED] will not purchase any loans that are not FHA-insured, the term "obtain" should be deleted from the last paragraph.

Page II- 1 - Required Application Documentation

Comment: In its request for approval of the Pilot Program. The FHLBank [REDACTED] represented that Customer's must be approved a GNMA, FNMA or FHLMC seller/servicer of mortgage loans.

Page II-5 - Execution of Master Loan Purchase and Service Agreement

Comment: Since the Lender's Manual along with the MLPSA, PSA and LSA are the essential agreements that govern the Pilot Program, it should be referenced within this section.

Page IV-2 - Document Review Guidelines

The FHLBank requires the Customer to endorse the Promissory Note "without recourse."

Comment: Since this endorsement means that the Customer is not liable on the note, there should be an additional provision which indicates that the endorsement, "without recourse," will not affect the Customer's repurchase obligation under the MLPSA, the PSA, or the LSA.

Page IV-4 - Assignment of Deed of Trust

Comment: Although § 1430(f) of the Bank Act, provides that any security interest granted to a Federal Home Loan Bank receives priority over most other claims, it is not superior to claims that 1) are entitled to priority under otherwise applicable law, and 2) are held by bona fide purchasers for value, or 3) held by an actual secured party with a perfected security interest. See 12 U.S.C. §1430(f). At least one Washington court has held that possession of an assignment of a mortgage is sufficient to protect the assignee's interest against any subsequent purchasers of the mortgage from the record owner, even where the assignee fails to record. See Fidelity & Deposit Company of Maryland v. Ticor Title Insurance Company, 943 P.2d 710 (1997). The Bank should ascertain the law in each state and do whatever is necessary to protect its interest in that particular state.

The Bank's retention of a copy of the recordable Assignment is appropriate in some jurisdictions for purposes of proving that it has a perfected interest in the mortgage loan. The Bank should ensure, however, that the relevant jurisdiction would accept a copy of the Assignment instead of the original. Perhaps, in an effort to avoid all possible risks associated with proving its interest in the mortgage loan, the Bank may consider it prudent to hold the original note and Assignment documents instead of copies.

Page VII- 1 - Servicing of Delinquent Loans

In its submissions to the Finance Board, the FHLBank ██████ represented that the Customer would be responsible for all foreclosure activities and costs.

Comment: In addition to being responsible for foreclosure losses, there should be explicit language that makes the Customer responsible for all foreclosure activities (e.g., filings and appearances) and all costs associated with foreclosure.

5. Legal Opinion of George Akers, Esquire - Updates prior legal opinion.

Comment: This is consistent with the Board Resolution which requires the Bank's counsel to opine that the authority of a fiduciary to invest in residential mortgage loans under the laws of Washington State remains valid as of the date on which the Pilot is implemented.

cc: Jim Winning
Greg Goggans

RST/OS legal memo