



REGULATORY INTERPRETATION 1999-RI-17

Date: October 26, 1999

Subject: Standby Bond Purchase Agreements with State Housing Finance Agencies

Request Summary:

A Federal Home Loan Bank (FHLBank) wishes to enter into standby bond purchase agreements (purchase agreements) with state housing finance agencies (HFA) and has requested an interpretation that such agreements are permitted under section II.B.11 of the Financial Management Policy (FMP), which allows the FHLBanks to purchase HFA bonds that meet certain criteria.

Background:

The FHLBank has requested that the Federal Housing Finance Board (Finance Board) interpret section II.B.11 of the FMP to permit the FHLBank to enter into purchase agreements with a state HFA. Under the purchase agreements, the FHLBank would serve as a liquidity provider by agreeing to buy state HFA temporarily floating-rate, tax-exempt bonds¹ (bonds) at par from holders of those bonds should such a holder choose to sell the bonds. On the date that the FHLBank executes the purchase agreement, all bonds subject to the agreement will be rated at least double-A by Standard & Poor's or Moody's. During such time as the FHLBank actually holds any of these bonds, the coupon temporarily would be adjusted from the tax-exempt rate to a floating premium rate² that provides the FHLBank an acceptable rate of return. Each purchase agreement has a "Special Event of Default" trigger that terminates the FHLBank's obligations under the purchase agreement should the rating assigned by Moody's or Standard & Poor's fall below triple-B. Since the bonds are highly stable investments, a downgrade would be unusual. The purchase agreements would have a three-year duration, would be renewable annually after the first three years and the FHLBank would receive a quarterly commitment fee for entering into the purchase agreement.

The FHLBank indicates that while such purchase agreements have been used over the past 20 years, there have been very few cases in which prior liquidity providers have been required to purchase a bond. In the event that the FHLBank should be required to purchase any bonds, the FHLBank would be able to sell the bonds at par either independently or through the HFA's repurchasing agent. The purchase agreement gives the repurchasing agent 60 days in which to sell the bonds. Following the expiration of the 60-day resale period, the state HFA would redeem the bonds by purchasing them from the FHLBank

¹ The rate on the bonds is reset weekly to keep the value of the bonds at par. Because the purchase agreement assures that the bonds will always have a guaranteed buyer, i.e., the bonds are always liquid, the bonds are eligible for investment by tax-exempt money market mutual funds, which must maintain a dollar value for their shares.

² The rate would be the higher of the prime rate or the fed funds rate plus 0.5 percent. Such a rate would exceed not only the tax-exempt rate but also the taxable rate on HFA bonds.

in four equal consecutive semiannual principal installments on June 1 and December 1 commencing on the first such date following the end of the 60-day resale period.

The FHLBank's analysis indicates that entering a purchase agreement presents no greater economic risk to the FHLBank than purchasing HFA bonds if the bonds are rated at least double-A at the time the FHLBank enters into the purchase agreement. In fact, the risk that the FHLBank will be left holding an illiquid instrument is reduced since, under the terms of the purchase agreement, the state HFA agrees to repurchase the bonds within two years of any bond purchase. Moreover, the FHLBank would not be required to purchase any bonds should the rating of the bonds fall below triple-B.

The FHLBank also has requested to enter into purchase agreements with other state HFAs where the underlying obligations are rated at least double-A at the time of the execution of the purchase agreement.

Analysis or Discussion:

Section II.B.11 of the FMP authorizes the FHLBanks to invest in “[m]arketable direct obligations of state and local government units or agencies, rated at least Aa by Moody’s or AA by Standard and Poor’s, where the purchase of such obligations by a FHLBank provides to the issuer the customized terms, necessary liquidity, or favorable pricing required to generate needed funding for housing or community development.” This section was added to the FMP as one of a series of amendments adopted by the Board of Directors of the Finance Board at its July 3, 1996 meeting, *see* Res. No.96-45 (July 3, 1996), and was intended to encourage the FHLBanks to invest in mission-related obligations of state and local agencies where FHLBank involvement would have a measurable impact on the availability of funds for housing and community development. Factors that should be included in determining whether a particular HFA obligation meets the measurable impact requirement include whether there is a ready market for the obligation absent Bank involvement and whether FHLBank involvement provides the HFA with some benefit such as favorable pricing, liquidity, or customized terms necessary to generate needed funding for housing or community investment.

The purchase agreement that the FHLBank wishes to enter into is an agreement to purchase state HFA bonds in the future contingent upon the liquidity needs of the investors who initially purchase the bonds. The state HFA requires such a liquidity provider in order to ensure the initial sale of the bonds. Therefore, the FHLBank would facilitate the sale of the bonds by serving as the standby liquidity provider for the issue. The bonds are issued pursuant to the state HFA’s statutory mission to increase the supply of, and encourage and assist in the purchase, development and construction of, housing for low- and moderate-income families and persons in the state. The proceeds of the bonds are used to finance the purchase of mortgage loans that assist low- and moderate-income families and persons in the state and otherwise further the statutory purposes of the state HFA. The purchase agreement, therefore, meets the requirement of Section II.B.11 of the FMP that the FHLBank involvement have a measurable impact on the availability of funds for housing. The bonds associated with the repurchase agreement are rated at least Aa by Moody’s or AA by Standard & Poor’s on the date of execution of the purchase agreement and conditions of the agreement ensure that the bonds remain marketable if the FHLBank is required to purchase them.

To date, the Banks have invested only in taxable bonds issued by HFAs. For HFAs, demand for mortgage funds is generally greater than the amount of funds that can be raised through tax exempt bonds. The amount of tax exempt bonds that can be issued is limited by law. Because of these limits, HFAs blend taxable issues with tax exempt issues to “stretch” their ability to meet demand for mortgage funds. Because the FHLBanks do not pay taxes, the yield offered on taxable HFA bonds is more

attractive to them than to other participants in the market that must pay taxes. As a result, the FHLBanks can be very competitive in meeting the pricing required by the HFA, thus providing favorable pricing and needed liquidity for the HFA as required by Section II.B.11 of the FMP. While the tax-exempt bonds issued by HFAs generally do not offer the FHLBanks an acceptable rate of return because the Banks do not pay taxes, in this case the conditions of the purchase agreement would provide the FHLBank with a rate higher than the tax-exempt rate should the FHLBank actually purchase any tax-exempt bonds.

The FHLBank's participation in purchase agreements would be permissible under the proposed Financial Management and Mission Asset regulation.

Interpretation:

Standby purchase agreements to purchase HFA bonds that are rated Aa by Moody's or AA by Standard & Poor's at the time of execution of the agreement are permitted under Section II.B.11 of the FMP.

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).