



REGULATORY INTERPRETATION 1999-RI-15

Date: October 6, 1999

Subject: Targeted Mortgage Purchase Program

Request Summary:

A Federal Home Loan Bank (FHLBank) has requested Federal Housing Finance Board (Finance Board) approval to purchase up to \$100 million in targeted mortgages from members (Program).

Background:

As described in its proposal, the FHLBank would purchase from its members up to \$100 million of single-family, fixed-rate mortgage loans originated by the member and made to low-income borrowers, *i.e.*, borrowers whose incomes are at or below 80 percent of the higher of state or county median income. The FHLBank would purchase the loans with full recourse to the member. The Program would allow the purchase of loans with a loan-to-value (LTV) ratio of up to 100 percent with no primary mortgage insurance and where originating members will be given maximum underwriting flexibility.

The underlying rationale for this Program, as proposed by the FHLBank, is that there are opportunities for members to make loans to creditworthy low-income borrowers who are now unable to obtain financing on terms they can afford, primarily because they cannot qualify for fixed rate loans that meet secondary market standards. The loans are unable to meet secondary standards due to the characteristics of either the borrower or the property to be financed (*e.g.*, unacceptable mortgage qualifying debt ratios, unacceptable FICO scores, distance from fire protection, unacceptable water or sewer facilities, or inadequate mechanical systems).

The FHLBank states in its proposal that the Program is designed to enable low-income consumers to qualify for a mortgage loan and purchase a home. Because primary mortgage insurance will not be required, the mortgages will not need to conform to nationally based standards that may not take local conditions and needs into account.

The FHLBank provided an opinion of counsel that mortgages under the Program are instruments in which fiduciary and trust funds may invest under the laws of the state in which the FHLBank is located, as required by sections 11(h) and 16(a) of the Federal Home Loan Bank Act, 12 U.S.C. §§ 1431(h) and 1436(a).

Analysis:

Section II.B.12 of the Finance Board's Financial Management Policy (FMP) permits the FHLBanks to enter into investments that support housing and community development provided that prior to entering into such investments the FHLBank meets three specific standards. Following is a discussion of how, in the judgement of Finance Board staff, the FHLBank's proposed Program meets each of the three criteria.

- (1) 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 FHLBank System's triple-A rating

The Program is structured such that the inherent risks in single-family mortgage lending are allocated to the entities that have the most experience in managing those risks. While the FHLBank utilizes its expertise in managing interest rate risk, prepayment risk and liquidity to manage those components of mortgage lending, the participating members, who are experienced credit underwriters, manage the credit risk.

Under the Program, a member will sell loans to the FHLBank with full recourse to the member, thereby allocating most of the credit risk on the loans to the member. The member will be obligated to provide recourse to the FHLBank if a loan becomes 90 days delinquent. The FHLBank is exposed to credit risk only if the borrower defaults on a loan, the originating member fails and is unable to repurchase the loan, and the FHLBank is unable to recover the outstanding balance of the loan through the sale of or foreclosure on the underlying mortgage collateral. The primary risks to the FHLBank are interest rate and prepayment risk. The FHLBank will manage the interest rate and prepayment risk on a macro basis, in much the same way it does with its mortgage-matched advance product.

- (2) 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 less attractive terms

The Program will offer members of the FHLBank a financing source for mortgage loan originations where only limited or less attractive alternatives are currently available. The FHLBank conducted surveys and focus groups and concluded that some members had a need for affordable financing for high LTV loans that do not conform to secondary market standards. Under the Program, standards for determining what properties are acceptable will be set by the member lending institutions using their own underwriting standards as opposed to national standards set by the secondary market. By allowing flexibility in underwriting, local lenders, who are familiar with their local economies, determine how factors such as seasonal or self-employment income will be treated when reviewing an applicant's ability to pay a loan. Members who wish to participate in the Program will undergo an approval process, including a review of the originating members credit strength and quality of operations.

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

The Program promotes the cooperative nature of the FHLBank System by offering its members a new way to serve the housing finance needs of their markets, providing all members the

opportunity to participate, and relying on members to originate and service the loans purchased under this Program. Through this Program, the FHLBank will create a limited-purpose secondary mortgage market for housing loans to low-income buyers. According to the FHLBank, the Program will appeal to smaller and, perhaps, rural institutions who do not have as many alternative funding tools or staff expertise for dealing with funding issues. Additionally, the ability of member to design their own underwriting criteria combined with a perceived ease of execution with the FHLBank helps promote the cooperative nature of the FHLBank System.

Conclusion:

It is the opinion of Finance Board staff that the purchase of \$100 million in mortgages as described in the FHLBank's Proposal is authorized under the (FMP. However, the FHLBank's purchase of housing loans shall be subject to the conforming loan limits established pursuant to 12 U.S.C. § 1717(b)(2).

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. 64 Fed. Reg. 30880 (June 9, 1999), *to be codified* at 12 C.F.R. part 903.