



Federal Housing Finance Board

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December 10, 1998

[REDACTION]

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[REDACTION]

[REDACTION]

Regulatory Interpretation: Status of section 108 participation certificates under section II(C)(2) of the FMP (98-RI-8)

Dear [REDACTION]:

This is in response to your request dated September 1, 1998 regarding whether section 108 participation certificates guaranteed by the U.S. Department of Housing and Urban Development (HUD) must be included in the "three times capital" limitation on the purchase of MBS, CMOs, REMICs and eligible asset-backed securities set forth in section II(G)(2) of the Federal Housing Finance Board's (Finance Board) Financial Management Policy (FMP).

Based on the information provided by the Federal Home Loan Bank (FHLBank or Bank) [REDACTION] and recent conversations with Bank staff, the Finance Board has determined that the Bank's proposed purchase of the entire offering of the Section 108 Participation Certificates, which is estimated at \$[REDACTION], through a private placement with HUD will have a measurable impact on the availability of housing and community development funds, and therefore, will be considered outside the purview of section II(C)(2) of the FMP. The Finance Board's analysis upon which this conclusion is based is set forth below.

Description of the Investment

Under the Housing and Community Development (HDC) Act of 1974, HUD provides annual formula-based community development block grants (CDBG) to units of local government that meet certain statutory and regulatory requirements, generally, cities with populations of 50,000 or more and urban counties with populations of 200,000 or more. HUD also provides annual formula-based CDBGs to States under certain conditions. CDBG funds are used to fund eligible economic development projects and housing rehabilitation activities and must be used either for projects or activities that principally benefit low and moderate income households (70 percent of the households

[REDACTION]

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benefiting must have incomes of 80 percent of area median income (AMI) or less) that are located in low or moderate income neighborhoods, that eliminate slums or blight or that address urgent needs.

Pursuant to section 108 of the HDC Act (amended in 1994), HUD may guarantee 1) notes issued by units of local government receiving annual grants under the CDBG program (section 108 interim notes), and 2) certificates backed by trusts or pools of such notes (section 108 participation certificates). Current and future CDBGs and grant allocations are pledged for the repayment of the section 108 interim notes and the section 108 participation certificates. Your request to the Finance Board indicated interest in both securities, however, in a recent conversation, you stated that the Bank is now only interested in purchasing the section 108 pool certificates.

According to information provided by the Bank, there have been three previous offerings of section 108 participation certificates, one each year in 1995, 1996 and 1997. These offerings were fully underwritten and ranged from \$246 million to \$322 million in aggregate principal amount. The next offering is estimated to be \$[REDACTION].

Section 108 Participation Certificates are allowable investments under Section II(B)(6) of the FMP

Securities guaranteed by the US. are permissible investments under section II(B)(6) of the FMP. The full faith and credit of the U.S. is pledged to honor the HUD guarantee of the section 108 interim notes and the section 108 participation certificates. Therefore, both of these securities are permissible investments for the FHLBanks.

Section 108 Participation Certificates will be considered outside the purview of section II(C)(2) of the FMP

The section 108 participation certificates represent a fractional undivided interest in a portion of a trust sponsored by HUD. The assets of the trust are the notes issued by local government units, which are backed by current and future CDBGs, and the guaranty issued by HUD, which guarantees the timely payment of principal and interest due on the notes. Because the section 108 participation certificates are technically asset-backed securities, a determination regarding whether the securities are subject to the 300 percent of capital limitation of the FMP must be made.

Section II.C.2 of the FMP states:

A Bank may enter into agreements to purchase MBS, CMOs, REMICs and eligible asset-backed securities as 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.

FMP §II(C)(2). A January 5, 1998 memorandum from the Finance Board's Office of General Counsel (OGC), which was transmitted to the FHLBanks under cover of a January 21, 1998 letter from Chairman Bruce Morrison and which is referred to in the Office of Supervision's Advisory Bulletin No 98-8, dated April 21, 1998, clarified which types of investments must be included in the "three times capital" limitation set forth in section II(C)(2). The OGC memorandum concluded that section II(C)(2) is intended to limit FHLBank investments in MBS, CMOs, REMICs and asset-backed securities that do not have a measurable impact on the availability of housing and community development funds, irrespective of the FMP provision under which the security qualifies for FHLBank investment. Conversely, FHLBank investments that are likely to have a measurable impact on the availability of housing and community development funds are not subject to the "three times capital" limitation, even if the securities in question possess characteristics similar to those of MBS, CMOs, REMICs and asset-backed securities. These conclusions were adopted as the official position of the Board of Directors of the Finance Board on June 24, 1998, as part of its approval of the settlement of a supervisory determination. Factors to be considered in determining whether a FHLBank's purchase of a particular security will have a measurable impact on the availability of housing and community development funds include: whether there is a ready market for the security without FHLBank involvement; and whether FHLBank involvement provides the issuer with some benefit such as favorable pricing, liquidity, or customized terms that generate funding for housing or community development.

[REDACTION] has specifically requested exemption from the 300 percent of capital limitation for the purchase of approximately \$[REDACTION] of section 108 pool certificates on the basis that the Bank will provide additional value to the issuer. The Bank intends to negotiate a private placement with HUD to purchase the entire offering of section 108 participation certificates. The terms provided under the private placement would be tailored to the financing needs of the local government units. Additional benefits of the private placement include reduced administrative costs and elimination of underwriter and bond counsel expenses.

The Bank's purchase of the section 108 participation certificates through a private placement with HUD would provide financial benefit in the form of lower pricing and cost savings to the local government units that would use the funds raised through the section 108 participation certificates offering for eligible housing and community development projects. The pricing and cost savings of the private placement would not be available to HUD without FHLBank involvement. As such, the Bank's purchase of the section 108 participation certificates has a measurable impact on the availability of housing and community funds and will be considered exempt from the limitations of section II(C)(2) of the FMP that would apply to MBS and other asset-backed securities.

[REDACTION]

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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. Treatment of subsequent purchases of such investments as the Bank's proposed investment in section 108 participation certificates under the new financial management regulation has not been determined. However, analysis of investments such as the one the Bank is proposing 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

cc: Scott L. Smith
Deborah F. Silberman
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. 98-5 1 (October 28, 1998). The regulatory guidance set forth herein is applicable 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