



## REGULATORY INTERPRETATION 2002-RI-05

**Date:** May 21, 2002

**Subject:** Obligations of State Housing Finance Agencies and Unsecured Credit Limitations

***Request Summary:***

Certain Federal Home Loan Banks (FHLBanks) have requested that the Federal Housing Finance Board (Finance Board) concur with their view that certain obligations of state housing finance agencies (HFAs) already purchased or to be purchased by the FHLBank are not unsecured extensions of credit within the meaning of 12 C.F.R. § 932.9.

***Conclusion:***

Obligations of state HFAs would not be considered unsecured extensions of credit, and thus would not be subject to the limitations and reporting requirements of 12 C.F.R. § 932.9, if the FHLBank has documented that the obligation in question: (1) is principally secured by high-quality mortgage loans and/or high-quality mortgage-backed securities (or funds derived from payments on such assets or from payments from any guarantees or insurance associated with such assets) or from the proceeds derived from the issuance of the bonds themselves, all of which are pledged to a trustee for the benefit of the bondholders such that the program asset to debt ratio exceeds 1.0; (2) is not a subordinate bond when the bond has more than one class, *i.e.*, it is the most senior class; and (3) is rated no lower than the second-highest investment-grade rating by a Nationally Recognized Statistical Rating Organization (NRSRO).

***Background:***

The unsecured credit rule provides that any debt obligation purchased by an FHLBank is deemed to be an unsecured extension of credit, unless the FHLBank holds collateral against the debt or the Finance Board has determined, on a case-by-case basis, that the obligation should not be considered unsecured credit. 12 C.F.R. § 932.9(f)(2). The preamble to the unsecured credit rule makes clear that the above presumption applies to state HFA obligations. *See* 66 Fed. Reg. 66718, 66723 (Dec. 27, 2001). In support of their requests, the FHLBanks submitted materials describing representative HFA bond issues. These materials indicate there is substantial mortgage collateral supporting these particular obligations, although the actual collateralization of the investments critically depends upon the indenture and actions taken by the trustee.

### ***Analysis or Discussion:***

The Finance Board staff has reviewed the structure of a number of state HFA obligations to determine the extent to which these obligations are collateralized. Based on that review, Finance Board staff has identified three criteria that it intends to use in determining whether a particular obligation is deemed not to be an unsecured extension of credit. The three criteria are that the bond: (1) is principally secured by high-quality mortgage loans and/or high-quality mortgage-backed securities (or funds derived from payments on such assets or from payments from any guarantees or insurance associated with such assets) or from the proceeds derived from the issuance of the bonds themselves, all of which are pledged to a trustee for the benefit of the bondholders such that the program asset to debt ratio exceeds 1.0; (2) is not a subordinate bond when the bond has more than one class, *i.e.*, it is the most senior class; and (3) is rated no lower than the second-highest investment-grade rating by an NRSRO. If an FHLBank can document that a particular HFA bond issuance satisfies each of these three criteria, the amount invested in the bond will not be considered an unsecured extension of credit for purposes of compliance with 12 C.F.R. § 932.9.

State HFA obligations have many variations. However, most of these obligations have high-quality mortgages or federally related mortgage-backed securities pledged to an independent third-party trustee to assure repayment of the bonds. In addition, depending on the bond structure, the bond may have various cash accounts pledged to and managed by the trustee for the benefit of the bondholders. In some cases, the HFA issues the bonds before the mortgages are acquired, thus the trustee may hold the bond proceeds in the form of cash or high-quality liquid assets until the mortgages are assembled. As a practical matter, holding the bond proceeds in the form of cash would result in a negative carry on the bonds, and thus the HFA and trustee would normally strive to acquire mortgages as expeditiously as possible. This Regulatory Interpretation allows the obligation to be considered secured by these various cash accounts in addition to the mortgage loans, and imposes the substantive condition that the value of all of the collateral securing the obligation must exceed the par amount of the obligation, that is, the program asset to debt ratio must exceed 1.0.

Some state HFA obligations may use a senior-subordinated structure whereby the senior bondholders have certain preference rights in the case of delinquency or default over the subordinated bondholders. While some subordinated bonds may be supported by the collateral pledged to a bond trustee, whether such collateral would be sufficient to warrant a determination that the bonds should not be considered to be unsecured credit depends on the particular facts of each case. Accordingly, this Regulatory Interpretation applies only to the most senior class in a multiple class bond structure, which means that any subordinate (or mezzanine) bonds issued by a state HFA would be considered to be unsecured credit for purposes of the rule, unless the Finance Board were to determine, on a case-by-case basis, that the debt issuance should not be considered to be unsecured credit.

The third condition is that the obligation must be rated no lower than the second-highest investment grade by an NRSRO. This restates the ratings requirement contained in 12 C.F.R. § 956.3(a)(4)(iii). While this regulatory provision would appear to preclude the purchase of any HFA obligation rated lower than the second-highest investment grade, an FHLBank could purchase certain targeted HFA obligations rated lower than the second-highest investment grade under the core mission activities provisions of 12 C.F.R. § 940.3(e). As with the purchase of

subordinated HFA obligations, an FHLBank could still request a case-by-case determination that a particular targeted HFA obligation rated lower than the second-highest investment grade not be considered unsecured credit.

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. 12 C.F.R. §§ 907.1 and 907.5.