REGULATORY INTERPRETATION 2002-RI-03

Date: March 6, 2002

Subject: Use of Mortgage Pool Insurance as Part of a Credit Enhancement for Acquired Member Assets

Request Summary:

A Federal Home Loan Bank (FHLBank) filed with the Federal Housing Finance Board (Finance Board) a notice of a new business activity as required by 12 C.F.R. § 980.3(a) with respect to a proposed acquired member asset product (AMA Special) for which the FHLBank proposes to purchase mortgage pool insurance (pool insurance) as part of the credit enhancement structure. Although the Finance Board's rules governing AMA, 12 C.F.R. part 955, allow use of pool insurance in only limited circumstances as part of the credit enhancement provided by a participating financial institution (PFI), the rule does not directly address the FHLBank's purchase of pool insurance as a credit enhancement. As part of its review of the new business activity, staff is addressing whether the Finance Board's rules restrict an FHLBank in purchasing pool insurance to supplement credit enhancements provided by a PFI.

Conclusion:

An FHLBank may obtain pool insurance for pools of AMA assets to supplement the credit enhancements provided by PFIs so long as the PFI-provided enhancements comply with the requirements of section 955.3. Further, a FHLBank can calculate its capital charge under section 955.6 based on the credit rating of the AMA after considering the effects of the pool insurance, so long as the Finance Board does not find the pool insurance to be deficient.

Background:

The FHLBank proposes to acquire one-to-four family loans using AMA Special. Like other AMA products offered by the FHLBank, the overall credit enhancement structure of AMA Special is intended to create pools of assets with a credit quality equivalent to an AA-rated instrument. However, unlike the Bank's other AMA products, AMA Special will make use of pool insurance as a component of the credit enhancement structure. The pool insurance would follow the more junior credit enhancement structures that the PFIs are required to provide under the terms of AMA Special. Specifically, these more junior credit enhancement components are the first loss account (FLA) and supplemental mortgage insurance (SMI). The pool insurance would cover any portion of the AA rating level credit enhancement not covered by the FLA and

SMI.[1] The FHLBank maintains that the PFI-provided portions of the credit support structure for AMA Special would raise the credit quality of the pool to at least that of an AA-minus-rated asset. Although staff does not necessarily accept the FHLBank's assertion that the PFI-provided portions of the credit enhancement will raise the credit quality of the pools of AMA Special to AA-minus, staff believes that the PFI-provided credit enhancements will at a minimum result in pools of AMA Special with a credit quality equivalent to an instrument with the fourth highest investment grade rating.

The structure of AMA Special is such that pool insurance covers that portion of the credit enhancement requirement that, under other FHLBank AMA products, would be covered by a member guarantee. The FHLBank structured AMA Special so that PFIs would not be required to provide any guarantee against credit losses not covered by the FLA and SMI. According to FHLBank staff, the charter of certain potential members does not allow them to execute such guarantees.

Analysis or Discussion:

Part 955 of the Finance Board's rules (the AMA rule) establishes the criteria whereby the FHLBanks may acquire mortgage assets from their members and other eligible PFIs. In relevant part, section 955.3(a) of the AMA rule stipulates that an FHLBank determine the credit enhancement needed to enhance the credit quality of AMA to assure that its exposure to losses is no greater than "an instrument having at least the fourth highest credit rating from a [Nationally Recognized Statistical Rating Organization (NRSRO)] or such higher rating as the acquiring FHLBank may require." 12 C.F.R. § 955.3(a). Section 955.3(b) of the AMA rule, 12 C.F.R. § 955.3(b), in turn, requires an FHLBank to implement a credit risk-sharing structure for AMA so that a PFI provides sufficient credit enhancement to limit the FHLBank'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 the higher rating stipulated by the FHLBank. This provision further allows that a portion of the credit enhancement may be provided by specific means described therein including "purchasing pool level insurance, but only where such insurance ... [i]nsures that portion of the credit enhancement requirement attributable to the geographic concentration and size of the pool ….”[2]

Section 955.3(b)(1) also requires that the credit enhancement structures enumerated thereunder must generally be positioned to bear only those losses that occur after the PFI has borne any

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[1] SMI applies only to individual mortgages and generally covers only losses up to a certain limit. Under certain stress scenarios, losses on individual loans can greatly exceed the SMI limits. Without some form of PFI guarantee to cover losses on individual loans, the losses on individual loans could be so great as to result in losses for the pool that would be passed on to investors. Pool insurance could address this problem by providing coverage when losses on individual loans exceed SMI "per loan" limits, and acts as an alternative to requiring PFIs to guarantee losses that pierce the SMI on individual loans.

[2] *See* 12 C.F.R. § 955.3(b)(1). The pool insurance provided by the FHLBank for AMA Special would address the credit exposure arising from insufficient pool size or geographic concentration and exposures arising from the credit risk of fully diversified pools. Thus, the pool insurance could not be purchased by the PFI because of the limitations in section 955.3(b)(1)(iii). 12 C.F.R. § 955.3(b)(1)(iii).

losses pursuant to the credit enhancement structures required by section 955.3(b)(2), 12 C.F.R. § 955.3(b)(2), which mandates that the PFI "bear the direct economic consequences of actual credit losses on the asset or pool of assets" in an amount equal to or exceeding the expected losses on the asset or pool of assets.[3] As the Finance Board explained in the Supplementary Information section of the adopting release for the final AMA rule, "[e]xpected losses may be calculated as the mean of the losses associated with economic conditions represented by the sixth ratings category (*e.g.*, single-B)."[4] 65 Fed. Reg. 43969, 43976 (July 17, 2000). *See also* 12 C.F.R. § 955.1 (defining "expected losses"). When read together, 955.3(b)(1) and (2) require a PFI to provide credit enhancements that raise the credit quality of the AMA pool to at least the fourth highest investment grade such that one portion of any enhancement must be structured as required under section 955.3(b)(2) and raise the credit quality of an AMA pool to the equivalent of at least a single-B-rated asset, and, that any additional credit enhancements provided by the PFI are subject to the specific limitations listed in section 955.3(b)(1). An FHLBank is further required to hold "retained earnings plus general allowances for losses to support the credit risk of all AMA estimated by the [FHL]Bank to represent a credit risk greater than that of comparable instruments that have received the second highest credit rating from an NRSRO."[5]

The AMA rule clearly limits the PFI-provided credit enhancement structure, and, subject to the specific exception relating to geographic concentration or the size of the pool in section 955.3(b)(1), it does not allow pool insurance to be part of the PFI-provided credit enhancement. The AMA rule, however, does not address whether an FHLBank may itself provide pool insurance or other forms of credit enhancement to supplement the credit risk-sharing structure required under the rule as part of an AMA product. Nevertheless, the Finance Board appears to have contemplated that an FHLBank could do so. For example, the Finance Board made clear that, while reserves put aside by an FHLBank against AMA losses cannot be used to comply with the requirements imposed on PFIs under section 955.3(b), such reserves could be used to reduce the risk-based capital charges for AMA under section 955.6, indicating that an FHLBank can take account of the benefits from at least one type of FHLBank-supplied credit enhancement. 65 Fed. Reg. at 43976. More importantly, the credit-risk capital provision for AMA under the recently adopted part 932 of the Finance Board rules (the capital rule) states clearly that the credit risk requirement for AMA should be calculated after considering any credit enhancements obtained directly by an FHLBank "through the purchase of insurance or other means." *See* 12 C.F.R. § 932.4(e)(2)(ii)(E) and 66 Fed. Reg. 8262, 8285-86 (Jan. 30, 2001). In allowing an

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[3] A PFI may contract with a member or housing associate of any FHLBank to provide a credit enhancement that is positioned to bear losses on an asset or pool of assets from the first dollar up to the expected losses. *See* 12 C.F.R. § 955.3(b)(1)(iv) and (b)(2). In such cases, however, the PFI would be required to bear the direct economic consequences of losses immediately following the expected losses in an amount equal to or exceeding the amount of the expected losses. Pool insurance or SMI, however, must always be positioned after any enhancement structure required by section 955.3(b)(2). See 12 C.F.R. § 955.3(b)(1)(i) - (iii).

[4] Section 955.3(b) also imposes additional requirements on AMA. The structure of AMA Special does not raise any issues under these other requirements so they are not addressed by this regulatory interpretation.

[5] *See* 12 C.F.R. § 955.6. After it implements the capital structure required by the Gramm-Leach-Bliley Act, an FHLBank will calculate all capital charges, including credit risk charges related to AMA, under recently adopted part 932 of the Finance Board regulations. 12 C.F.R. part 932. Until that time, section 955.6 of the AMA rule sets forth the credit risk capital charges applicable to AMA.

FHLBank to calculate capital requirement for AMA after accounting for loss reserves, insurance or other forms of credit enhancement provided by the FHLBank, both the AMA rule and the capital rule presume that an FHLBank has authority to acquire such supplemental credit enhancements for AMA, even if the AMA rule does not clearly delineate this authority. Thus, given that the AMA rule does not specifically restrict an FHLBank's right to supplement the credit enhancement provided by a PFI for AMA, and that section 932.4 of the capital rule clearly contemplates that an FHLBank may obtain insurance or other forms of credit enhancement to supplement the PFI-provided enhancements for AMA, an FHLBank should not be prohibited from obtaining pool insurance as part of an AMA product structure to supplement the required PFI-provided credit enhancements, so long as the PFI-provided enhancements comply with section 955.3.

Furthermore, an FHLBank that purchases pool insurance to supplement PFI-provided credit enhancements should be able to take account of the added protection against credit loss provided by the pool insurance to reduce the capital charges required by section 955.6. Section 955.6 does not specifically address the effect of FHLBank-provided pool insurance on the capital that an FHLBank is required to hold against AMA, thereunder, although, as already discussed, the Finance Board stated that an FHLBank could reduce the AMA capital charges based on FHLBank-provided loss reserves. The capital rule, however, clearly allows a reduction in capital charges for AMA-based FHLBank-provided credit enhancements, including pool insurance, subject only to the Finance Board's "right to adjust the credit capital charge to account for any deficiencies with the supplemental enhancement [provided by the FHLBank] on a case-by-case basis." *See* 12 C.F.R. § 932.4(e)(2)(ii)(E); *see also* 66 Fed. Reg. at 8286. Given that section 956.6 does not require that pool insurance be treated differently than loss reserves for capital purposes, this provision should be interpreted in light of the approach, and the clear allowance of a capital benefit for FHLBank-purchased pool insurance, adopted in the more recently promulgated section 932.4 of the capital rule so that an FHLBank would calculate its capital charge under section 955.6 based on the credit rating for the pool of AMA after considering the effects of the pool insurance, so long as the Finance Board does not find the pool insurance to be deficient.