



ADVISORY BULLETIN 2008-AB-02

July 1, 2008

*Federal Housing Finance Board
Office of Supervision*

To: Federal Home Loan Bank Chairs, Presidents, and
Directors of Internal Audit
Managing Director, Office of Finance

From: Stephen M. Cross
Director
Office of Supervision

Subject: Application of Guidance on Nontraditional and Subprime Residential Mortgage Loans to Specific FHLBank Assets

Background

The federal banking agencies published *Interagency Guidance on Nontraditional Mortgage Product Risks* on October 4, 2006 and *Statement on Subprime Mortgage Lending* on July 10, 2007 (collectively “interagency guidance”). The interagency guidance focuses on certain loans with features that permit borrowers to defer principal and interest payments. The interagency guidance emphasizes underwriting standards intended to ensure a borrower’s ability to repay a mortgage loan at the fully indexed rate and assuming an amortizing repayment schedule. The interagency guidance also recognizes that many nontraditional mortgage loans, particularly subprime loans with risk-layering features, warrant strong risk management standards, capital levels commensurate with the risk, and appropriate consumer disclosures.

On April 12, 2007, the Finance Board’s Office of Supervision issued Advisory Bulletin 2007-AB-01, *Nontraditional and Subprime Residential Mortgage Loans*. That advisory bulletin requires each Federal Home Loan Bank (FHLBank) to implement policies and practices that establish risk limits for, and mitigation of, credit exposure on nontraditional and subprime mortgage loans. In addition, Finance Board examiners informed FHLBank officials how to apply that advisory bulletin in determining collateral eligibility for mortgage loans originated

after the interagency guidance was issued. This advisory bulletin supplements Advisory Bulletin 2007-AB-01 and the earlier examiner communications by providing written guidance regarding mortgages purchased under the Acquired Member Assets (AMA) programs, investments in private-label MBS, and collateral securing advances.

Guidance

Acquired Member Assets

AMA programs currently allow only for the acquisition of fixed-rate residential mortgage loans of up to \$417,000. Some FHLBanks hold mortgages with characteristics, such as low credit scores, suggestive of subprime loans. Some hold mortgages underwritten according to reduced documentation requirements. Effective upon issuance of this guidance, we expect mortgage loan commitments entered by the FHLBanks under the AMA programs to comply with all aspects of the interagency guidance.

Private-Label Mortgage Backed Securities

Some FHLBanks also have exposure to nontraditional and subprime mortgages in their holdings of private-label MBS. Effective upon issuance of this guidance, we expect that purchases of private-label MBS by the FHLBanks will be limited to securities in which the underlying mortgage loans comply with all aspects of the interagency guidance.

Collateral Securing Advances

Effective upon issuance of this guidance, mortgages that were originated or acquired by a member after July 10, 2007 may be included in calculating the amount of advances that can be made to the member only if those mortgages comply with all aspects of the interagency guidance. Similarly, private-label MBS that were issued after July 10, 2007 may be included in calculating the amount of advances that can be made to a member only if the underlying mortgages comply with all aspects of the interagency guidance.

Each FHLBank should adopt business practices and take the quality control steps necessary to ensure the orderly and effective implementation of this guidance as it applies to the acquisition of AMA, the purchase of private-label MBS, and the calculation of the amount of advances that can be made to a member. Each FHLBank may conduct the due diligence on the assets it acquires itself, rely on an independent third party to assess the assets for compliance, or rely on representations and warranties provided by the member for mortgages sold into the AMA programs and by the issuers of any private-label MBS the FHLBank acquires. However, we expect the FHLBank to rely on representations and warranties and third-party assurances only if the FHLBank has a credible plan to test and verify their dependability.

To include mortgages originated or acquired by a member after July 10, 2007 in the calculation of the amount of advances that can be made to the member, the FHLBank's policies and business practices should require the member to certify that those mortgages comply with the interagency guidance. To include private-label MBS issued after July 10, 2007 in the calculation of the amount of advances that can be made to a member, the FHLBank's policies and business practices should require the member to obtain an enforceable representation and warranty from

the issuer that the residential mortgages included in the loan pools securitized by those private-label MBS comply with the interagency guidance.

Please direct any questions or comments regarding this advisory bulletin to the principal contacts listed below. If needed, we will provide further guidance or clarification.

Related Guidance

Nontraditional and Subprime Residential Mortgage Loans, Federal Housing Finance Board Advisory Bulletin AB-2007-01, April 12, 2007.

Interagency Guidance on Nontraditional Mortgage Product Risks, Federal Register, Volume 71, Number 192, October 4, 2006, pp. 58609-58618.

Statement on Subprime Mortgage Lending, Federal Register, Volume 72, Number 131, July 10, 2007, pp. 37569-37575.

Principal Finance Board Contacts

Kari Walter, Senior Associate Director, Supervisory and Regulatory Policy, (202) 408-2829, walterk@fhfb.gov.

Lou Scalza, Associate Director, Policy and Program Development, (202) 408-2953, scalzal@fhfb.gov.

An Advisory Bulletin is an Office of Supervision staff document that provides guidance to the Federal Home Loan Banks and the Office of Finance regarding particular supervisory issues. Although an Advisory Bulletin does not have the force of a regulation or an order, it does reflect the position of the Office of Supervision on the particular issue, and will be followed by examination staff. If non-compliance with an Advisory Bulletin is cited as the basis for a supervisory determination, any such determination will be subject to review by the Board of Directors pursuant to the procedures of 12 CFR 907.9. Advisory Bulletins are effective upon issuance.