REGULATORY INTERPRETATION 2005-RI-05

October 21, 2005

Subject:

Ability to Sever the Credit Enhancement Obligation From the Related Mortgage Loan Under the Acquired Member Asset Regulations.

Request Summary:

A Federal Home Loan Bank (Bank) requested confirmation that Federal Housing Finance Board (Finance Board) regulations would prohibit a Bank from selling or otherwise transferring the mortgage loans that it purchased or funded under its acquired member asset (AMA) program while retaining the related credit enhancement provided by eligible members or housing associates that participated in the AMA transactions, or alternatively, from selling or transferring the credit enhancement obligation while retaining the related mortgage loans.

Guidance:

As a general matter, with regard to any mortgage loans acquired under an AMA program, the Finance Board's rules would prohibit a Bank from either selling or otherwise transferring the required credit enhancement while retaining the related mortgage loans and from selling or transferring the mortgage loans while retaining the related credit enhancement obligation.[1]

[1] In this Regulatory Interpretation, we address only the issue of a Bank's right to sell or transfer AMA mortgage loans or the related credit enhancement obligation while retaining the other piece of the transaction. This Regulatory Interpretation does not affect the ability of the PFI to transfer its rights and responsibilities under the credit enhancement obligation. As the Finance Board explained in adopting the AMA rule:

> Six comments were received advocating a provision in part 955 that would give members participating in AMA programs the ability to transfer credit enhancement obligations . . . to other members in the same or other Bank districts. The final [AMA] rule does not explicitly address, nor does it restrict, such transfers, though they may only be undertaken with the concurrence of the Bank of which the transferee is a member. In addition, such transfers must be accompanied by a similar undertaking by the transferee of the . . . requirements in § 955.2(b)(2).

Final Rule: Federal Home Loan Bank Acquired Member Assets, Core Mission Activities, Investments and Advances, 65 Fed. Reg. 43969, 43978 (July 17, 2000) (Final AMA Rule). *See also* Regulatory Interpretation 2002-RI-02 (Mar. 6, 2002).

Background:

Under the AMA rules, a Bank may acquire mortgage loans that meet specific criteria, or interests in such loans, from eligible Bank System members or housing associates (collectively participating financial institutions or PFIs).[2] The PFI must provide a credit enhancement for those mortgage loans so that the Bank will be acquiring assets that have credit ratings at least equivalent to the lowest investment grade, or such higher rating required by the Bank, when standards used by a Nationally Recognized Statistical Rating Organization (NRSRO) are applied. *See* 12 C.F.R. § 955.3. The credit enhancement provided by the PFI may take various forms, including a direct, secured liability to pay losses incurred on loans up to set limits, an obligation that the PFI obtain and pay for supplemental mortgage insurance (SMI) to cover those losses, and/or credit enhancement fees that are paid by the Bank on a contingent basis and withheld against losses up to certain set limits. Under the AMA programs, the PFIs are paid a credit enhancement fee as an incentive to minimize credit losses and share in the risk of loss on the mortgage loans and to pay for SMI, rather than paying a guaranty fee to other secondary market purchasers.

The AMA programs are designed to provide Bank members a product that is functionally equivalent to the Banks' traditional secured lending product, known as advances, in that they allow members or housing associates to use eligible housing financing assets to access liquidity for further housing-related lending while assuring that all or a material portion of the credit risk attached to those assets is borne by the member or housing associate. *See* Final AMA Rule, 65 Fed. Reg. at 43974.

In connection with a question concerning the proper accounting treatment to be afforded by the Banks to the PFI-provided credit enhancement, a Bank has requested confirmation that Part 955 would prohibit a Bank either from selling or transferring the credit enhancement obligation related to mortgage loans acquired under a Bank's AMA program while retaining the mortgage loans themselves, or alternatively, from selling the mortgage loans while retaining the credit enhancement. The Bank has interpreted the Part 955 regulations as prohibiting such separation

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[2] *See* 12 C.F.R. part 955. Finance Board rules prohibit a Bank from acquiring a whole mortgage loan or any interest in a mortgage loan unless the mortgage loan or interest therein: (i) qualifies as AMA under Part 955 of the Finance Board rules; (ii) is a targeted investment described in section 940.3(e) of the Finance Board rules; (iii) is a marketable direct obligation of a state, local, or tribal government unit or agency that meets certain additional conditions; (iv) is a mortgage-backed security, or certain asset-backed securities collateralized by manufactured housing loans or home equity loans, that meet the definition of security under 15 U.S.C. § 77b(a)(1); or (vi) is a loan that is acquired and held pursuant to authority in section 12(b) of the Federal Home Loan Bank Act (Bank Act). *See* 12 U.S.C. § 1432(b); 12 C.F.R. § 956.3(a)(4).

Section 940.3(e) of the Finance Board rules describes certain investments that primarily benefit households having a targeted income level, a significant portion of which must benefit households with income at or below 80 percent of area median income or areas targeted for redevelopment by local, state, tribal or Federal government, as well as that meet other conditions. 12 C.F.R. § 940.3(e). Section 12(b) of the Bank Act authorizes the Banks to acquire certain types of housing project loans that meet specific, enumerated criteria. 12 U.S.C. § 1432(b). In general, mortgage loans that qualify for purchase as AMA would not qualify for purchase under the other exceptions set forth in section 956.3(a)(4) of the Finance Board rules, and thus, could not be purchased by the Bank if the loans did not qualify as AMA.

of mortgages acquired under the AMA program from the PFI-provided credit enhancement. The Bank has noted, however, its belief that the Finance Board rules would allow, subject to the New Business Activity requirements in Part 980, certain "back-to-back transactions" that would leave the Bank and the PFI in essentially the same position after the transactions as they were before.[3] Similarly, the Bank believes that "the AMA regulation does not appear to prohibit the parties to a transaction from agreeing to restructure the PFI [c]redit [e]nhancement in the event of a change in circumstances, such as a PFI ceasing its mortgage operations and its membership in the [Bank] System. . . ." The request does not provide specific details on how these back-to-back or restructuring transactions would be executed or indicate that such transactions are currently planned.[4]

Discussion:

To qualify as AMA, mortgage loans must meet specific loan-type requirements, member or housing associate nexus requirements, and a credit risk-sharing requirement. *See* 12 C.F.R. § 955.2. Most relevantly, the credit risk sharing provisions mandate that a Bank implement a credit risk-sharing structure for AMA so that a PFI provides sufficient credit enhancement to limit "the Bank's exposure to credit risk *for the life of the AMA* to no greater than to an asset rated in the fourth highest credit rating category . . . or such higher rating as the Bank may require." 12 C.F.R. § 955.3(b) (emphasis added). In adopting the AMA regulation, the Finance Board made clear that it expected the credit enhancement to extend for the life of the AMA asset or pool of assets, and that credit enhancement structures which were designed to allow the credit enhancement to slip below required levels over time would not comply with the rule. *See* Final AMA Rule, 65 Fed. Reg. at 43976.

Both the wording of section 955.3(b) and the Finance Board's discussion of the credit enhancement requirement make clear that a Bank is expected to design and maintain a credit enhancement structure that limits the Bank's credit exposure to its AMA mortgage loans for as long as the Bank holds the loans.[5] Without such an acceptable credit enhancement structure in

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[3] The example of a back-to-back transaction provided in the request is a transfer of the mortgage loans to a qualified special purpose entity (QSPE) where the Bank's rights and responsibilities owed to, or due from, the QSPE with respect to the mortgage loans would mirror the PFI's rights and responsibilities owed to, or due from, the Bank with respect to those loans.

[4] While the Bank's request discussed only the Mortgage Partnership Finance program (MPF), which is one of two AMA programs approved by Finance Board to be offered by individual Banks to their members, this Regulatory Interpretation addresses the relevant rules in terms of AMA programs generally.

[5] As the Finance Board noted, the credit risk-sharing requirement was designed to:

> . . . promote and preserve the basic business relationship between the Banks and their members that has been established and maintained throughout the history of the Bank System through advance transactions. The Bank would manage the interest rate risk, while the member would manage a material portion of the credit risk. This requirement emphasizes the cooperative nature of the Bank System by ensuring that the member or [housing] associate shares with the Bank the financial benefits and responsibilities of the asset. Based on the totality of its experience in monitoring the Banks' mortgage purchase programs, the Finance Board is confident that the credit risk-sharing requirements . . .

place, the related mortgage loans would no longer meet the credit risk sharing requirement under section 955.2(c) of the Finance Board rules, and would therefore no longer qualify as AMA. *See* 12 C.F.R. § 955.2(c). More importantly, if the mortgage loans no longer qualified as AMA, they would not be authorized investments for the Bank. *See* 12 C.F.R § 956.3(a)(4). *See also* n.2, *supra.* It would be inconsistent with these regulations to allow a Bank to take affirmative steps to create what would be an unauthorized investment by transferring the PFI-provided credit enhancement obligation related to the AMA loans but continuing to hold, and being exposed to the full credit risk of, those loans.

Similarly, it does not appear that Finance Board rules would allow a Bank to maintain the credit enhancement as a stand alone item, which would be the case if it were to sell or transfer the related mortgage loans. While the AMA rules themselves do not categorize the credit enhancement obligation as any particular type of instrument, the request raises the potential for the credit enhancement to be deemed a derivative contract. If this outcome were to occur, the most likely Finance Board regulations governing the Banks' authority to hold the credit enhancement obligation, once it was severed from the AMA loans, would be those addressing a Bank's use of derivative contracts.

A Bank's investment in derivative instruments is governed principally by sections 956.5(a) and 956.6 of the Finance Board rules. *See* 12 C.F.R. §§ 956.5(a) and 956.6. While section 956.5(a) allows a Bank to enter into derivative contracts, section 956.6 specifically limits the Bank's use of derivatives to those that qualify as hedging instruments under generally accepted accounting principles (GAAP)[6] or for which the Bank documents non-speculative use.[7]

> would efficiently allocate risks so as to best use the core competencies of the entities involved and provide capital market funding and risk management alternatives, all to the ultimate benefit of the consumer.

Proposed Rule: Federal Home Loan Bank Acquired Member Assets, Core Mission Activities, Investments and Advances, 65 Fed. Reg. 25676, 25682 (May 3, 2000). Interpreting the AMA rules as allowing a Bank generally to sever and dispose of only the AMA mortgage loan or the credit enhancement obligation would be inconsistent with the stated intent for the credit risk sharing provision.

[6] Finance Board rules define GAAP as "accounting principles generally accepted in the United States." 12 C.F.R. § 900.3.

[7] In discussing its reasons for proposing the provision allowing non-speculative use of derivative contracts, the Finance Board noted that Banks had entered into derivatives contracts that did not qualify for hedge accounting treatment under Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133), but which the Finance Board intended to permit. Specifically, the Finance Board stated that the Banks used some derivative contracts to hedge and manage their risks that nevertheless did not receive FAS 133 hedge accounting treatment, and that the Banks served as intermediaries in derivative contracts with members that were designed to assist members in managing and hedging risks associated with their assets and liabilities. *See* Proposed Rule: Capital Requirements for Federal Home Loan Banks, 65 Fed. Reg. 43408, 43435 (July 13, 2000). The Finance Board concluded that it was "proposing to permit such transactions, provided that the Bank documents that the use of the hedging instrument is non-speculative." The Finance Board basically adopted these derivative provisions as proposed. *See* Final Rule: Capital Requirements for Federal Home Loan Banks, 66 Fed. Reg. 8262, 8306 (Jan. 30, 2001).

Generally, if a Bank were to continue to hold the credit enhancement after selling the related mortgage loans, and thereby were no longer exposed to the credit risk of those loans, the credit enhancement would no longer be acting as a hedge against losses associated with the mortgage loans. Instead, by continuing to hold the credit enhancement, the Bank would have created a speculative exposure to the future performance of the mortgage assets that it had sold. Under these circumstances, the Bank's maintenance of such a position would violate the Finance Board's limitation on entering into derivative contracts for speculative purposes.

For all of the reasons stated above, it is our view that Finance Board rules generally do not allow a Bank to sell or transfer either the mortgage loans or the related PFI-provided credit enhancement obligation while continuing to hold the other piece of the transaction. In reaching this conclusion, we have not considered, nor do we address, the application of the Finance Board's rules to the back-to-back or restructuring transactions briefly mentioned in the Bank's request.

A Regulatory Interpretation is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. part 907.