



REGULATORY INTERPRETATION 1999-RI-02

Date: January 26, 1999

Subject: Investment in Federal Housing Administration Small Projects Program Loans under the Financial Management Policy

Request Summary:

A Federal Home Loan Bank (Bank) has requested that the Federal Housing Finance Board (Finance Board) approve a proposal called the Multifamily Pilot Program or MPP, under which the FHLBank will invest approximately \$62.5 million in Federal Housing Administration (FHA) Small Projects Program (SPP) insured loans over a three-year period. The FHLBank seeks approval for this investment under the Finance Board's Pilot Procedures, Resolution Number 97-70, dated Nov. 12, 1999). Based on the proposal and other information the FHLBank has provided, Finance Board staff has determined that the investment is authorized under the Federal Home Loan Bank Act (Bank Act) and the Finance Board's Financial Management Policy (FMP). As such, no further approval by the Finance Board is required for the FHLBank to offer the MPP under the Finance Board's Pilot Procedures or otherwise, and no regulatory dollar limit on the amount of the product that may be offered need be set for the FHLBank.

Background:

As described by the FHLBank, MPP involves a cooperative arrangement among the FHLBank, the FHA and members of the FHLBank to address the need for financing for small and unconventional multifamily housing developments throughout the region. MPP is designed to assist members in identifying loans that might qualify under one of several FHA loan insurance programs, and specifically under the FHA's SPP. The SPP is a recently developed FHA insurance program for multifamily loans under \$1.0 million that is still in its early stages; no SPP loans have been originated in the region thus far under the program. According to the proposal, 99% of the unpaid principal balances on SPP loans would be FHA insured.

The FHLBank proposes to begin with a small group of geographically diverse members with experience in the multifamily market that is willing to participate in the program. The FHLBank will work with those members and the FHA to market the program to potential borrowers. FHLBank members will conduct the initial review of requests and applications for loans. The FHLBank will assist its members in identifying loans that could qualify for FHA insurance programs and perform a secondary review. If a loan application is acceptable, FHA would issue a firm commitment for insurance, and the member would decide whether to use an advance from the FHLBank to fund the loan, or whether to fund the loan itself and then sell the insured loan to the FHLBank at project completion. An FHA-approved servicer (which could be the member) would service loans purchased by the FHLBank.

The MPP is designed to increase the availability of fixed-rate financing for small multifamily rental projects through the use of FHA multifamily insurance programs by the FHLBank's members. The FHLBank has conducted market research to support the need for such funding in the district, is conducting meetings with its members and with the FHA to refine program design, and is adding expertise to its staff to implement the program. On the basis of its market analysis, the FHLBank projects that within the first three years of MPP's existence, the FHLBank could fund through advances or acquire approximately 125 FHA-insured multifamily loans totaling \$62.5 million in the aggregate.

Analysis:

1. Assistance to Members

With respect to the FHLBank proposal to assist its members in identifying loans that could qualify for FHA insurance, work with members and the FHA to market the MPP to potential borrowers, and review applications to the FHA for insurance, the FHLBank has full authority under sections 10, 11 and 12 of the Bank Act (12 U.S.C. §§ 1430, 1431 and 1432) to engage in such activities for and with its members. The FHLBank does not require Finance Board approval to engage in such activities.

2. Funding of Advances for MPP Loans

With respect to the FHLBank proposal to make advances to members that make loans under the MPP, the FHLBank has full authority under section 10 of the Bank Act (12 U.S.C. § 1430) to make such advances. The FHLBank does not require Finance Board approval to make advances.

3. Purchasing FHA-Insured Multifamily Loans

A. Statutory Requirements

Sections 11(g), 11(h) and 16(a) of the Bank Act (12 U.S.C. §§ 1431(g), 1431(h) and 1436(a)) authorize the FHLBanks to invest their surplus and reserves in certain categories of investments, subject to any regulations or other limitations that may be imposed by the Finance Board. Section 934.1 of the Finance Board regulations provides that FHLBanks may acquire such statutorily-authorized investments only "with prior approval of the [Finance] Board ... or in conformity with: (1) [a]uthorizations of the [Finance] Board or (2) stated [Finance] Board policy." 12 C.F.R. § 934.1(a) (1997). In conjunction with this regulation, section II(B) of the FMP serves primarily as "stated Finance Board policy" regarding statutorily-authorized investments that FHLBanks may make without seeking specific authorization from the Finance Board. All investments enumerated under section II(B) are eligible for FHLBank investment only to the extent that they are specifically authorized under the Bank Act or are "such securities as fiduciary and trust funds may be invested in under the laws of the state in which the [FHL]Bank is located," *See* 12 U.S.C. §§ 1431(h) and 1436(a), and FMP sec. II(B) (preamble).

With respect to the FHLBank proposal to purchase from its members loans made by the members under an FHA insurance program, the Finance Board previously has determined that if such loan is one in which fiduciary and trust funds may be invested in under the laws of the State in which the FHLBank is located, then the purchase of such loans would be an authorized investment under sections 11(h) and 16(a) of the Bank Act (12 U.S.C. §§ 1431(h) and 1436(a)). *See, i.e.,* Op. G.C., Oct. 22, 1997. As part of its proposal, the FHLBank has submitted an opinion of its General Counsel that FHA-insured loans are permitted investments under state law.

B. FMP Standards – Section II.B.12

Section II.B.12 of the FMP authorizes the FHLBanks to make investments that support housing and community development provided that three specific standards are met. Following is a discussion of how, in the judgment of Finance Board staff, the investments proposed to be made by the FHLBank meet each of the three standards.

- (i) 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 the System’s triple-A rating.

The loans to be purchased by the FHLBank will be insured by the FHA. The Proposal indicates that 99% of the unpaid principal balance on SPP loans will be FHA insured. Therefore, the FHLBank’s exposure to credit risk is limited. [REDACTED]

Interest rate risk will be identified and managed according to the FHLBank’s asset/liability management procedures [REDACTED]

Based on the above, Finance Board staff concurs that there would be minimal risk exposure to the FHLBank.

- (ii) 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 Proposal, low vacancy rates and corresponding increases in rents throughout the region indicate a significant need for the additional multifamily housing and new rental housing for low-and moderate-income households that the MPP is designed to finance. Further, the FHLBank’s involvement in MPP is anticipated to influence the success of the SPP and other FHA loan programs in the region that have not been widely used to date. It is also anticipated that FHA production in the region, especially by depository institutions, will increase in response to the MPP. The FHLBank has included in its Proposal a market analysis demonstrating the need in the district for multifamily housing. The Proposal notes that scarcity of long-term fixed rate debt contributes to higher default risk, insufficient maintenance, and less affordable rental rates, but that the use of MPP to support SPP, the market may be expanded, which could offset some of these problems. The Proposal also notes that the multifamily market is substantial, and that the FHA could have an increased presence, particularly through its SPP, in a potentially significant new lending market for depository institutions.

- (iii) The FHLBank ensures that such investment activity promotes (or at the very least, does not detract from) the cooperative nature of the System.

The FHLBank believes that its involvement in MPP will further the cooperative nature of the System and benefit its members by making its members more competitive with non-banks, which have been gaining prominence in the multifamily market since the mid-1990s. The Proposal states that, by facilitating the making of insured multifamily loans by members, the FHLBank will enable its members to maintain and possibly expand their share of the market. By assisting its members with FHA servicing approval, the FHLBank also will thereby help its members retain valuable customer relationships. Working with the FHA to refine its insurance programs for small multifamily projects and to reduce their complexity and processing times, the FHLBank will assist its members to expand the available of fixed-rate financing for decent affordable rental housing in the region.

C. FMP Standards – Section II.C.2

While the risk characteristics of a portfolio of such FHA-insured loans may be similar in many respect to those of an MBS, the value of such loans purchased under the Proposal need not be counted in calculating the FHLBank's compliance with section II.C.2 of the FMP, which provides that “[a] [FHL]Bank may enter into agreements to purchase MBS, CMOs, REMICs, and eligible asset-backed securities so long as such purchases will not cause the aggregate book value of such securities held by the [FHL]Bank to exceed 300 percent of the [FHL]Bank's capital.” FMP sec. II.C.2. Section II.C.2 is intended to limit FHLBank investments in standard MBS, CMOs, REMICs and eligible asset-backed securities that do not have a measurable impact on the availability of housing and community development financing. In contrast, section II.B.12 is intended to encourage FHLBanks to undertake mission-related investments that support housing and community development, provided that certain standards are met. Because the Proposal makes a convincing case that the investments will make a positive measurable impact on the availability of financing for multifamily housing in the region, Finance Board staff has determined that the FHLBank need not include these transactions in the 300 percent limit set forth in section II.C.2.. *See Op. G.C. (Dec. 23, 1997).*

Interpretation:

Based on the facts and analysis presented above, Finance Board staff has determined that the FHLBank Proposal to provide advances to members for, or to purchase from members, FHA-insured multifamily loans is authorized under the Bank Act and the FMP and requires no further Finance Board approval. This determination in no way relieves the FHLBank from performing on an ongoing basis appropriate credit analysis of the investment if loans are to be purchased; or from determining on an ongoing basis that the investment meets the FHLBank's profitability requirements. The operations of the MPP will be subject to regular examination on an ongoing basis.

As you are aware, the Finance Board currently is developing a revised financial management policy for the System that will be a more generic and flexible financial management regulation. Whether subsequent purchases of such loans as proposed under the MPP will be permissible under the new financial management regulation has yet to be determined. However, analysis of such investments will be carefully considered in crafting the new regulation.

<p>This is a Finance Board regulatory interpretation within the meaning of the Procedures for Requests and Applications adopted by the Board of Directors of the Finance Board pursuant to Resolution Number 98-51, dated October 28, 1998. The regulatory guidance set forth herein may be relied upon subject to modification or rescission by action of the Board of Directors of the Finance Board.</p>
