



***Federal Housing Finance Board
Office of Supervision***

Date: August 12, 2004

To: Federal Home Loan Bank Presidents and Directors of Internal Audit

From: Stephen M. Cross
Director
Office of Supervision

Subject: Rating Loan Pools with Fewer than 300 Loans (Small Loan Pools)

Background

Federal Housing Finance Board (“Finance Board”) regulations prohibit a Federal Home Loan Bank (“Bank”) from acquiring or funding any mortgage loan or pool of mortgage loans that cannot be putatively rated as investment grade using a methodology that, to the satisfaction of the Finance Board, is comparable to the methodology used by a nationally recognized statistical rating organization (“NRSRO”) (see 12 C.F.R. § 955.3(a), (b)). Standard and Poor’s (“S&P”) Loan Evaluation and Estimate of Loss System (“LEVELS”) model is the only model that the Finance Board has approved to determine the credit enhancement required to achieve a putative investment grade credit rating for the loans acquired through the Banks’ mortgage loan purchase programs.

On June 28, 2004, S&P issued the latest in a series of S&P Issuer Alerts (“Alert”)¹ to clarify its criteria to rate transactions collateralized by residential mortgage pools with fewer than 300 loans. The Alert, a copy of which accompanies this advisory bulletin, states that regardless of the structure of the transaction, LEVELS will generate an accurate credit enhancement for any size pool of loans. However, if a transaction is collateralized by a mortgage pool of fewer than 300 mortgage loans, a pool level adjustment factor must be calculated by LEVELS. This adjustment reflects the fact that the rate of foreclosure is proportionately greater for progressively smaller pools of loans. The LEVELS model will determine a pool size adjustment factor that increases at an increasing rate as pool size decreases. LEVELS output includes a Pool/Portfolio Loss Coverage Summary Report (Report 17), which indicates the pool level adjustment and the ultimate credit enhancement required for any pool of fewer than 300 loans.

Guidance

¹ The June 28th S&P Issuer Alert clarifies and consolidates the positions stated in recent Alerts dated May 27, 2004, June 8, 2004 and June 15, 2004.



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The Bank must determine the required credit enhancement for any Acquired Member Asset (“AMA”) acquired either through the Mortgage Purchase Program (“MPP”) or Mortgage Partnership Finance (“MPF”) program. The pool level adjustment factor in the LEVELS model, which is 1.0 for pools larger than 300 loans and greater than 1.0 for pools with fewer than 300 loans, must be used to calculate the credit enhancement.

If the Bank owns an interest in any pools with fewer than 300 loans, for which the pool level adjustment factor was not used to calculate the credit enhancement at the time of purchase, the Bank must recalculate the credit enhancement for those pools. Based upon the appropriate credit enhancement required for such pools, additional risk-based capital may need to be allocated in accordance with the Finance Board’s regulations. The capital charge for Banks that have converted to a new capital structure is determined by multiplying the percentage associated with the putative credit rating of the mortgage loans or pool of loans in Table 1.2 of Part 932 of the Finance Board regulations times the outstanding balance of those assets. Permanent capital (retained earnings plus class B stock) can be used to meet this capital charge. The capital charge for Banks that have not converted to a new capital structure is determined by multiplying the percentage based on the putative credit rating of the mortgage loans or pool of loans in Table 1 of Part 955 of the Finance Board’s regulations times the outstanding balance of those assets. Retained earnings plus a general allowance for losses can be used to meet this capital charge.

An Office of Supervision Advisory Bulletin presents guidance to the Federal Home Loan Banks on the application of legal requirements through the supervisory process. It is not a supervisory determination. Any supervisory determination implementing such guidance is subject to review pursuant to the Procedures for Review of Disputed Supervisory Determinations.