REGULATORY INTERPRETATION 1999-RI-19

Date: December 1, 1999

Subject: Multifamily Mortgage Loan Purchase

Request Summary:

A Federal Home Loan Bank (FHLBank) has requested Federal Housing Finance Board (Finance Board) approval to purchase a participation interest in a pool of multifamily mortgage loans (loan pool purchase) from a member.

Background:

As described in the FHLBank's proposal, a member has requested that the FHLBank purchase a pool of seasoned, multifamily loans with an unpaid principal balance estimated at $250 million. A majority of the loans representing a majority of the unpaid principal balance of the pool are mortgages on multifamily rental properties, while the remaining loans in the pool are multifamily loans underlying cooperative mortgages. The member originated the loans for five or seven year terms with five-year borrower extension options. The remaining maturities on the loans in the pool are approximately two to three years, unless the borrowers exercise the extension options. Since most of the extension periods are priced at a floating rate of prime plus one percent, the member expects that most of the borrowers will refinance their loans, which will cause the pool to shrink significantly within three years.

The properties are located in the member's service area and are either elevator or walk-up apartment buildings with 10 to 200 units and low vacancy rates. All of the properties are subject to rent regulation and the FHLBank expects that most of the properties meet Community Investment Program (CIP) income guidelines, *i.e.*, affordable to individuals at or below 115 percent of the area median income. The member has proposed the loan pool purchase to create additional balance sheet capacity. The member intends to use the liquidity provided by the sale to continue multifamily lending in its service area.

The member has agreed to provide a full credit recourse guarantee on all loans in the pool. In the event of a 90-day payment delinquency on any loan, the guarantee requires the member to repurchase the FHLBank's remaining interest in that loan, therefore guaranteeing 100 percent of the unpaid principal balances purchased by the FHLBank and minimizing credit risk of the FHLBank. If the repurchase is not completed in a timely manner, the guarantee obligation will convert to an FHLBank advance, which would be secured by collateral eligible to secure advances under section 10(a) the Federal Home Loan Bank Act (Bank Act) (12 U.S.C. § 1430(a)) and the FHLBank's blanket lien.

The FHLBank has provided an opinion of counsel that multifamily loans are an authorized investment for fiduciary and trust funds under the laws of the state in which the FHLBank is located, as required by sections 11(h) and 16 (a) of the Bank Act (12 U.S.C. §§ 1431 (h) and 1436(a)).

Analysis or Discussion:

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 judgment of Finance Board staff, the FHLBank's proposed multifamily loan purchase 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 loan pool purchase is structured such that the inherent risks in multifamily 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 member, who is an experienced multifamily credit underwriter, will manage the credit risk.

The member will sell loans to the FHLBank with full recourse to the member, thereby retaining most of the credit risk. The member will be obligated to provide recourse to the FHLBank if the loan becomes 90 days delinquent. The FHLBank is exposed to credit risk only if the borrower defaults on a loan, the member selling the loans 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. However, the member has agreed that its guarantee obligation will convert to an advance that would be secured by collateral eligible to secure advances under section 10(a) of the Bank Act and the FHLBank's blanket lien if the repurchase is not completed in a timely manner, thereby further reducing the FHLBank's credit risk exposure. Although most likely in only a minimal amount, the FHLBank is also exposed to credit risk through the potential loss of interest on the loans during the 90-day period in which the loans become delinquent but prior to the time the member repurchases the FHLBank's remaining principal interest. The primary risks to the FHLBank are interest rate risk and prepayment risk. The FHLBank will manage the interest rate risk using its asset/liability management procedures. Prepayment risk is considered minimal because of the short term (two to three years) remaining on the loans and the fact that the loans carry a prepayment penalty.

Notwithstanding the merits of the loan pool purchase structure, the FHLBank must have appropriate policies, procedures and controls in place to determine both the quality of the loans being purchased and the capacity of the member to meet its guarantee obligations. Should the FHLBank be using policies, procedures and controls for this loan pool purchase that have not been reviewed, an Office of Supervision review to determine that appropriate policies, procedures and controls are in place will be necessary.

(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.

According to the FHLBank, the proposed loan pool purchase will offer the member a liquidity source for the multifamily mortgage pool where only limited or less attractive alternatives are currently available. The multifamily mortgage market in the member's service area is complex and distinctly different from other multifamily markets. The combination of unique property types, borrower types, neighborhoods, non-recourse provisions, rent regulation and other local laws have relegated most of the financing to locally-based lenders, especially in the 10 to 200 unit niche reflective of this pool. Additionally, the loans for this multifamily niche are relatively small, as is the pool itself, characteristics that are not attractive to secondary market purchasers of multifamily loans, according to the FHLBank. Increasing mergers and acquisitions of the local institutions active in multifamily lending have left the borrowing community with fewer local options for this type of financing. Because of the unique nature of this market, lenders need flexible underwriting tools to meet the needs of their borrowers, an approach that usually does not conform to the underwriting standards set by the secondary market. The FHLBank has asserted that it is in a position to provide a more attractive price for the loan pool than the pricing available in the secondary market.

(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 loan pool purchase promotes the cooperative nature of the FHLBank System by providing a member with liquidity at a price not likely to be available from other sources. The liquidity provided will allow the member to continue to serve its multifamily market niche.

Interpretation:

It is the opinion of Finance Board staff that the proposed loan pool purchase as described in the FHLBank's proposal fulfills the requirements of and is therefore authorized under the FMP, subject to a review and finding by the Office of Supervision that appropriate policies, procedures and controls are in place prior to the loan pool purchase.

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).