ADVISORY BULLETIN 2003-AB-12

December 3, 2003

Federal Housing Finance Board
Office of Supervision

To: Federal Home Loan Bank Chairs, Presidents, General Counsels, and Directors of Internal Audit

From: Stephen M. Cross
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Office of Supervision

Subject: Credit Risk Exposure to Supplemental Mortgage Insurance Providers

Background:

As a result of the growth of Federal Home Loan Bank (Bank) acquired member asset (AMA) portfolios and the members' use of mortgage insurance to credit enhance mortgage assets sold to the Banks as AMA, the Federal Housing Finance Board (Finance Board) views the Banks' exposure to supplemental mortgage insurance (SMI) providers as material. As with any material exposure, the Finance Board expects the Banks to monitor closely their exposures to individual mortgage insurers and manage those exposures prudently. Section 917.3(b)(3) of the Finance Board regulations (12 C.F.R.§ 917.3(b)(3)) requires each Bank to set forth standards for the Bank's management of each risk component. This Advisory Bulletin offers guidance on the minimum standards for managing the Bank's risk exposure to SMI companies.

Guidance:

Each Bank's board of directors should establish policies that set forth the criteria used to determine exposure limits to each SMI provider. These policies should consider not only the SMI provider's credit rating, but also should require the Bank to perform an independent credit analysis of the SMI provider commensurate with the magnitude of the exposure.[1]

[1] As required by Finance Board regulation, only those SMI providers rated not lower than the second highest credit rating category are eligible to provide insurance to credit enhance AMA.

Banks may continue to establish overall exposure limits based on credit ratings, but subject to those overall limits, the Bank should also establish individual limits for each SMI provider based on an independent credit analysis of those providers. For example, a Bank may establish an exposure limit to any SMI provider with the highest credit rating of a certain percentage of capital, but for each such SMI provider, should establish a limit based on the Bank's independent credit analysis of that provider. In addition, each Bank should establish and implement systems to monitor and track its exposure to SMI providers and report, at least quarterly, to its board of directors on such exposures. The Finance Board will review each Bank's policies, analyses, and exposure limits as part of its ongoing examination and supervision program.