



Federal Housing Finance Board

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December 10, 1998

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Regulatory Interpretation: Status of [REDACTED] insured securities under the FMP (98-RI-7)

Dear [REDACTED]:

This is in response to your letter dated September 28, 1998 to me requesting approval of the Federal Home Loan Bank (FHLBank) [REDACTED]'s proposal to invest up to \$[REDACTED] in [REDACTED]'s ([REDACTED]) insured small business loan-backed securities (securities) over a three-year period under section II.B.12 of the Federal Housing Finance Board's (Finance Board) Financial Management Policy (FMP).

Section II.B.12 of the FMP authorizes the FHLBanks to invest in "[O]ther investments that support housing and community development, provided that prior to entering into such investments, the [FHL]Bank" meets five criteria. The first three criteria set standards that the FHLBank must meet prior to making the investment. The fourth criterion requires the FHLBank to provide a description of the investment and an analysis of how the FHLBank meets the three standards. Finally, the FHLBank is required to receive confirmation from the Finance Board that the investment meets all of the other criteria. A copy of section II.B.12 of the FMP including the five criteria is attached.

Based on the information provided in your letter, recent conversations with FHLBank staff and information previously provided by the FHLBank, the Finance Board has determined that the proposed investment in up to \$[REDACTED] of [REDACTED] securities over the next three years meets the criteria and, therefore, is an authorized investment under section II.B.12 of the FMP. The Finance Board's analysis on which this determination is based is set forth below.

Description of the Investment

[REDACTED] is a state agency established by the [REDACTED] legislature in 1983 to further community development by stimulating the flow of private capital to qualified small businesses that cannot obtain conventional funding. Generally, loans are made by financial

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institutions to qualified small businesses and [REDACTED] insures 90 percent of each loan. Such loans, even with [REDACTED]'s guarantee, are not sufficiently profitable for the originating lender to hold in portfolio. As a result, the market for making such loans is limited.

To encourage lenders to make more community development loans eligible for [REDACTED]'s guarantee, [REDACTED] has developed a plan to create a secondary market by securitizing the insured portion of these loans. Under the proposed plan, originating lenders would be able to swap the insured portion of these loans for securities that the lender would then sell, thereby freeing up capital for additional loans. It may then be possible for smaller lenders to purchase the securities for credit under the Community Reinvestment Act (CRA) without having the in-house underwriting expertise needed to originate such loans in the first place, or to take the risk of holding the uninsured portions.

To assist [REDACTED] in implementing this program, the FHLBank [REDACTED] proposes to commit to purchase up to \$[REDACTED] of [REDACTED]'s insured small business loan-backed securities over a three-year period. By making this commitment to [REDACTED], the FHLBank [REDACTED] will assist [REDACTED] in overcoming the drawbacks of marketing a relatively small issue of a new security. [REDACTED] does not contemplate having the issue rated because it is not economical to obtain ratings for issues under \$[REDACTED]. A small, unrated, new security issue would most likely command a higher yield than [REDACTED] can afford to pay.

The FHLBank [REDACTED]'s purchase of the proposed securities would provide liquidity, thus encouraging lenders to make more such loans, and reduce the fees associated with issuing the proposed securities.

Standards for Investments authorized under Section II.B.12 of the FMP

Section II.B.12 of the FMP authorizes the FHLBanks to make investments that support housing and community development provided that three specific standards are met. Following is a discussion of how the FHLBank [REDACTED] meets each of the three standards.

- a. The FHLBank ensures the appropriate levels of expertise, establishes policies, procedures, and controls, and provides for any reserves required to effectively limit and manage risk exposure and preserve the FHLBank's and the System's triple-A rating.

As a condition of the investment by the FHLBank [REDACTED], [REDACTED] has agreed to obtain an opinion from the Attorney General of [REDACTED] confirming that the proposed securities would constitute obligations backed by the full faith and credit of the State of [REDACTED]. Since [REDACTED]'s long term rating from Standard and Poor's (S&P) is AA+, it may be inferred that if the proposed securities were rated, they would be rated AA+ by S&P. Based on this inferred rating of AA+, the FHLBank [REDACTED] believes that it will not incur any additional credit risk exposure by purchasing the securities.

The FHLBank will determine the price it will pay for the proposed securities based on market conditions at the time of the purchase, and, if the FHLBank should sell the securities prior to maturity, the FHLBank would set the price. As a result, the FHLBank does not anticipate that the purchase of the proposed securities will add any market risk exposure beyond that currently managed by the FHLBank.

The FHLBank [REDACTED] intends to invest up to \$[REDACTED] in [REDACTED] securities over a period of three years. As of June 30, 1998, the Bank had assets of \$[REDACTED], total investments of \$[REDACTED] and total capital of \$[REDACTED]. Because of the de minimus amount to be invested, the Finance Board concurs that there would be minimal risk exposure to the FHLBank.

- b. The FHLBank ensures that its involvement in such investment activity assists in providing housing and community development financing that is not generally available or that is available at lower levels or under lessattractive terms.

The FHLBank's purchase of the proposed securities will provide community development financing beyond what is currently available in the State of [REDACTED]. The Bank's proposed purchase could directly provide up to \$[REDACTED] of additional community development financing over three years -- \$[REDACTED] from the insured portions plus \$[REDACTED] from the uninsured portions. The FHLBank's role in assisting [REDACTED] in getting its secondary market program under way couldindirectly lead to much more community development financing being provided once the program becomes established.

In a letter dated August 13, 1998 addressed to me, [REDACTED], Director of Business Development, for [REDACTED], included the following statements. "The freed up capital resulting from the sale of the insured portion of the loan would be received by the [originating] bank and used to recapitalize its lending capacity.. . . Recapitalization through a secondary market insured loan sale would replenish bank funds that in turn will be used to make additional small business economic development/community development loans available to more businesses." ¹

- c. The FHLBank ensures that such investment activity promotes (or at the very least, does not detract from) the cooperative nature of the System.

The FHLBank [REDACTED] believes that its involvement in the [REDACTED] proposal will further the cooperative nature of the System by earning a profit from its investment that will ultimately benefit its members, and by facilitating a mechanism that will

¹ While the ability to securitize [REDACTED] insured loans will make them more attractive to lenders, there is no assurance that the funds generated from securitization will in fact be used to generate additional loans that [REDACTED] would insure.

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benefit its members both financially and from a CRA perspective. Given that [REDACTED] percent of the financial institutions in [REDACTED] are members of the FHLBank [REDACTED], almost all of the originators of the loans that will be securitized in the [REDACTED] proposal will be members.

Based on the facts and analysis presented above, the Finance Board has determined that the FHLBank [REDACTED]'s proposed investment in up to \$[REDACTED] [REDACTED] insured small business loan-backed securities over a three-year period meets the criteria of section II.B.12 of the FMP. This determination is conditioned on the FHLBank [REDACTED]'s (1) determining that the securities are a legal investment for fiduciary and trust funds in the State of [REDACTED]; (2) performing appropriate credit analysis of the investment; and (3) determining that the investment meets the FHLBank's profitability requirements. Further, the Finance Board has determined that the provisions of section II(C)(2) of the FMP shall not apply to this transaction.

This determination is based on the current FMP. As you are aware, the Finance Board currently is developing a revised financial management policy for the System that will be a more generic and flexible financial management regulation. Whether subsequent purchases of such investments as the FHLBank [REDACTED]'s proposed investment in [REDACTED] securities will be permissible under the new financial management regulation has yet to be determined. However, analysis of investments such as the [REDACTED] securities will be carefully considered in crafting the new regulation.

Should you have any further questions, please do not hesitate to contact Ellen Hancock in the Policy Development and Analysis Division of the Office of Policy, Research and Analysis on (202) 408-2906.

Sincerely,

James L. Bothwell

James L. Bothwell
Director, Office of Policy, Research
and Analysis

cc: Scott L. Smith
Deborah F. Silberrnan
Mitchell Berns

This is a Finance Board regulatory interpretation within the meaning of the Procedures for Requests, and Applications adopted by the Board of Directors of the Finance Board pursuant to Resolution No. 98-51 (October 28, 1998). The regulatory guidance set forth herein is applicable

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only to the specific transaction described above and may be relied upon by the recipient subject to modification or rescission by action of the Board of Directors of the Finance Board.

I concur: William W. Ginsberg
William W. Ginsberg, Managing Director

liquidity, or favorable pricing required to generate needed funding for housing or community development.

12. Other investments that support housing and community development. provided that prior to entering into Such investments. the Bank:
 - a. ensures the appropriate levels of expertise, establishes policies. procedures. and controls, and provides for any reserves required to effectively limit and manage risk exposure and preserve the Bank's and the System's triple-A rating;
 - b. ensures that its involvement in such investment activity assists in providing housing and community development financing that is not generally available. or that is available at lower levels or under less attractive terms;
 - c. ensures that such investment activity promotes (or at the very least. does not detract from) the cooperative nature of the System;
 - d. provides a complete description of the contemplated investment activity (including a comprehensive analysis of how the above three requirements are Willed) to the Finance Board: and
 - e. receives written confirmation from the Finance Board, prior to entering into such investments, that the above investment eligibility standards and requirements have been satisfied.

C. Limitations on Authorized Investments:

1. Investments in other than U.S. Dollar denominated securities are prohibited
2. A Bank may enter into agreements to purchase MBS, CMOs, REMICs, and eligible asset-backed securities so long as such purchases will not cause the aggregate book value of such securities held by the Bank to exceed 300 percent of the Bank's capital. A Bank may not increase its holdings of such securities in any one calendar quarter by more than 50 percent of its total capital at the beginning of that quarter. ⁴
3. The purchase of Interest Only or Principal Only stripped MBS, CMOs, REMICs. and eligible asset-backed securities is prohibited.
4. The purchase of residual interest or interest accrual classes of CMOs, REMICs. and eligible asset-backed securities is prohibited.
5. The purchase of fixed rate MBS, CMOs, REMICs, and eligible asset-backed securities, or floating rate MBS, CMOs, REMICs, and eligible asset-backed securities that on the trade date are at rates equal to their contractual cap. with average lives that vary more than six years under an assumed instantaneous interest