



FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2020-01: ACQUIRED MEMBER ASSETS RISK MANAGEMENT

Purpose

This Advisory Bulletin (AB) provides Federal Housing Finance Agency (FHFA) guidance regarding a Federal Home Loan Bank's (Bank) risk management of Acquired Member Assets (AMA), including FHFA's expectations that Bank boards of directors establish certain limits. The Banks should be able to demonstrate their progress toward adherence to this guidance by September 30, 2020 and should have final limits in place by December 31, 2020.

Background

The mission of the Banks is to provide to their members and housing associates financial products and services that assist and enhance such members' and housing associates' financing of housing and community lending.¹ Similar to taking an advance, when a member sells eligible mortgage loans to a Bank, the Bank serves as a funding source for the member's housing finance lending. FHFA regulations and guidance related to AMA embody the principles that the Banks must acquire AMA safely and soundly and in a manner that is consistent with the Banks' mission. Sound governance of AMA programs is critical to safety and soundness and should include the establishment of limits to control the risks inherent in owning mortgage loans. AMA programs should at the same time fulfill the affordable housing mission requirements articulated in the Bank housing goals. The guidance in this Advisory Bulletin highlights FHFA's supervisory expectations with respect to sound risk management practices and how they relate to AMA.

Regulatory Environment

The following provides a summary of some of the regulation and guidance for governance and AMA.

- *Responsibilities of Boards of Directors, Corporate Practices, and Corporate Governance Regulation.* This regulation provides that the management of each regulated entity shall be by or under the direction of its board directors. It states, "the ultimate responsibility of each entity's board of directors for that entity's oversight is non-delegable."² Included in

¹ 12 CFR § 1265.2

² 12 CFR § 1239.4(a).

the responsibilities of each Bank's board of directors is the establishment of a risk management program that aligns with the Bank's risk appetite and that each of the Bank's business lines has appropriate risk limitations.³

- *Prudential Management and Operating Standards (PMOS) Regulation.* FHFA addresses limits on investments and management of assets in its PMOS regulation, the appendix to which establishes eleven standards as guidelines, including Standard 6 (Management of Asset and Investment Portfolio Growth), Standard 7 (Investments and Acquisitions of Assets), and Standard 9 (Management of Credit and Counterparty Risk).⁴ The failure to meet any of the PMOS may constitute an unsafe or unsound practice for purposes of FHFA's administrative enforcement authority.⁵ If FHFA determines that a Bank has failed to meet a standard, it also may require the Bank to submit a corrective plan.⁶
- *AMA Regulation.* FHFA's AMA regulation prescribes the parameters within which the Banks may purchase mortgage loans from members and housing associates (known as participating financial institutions or PFIs). The core of the AMA rule is a three-part test, the first and second parts of which focus on asset eligibility and member nexus, respectively. The third part focuses on the transactions through which a Bank acquires AMA – specifically, credit risk-sharing.⁷
- *Core Mission Achievement Advisory Bulletin.* FHFA's Core Mission Achievement Advisory Bulletin describes AMA, along with advances, as "Primary Mission Assets," which are fundamental to the business of a Bank and most directly contribute to its mission.⁸ It states, "[b]ecause a portfolio of residential mortgage loans presents risks not present with advances, FHFA expects that each Bank's board of directors will establish a prudential limit on its maximum holding of AMA, which should be governed by the Bank's ability to manage the risks inherent in holding mortgages." FHFA included similar language in the preamble to the final AMA rule⁹ and in the AMA Price Risk Governance Advisory Bulletin.¹⁰
- *AMA Price Risk Governance Advisory Bulletin.* FHFA's AMA Price Risk Governance Advisory Bulletin describes the practices a Bank should employ, through management and controls, to mitigate its exposure to AMA price risk. AMA price risk, for purposes of the Advisory Bulletin, is the risk that the price the Bank pays for an AMA mortgage

³ 12 CFR §§ 1239.4(c)(1) and 1239.11(a).

⁴ 12 CFR Part 1236, Appendix.

⁵ 12 CFR § 1236.3(d). FHFA has the authority to address unsafe or unsound practices through issuance of an order to cease-and-desist, through assessment of civil money penalties, or removal from office. 12 U.S.C. §§ 4631(a)(1), 4636(b)(2)(A), 4636a(a)(2)(A).

⁶ 12 CFR § 1236.4.

⁷ 12 CFR §§ 1268.3 (asset test), 1268.4 (member nexus), and 1268.5 (credit risk sharing).

⁸ See *FHLBank Core Mission Achievement AB 2015-05*, July 14, 2015.

⁹ 81 FR 91682 (Dec. 19, 2016).

¹⁰ See *AMA Price Risk Governance AB 2017-03*, Nov. 21, 2017.

loan is too high relative to intrinsic value based on prevailing and forecasted market conditions at the time of acquisition.¹¹

- *Bank Housing Goals Regulation.* FHFA’s Housing Goals regulation establishes housing goals for AMA purchases of loans to low-income borrowers, very low-income borrowers, and borrowers in low-income areas.¹²

Guidance

Board-established Limits. Each Bank’s board of directors should establish limits on its AMA portfolios within the context of its risk appetite¹³ and the unique characteristics of its membership and district. At the same time, the board should ensure that the Bank serves as a liquidity source for members – particularly smaller members who may not have the same capacity or access to sell loans in the secondary market that larger members may have. For purposes of this Advisory Bulletin, the term “smaller members” includes all Bank members whose total assets are below the community financial institution (CFI) asset cap as defined in section 1263.1 of FHFA’s regulations, and includes credit unions, insurance companies, and non-depository community development financial institutions.

Management Thresholds. To support the board-established risk limits, management of each Bank should establish thresholds that would serve as monitoring tools to manage AMA-related risk exposure. Management thresholds typically should be set at levels sufficiently below the risk limits established by the board, so that management would have adequate time to address any relevant developments that might otherwise result in a breach of a board-established limit. If a Bank’s AMA holdings were to breach a management threshold, it should have a formal process in place to assess and manage the resulting AMA-related risks. The process may require management to conduct a targeted analysis or additional ongoing monitoring, which would also provide the board information useful in fulfilling its governance responsibilities. Examples of actions management might take to avoid breaching management thresholds, or to avoid exceeding board-established limits if a management threshold is breached, might include:

- Imposing loan acquisition restrictions by loan type, e.g., high-balance loans or third-party loans,
- Limiting loan purchases from a particular member that accounts for a disproportionate amount of total acquisitions, or
- Participating or selling interests in some of its AMA mortgage loans to other Banks.

¹¹ See *Acquired Member Asset Price Risk Governance*” AB 2017-03, Nov. 21, 2017.

¹² 12 CFR Part 1281.

¹³ The *Responsibilities of Boards of Directors, Corporate Practices, and Corporate Governance* regulation defines “risk appetite” as, “the aggregate level and types of risk the board of directors and management are willing to assume to achieve the regulated entity's strategic objectives and business plan, consistent with applicable capital, liquidity, and other regulatory requirements.” 12 CFR § 1239.2.

Establishing Board Limits

FHFA expects each Bank's board of directors to approve a strong risk management program, to evaluate AMA-related risks, based on management's proposals, and to establish limits to control those risks. To accomplish these objectives, each Bank should have staff with a strong understanding of, and insight into, the secondary mortgage market and the risks that affect the acquisition, funding, and servicing of mortgages. The staff should have a skill set that allows them to evaluate AMA risk beyond the determination of credit enhancement obligations. Ultimately, the staff should have the necessary expertise to monitor portfolio and market issues before they adversely affect either the mission focus or the safe and sound operation of the Bank.

FHFA expects that a prudent approach to managing risks associated with a Bank's AMA holdings would include the types of limits described in the paragraphs below. Boards may adopt other limits to control other AMA-related risks, as identified by Bank staff as being appropriate to the magnitude of the Bank's AMA portfolio.

AMA Portfolio Limits

Given the risks associated with AMA, which include price, interest rate, operational, credit, model, and liquidity risks, each Bank's board should consider how it can safely and soundly manage its portfolio. In considering portfolio limits, a Bank should consider, for example, the cost for safely and soundly managing how market risk may evolve in response to fluctuations in the size of the mortgage portfolio,¹⁴ and the risk of adverse effects on the Bank's profitability resulting from external factors that may occur in both the short and long term. Those risks may be magnified by concentrations of loan coupons or vintages. A board also should consider any risks associated with acquiring a large portion of its AMA mortgages from a single PFI. When a board is setting portfolio limits, FHFA expects a Bank to consider the needs of its smaller members, who may rely on the Bank as a liquidity source to a greater degree than its larger members, who may have alternative access to the secondary mortgage market. The Bank should ensure that its portfolio limits do not result in the Bank's acquisition of mortgages from smaller members being "crowded out" by the acquisition of mortgages from larger members.

- *Size of Portfolio.* Each Bank's board of directors should establish a limit on its maximum holdings of AMA that is consistent with its risk appetite and the long-term safety and soundness of the Bank. When establishing the limit on the size of its AMA portfolio, the board may develop its own metrics that it deems most appropriate for its business plans and the needs of its members, such as a percentage of assets or consolidated obligations, or as a multiple of capital. FHFA will assess the portfolio limit and the metrics used to set it as part of its regular supervisory process. If a board has considered multiple approaches to setting its portfolio limit and can demonstrate that it has used the most conservative of those approaches in establishing the binding board limit, FHFA generally would consider that to be consistent with the safe and sound operation of the Bank. FHFA also expects that the board of directors would monitor the appropriateness of its

¹⁴ A mortgage portfolio's prepayment optionality can result in unanticipated funding mismatches that can have a deleterious effect on a Bank's net income, market value of equity, market value of equity to book value of equity ratio, market value of equity to par value of capital ratio, and dividend payment capacity.

chosen metrics in light of changing conditions in the mortgage markets, capital markets, the Bank's financial condition, and the needs of its members, and consider any appropriate revisions to the metrics used to set the existing portfolio limits.

- *Growth.* Each Bank's board of directors should establish a limit on the amount of AMA the Bank could acquire during a defined period of time in order to mitigate risks associated with rapid growth. Reasonable metrics for managing rapid growth could include limits based on gross dollar amount acquired and net growth in AMA holdings in dollars or as percent of balances outstanding.
- *Single PFI Acquisition.* Each Bank's board of directors should establish annual limits on the dollar amount of AMA that the Bank may acquire from a PFI. PFI limits should be appropriate to the particular PFI, should be consistent with the Bank's overall AMA portfolio limit, should avoid undue concentrations of the overall AMA portfolio from particular PFIs, and should provide reasonable assurance that the Bank's smaller members will be able to continue to sell AMA to the Bank during the year, regardless of the amount of AMA purchased from the Bank's larger members.

Loan Concentration Limits

FHFA expects each Bank's board of directors to consider the risks associated with an aggregation of loans that have common characteristics, i.e., concentration risk. Pools of loans that have common characteristics are sensitive to the same economic developments or downturns. This sensitivity can cause a pool of loans to perform as if it were a single, large exposure, which potentially exposes the Bank to disproportionately greater credit losses that could negatively affect a Bank's capital. Concentration risk may be further exacerbated for pools composed of loans that have multiple common characteristics, i.e., risk layering. Each Bank should identify characteristics that, when aggregated in a pool or in the Bank's portfolio, could increase the Bank's risk exposure. Loan characteristic concentrations each board should consider include:

- *Geographic area concentration,* which is determined by evaluating the amount or percentage of acquired loans secured by properties within a geographic location. The geographic areas of AMA loans held by a Bank could be evaluated by, for example, state, county, or metropolitan statistical area.¹⁵ FHFA expects Banks to have specific limits on AMA concentrations in particular housing markets, both in- and out-of-district. The limits could be relative to a PFI's sales to a Bank, relative to total acquisitions in a given period, or relative to outstanding dollar balances.
- *High-balance loan concentration,* which is determined by evaluating the amount or percentage of acquired loans that are high-balance loans. "High-balance loans" are conforming loans secured by residential properties located in "high-cost areas" with

¹⁵ In general, in-district state level concentrations are acceptable given Banks must serve their district. However, FHFA expects the Bank to monitor and analyze housing-market level concentrations both within and outside its district.

loan amounts exceeding the baseline conforming loan limits. Such loans may perform differently than loans at the baseline limits.¹⁶

Third-party Loan Origination Limits

The AMA regulation authorizes the Banks to purchase mortgage loans from a member only if the member (or an affiliate) had originated the loan or had acquired it from a third party for a “valid business purpose.”¹⁷ The Federal Housing Finance Board issued a regulatory interpretation that lists some factors that would be sufficient to demonstrate that a loan acquired from a third-party originator meets the valid business purpose requirement.¹⁸ The interpretation also makes clear that a member must have meaningful influence or control over the mortgage assets it acquires or over the process by which it acquires them in order to demonstrate that the member has acquired them for a valid business purpose. The factors indicating the existence of a valid business purpose include: (1) whether purchasing loans from third-party originators represents a core business of the member; (2) how long the member has been involved in purchasing such loans; (3) whether the member is familiar with the third-party originators and experienced with the type, quality, and volume of the assets being purchased from the originators; (4) whether the member has a clear opportunity to identify and address the potential for fraud on an operational level; (5) whether the member itself approves and contracts with the originators; and (6) whether the member itself sets the terms of its contractual relationship with the third party originators, including asset standards and pricing.

As a legal matter, Banks acquiring mortgage loans that have been originated by nonmember third parties must be able to demonstrate that the member has acquired those loans for a “valid business purpose,” as required by the AMA regulations. The Banks should have processes in place that actively ensure that the member selling the loans to the Bank is exercising meaningful influence over or control of the assets it is selling, as described above. A perfunctory assessment of whether a member in fact exercises such influence or control would not demonstrate that a member has acquired mortgage loans from a third-party originator “for a valid business purpose,” which could cause the mortgage loans not to qualify as AMA.

Generally, loans originated by third parties are acquired by a Bank from members that have banking services networks that involve nonmembers. Such loans can potentially carry greater risk than loans originated by a member. FHFA expects a Bank’s board of directors to establish limits on the amount of loans it acquires that are originated by third parties. Those limits could be based on any reasonable metrics, such as a portion of the Bank’s total AMA acquisitions or a portion of its acquisitions from a single member. FHFA expects Banks to consider the risks associated with the acquisition of third-party originated loans that are secured by properties located outside of the Bank’s district.

In consideration of smaller members who may not have the same ability to sell loans in the secondary market that larger members may have, third-party loan origination limits need not

¹⁶ See <https://www.fhfa.gov/DataTools/Downloads/Pages/Conforming-Loan-Limits.aspx>

¹⁷ 12 CFR § 1268.4(a)(1)(ii).

¹⁸ See Regulatory Interpretation 2000-RI-25, *Acquired Member Assets Held for a Valid Business Purpose* (Nov. 17, 2000).

apply to smaller members that do not have their own mortgage origination operations. Nonetheless, such members must still meet the valid business purposes requirements established in the AMA rule and Regulatory Interpretation 2000-RI-25.

Pricing Limits

FHFA expects each Bank's board of directors to consider the price risk associated with AMA. The higher the price a Bank pays for an AMA mortgage loan, the lower its expected earnings will be, all else equal. If the expected yield on a risk-adjusted basis is too low, a Bank may not earn enough to cover operating costs. As stated in the AMA Price Risk Governance AB, a Bank "should set mortgage acquisition prices to ensure the resulting expected spread to funding covers its costs and provides adequate compensation for the risk assumed, e.g., option, interest rate, credit, and model risk. The [Bank's] management committee should provide oversight, which includes approving and periodically reevaluating the minimum expected spread to funding target that guides AMA pricing."

Each Bank's board of directors should establish a limit on the price at which the Bank will acquire AMA loans. Mortgages acquired with a relatively high premium to par increase the Bank's exposure to prepayment risk. The write down of a mortgage premium reduces returns to the Bank and may result in losses. Each board of directors should establish a price limit on an individual loan basis and a portfolio amortized cost basis as observed at a point in time. For the latter, a Bank's board should establish a limit on the volume of loans it acquires at a board-determined premium level. The board should also establish a limit on the percentage of the Bank's total outstanding portfolio that was acquired at the board-determined premium level.

FHFA Monitoring of AMA Risk Management

FHFA will consider each Bank's AMA risk management as part of its regular supervisory process, including the limits established by the Bank's board of directors. As part of its off-site monitoring of Bank safety and soundness, FHFA may request periodically that each Bank submit to FHFA its board-approved AMA risk limits or thresholds.

Supervisory Letter

A Bank or the Banks may receive a supervisory letter, as warranted, should FHFA determine adopted board limits are insufficient. Furthermore, examiners will issue findings during the examination process if a Bank does not have sufficiently safe and sound AMA limits approved by the board of directors.

Related Guidance

Federal Housing Finance Board Regulatory Interpretation 2000-RI-25, *Acquired Member Assets Held for a Valid Business Purpose* (Nov. 17, 2000).

FHFA has statutory responsibility to ensure the safe and sound operations of the regulated entities and the Office of Finance. Advisory bulletins describe FHFA supervisory expectations for safe and sound operations in particular areas and are used in FHFA examinations of the regulated entities and the Office of Finance. Questions about this advisory bulletin should be directed to SupervisionPolicy@fhfa.gov.