ADVISORY BULLETIN 2008-AB-01

April 3, 2008

Federal Housing Finance Board
Office of Supervision

To:	Federal Home Loan Bank Chairs and Presidents Managing Director, Office of Finance
From:	Stephen M. Cross Director, Office of Supervision
Subject:	Temporary Increase in Mortgage-Backed Securities Investment Authority

Background:

On March 24, 2008, the Board of Directors of the Federal Housing Finance Board (Finance Board) adopted Resolution 2008-08, which temporarily expands the authority of a Federal Home Loan Bank (FHLBank or Bank) to purchase mortgage-backed securities (MBS) under certain conditions. The resolution allows an FHLBank to increase its investments in MBS issued by Fannie Mae and Freddie Mac (Agency MBS) by an amount equal to three times its capital, which is to be calculated in addition to the existing Financial Management Policy (FMP) limit. The resolution restricts incremental Agency MBS purchases to those securities in which the underlying loans or MBS are all guaranteed by Fannie Mae or Freddie Mac. The new authority expires on March 31, 2010. However, the FHLBanks will not have to sell Agency MBS that are purchased under this authority at that time; an FHLBank will be permitted to hold those securities until they mature or the Bank chooses to sell them.

Under the FMP, the Finance Board has permitted an FHLBank to invest in MBS up to three times its capital, which limitation has applied to both private label MBS and Agency MBS. The resolution waives one provision of the Finance Board's FMP. Currently, Section II.C.2 of the FMP permits an FHLBank to purchase MBS up to three times its capital and limits the rate of increase in an FHLBank's MBS portfolio to no more than 50 percent of capital per quarter. The resolution temporarily permits an FHLBank to purchase and hold MBS in an amount up to six times its capital, but all MBS purchases must be investments in Agency MBS when existing MBS investments exceed three times capital. All incremental MBS purchased under the temporary investment authority must have underlying loans that are all guaranteed by Fannie Mae or Freddie Mac or have underlying MBS that are all issued by Fannie Mae or Freddie Mac. This limits the credit risk as Fannie Mae and Freddie Mac have well-established underwriting criteria and have put their corporate guarantee on the loans or securities.

All mortgage loans underlying any securities purchased under this authority must be originated after January 1, 2008. The Finance Board believes that such loans are generally of higher credit quality than loans originated at an earlier time, particularly in 2005 and 2006. The loans underlying any Agency MBS acquired pursuant to the new authority must be underwritten to conform to standards imposed by the federal banking agencies in the *Interagency Guidance on Nontraditional Mortgage Product Risks* dated October 4, 2006 and the *Statement on Subprime Mortgage Lending* dated July 10, 2007.

By allowing the FHLBanks to purchase additional Agency MBS, the Finance Board intends to further its statutory housing finance mission and to complement recent actions by the Federal Reserve and the Office of Federal Housing Enterprise Oversight and the economic stimulus package. To the extent that this action can increase the demand for Agency MBS, the added liquidity could help to restore the market for these securities and could, in turn, lead to lower liquidity premiums, lower mortgage rates, and increased home purchases.

The guidance below communicates to the FHLBanks the standards the Office of Supervision will apply in reviewing an FHLBank's notice that it intends to exercise the incremental authority. The guidance clarifies and supplements the conditions included in the resolution adopted by the Board of Directors on March 24, 2008. A Bank's notice that does not include a full discussion of the elements below will be incomplete and the Finance Board will notify the Bank that it may not exercise the incremental authority unless and until the Bank remedies the deficiencies.

***Guidance*:**

An FHLBank must notify the Office of Supervision of its intention to exercise the new authority at least 10 business days in advance of its first commitment to purchase additional Agency MBS. That notice must include the qualitative and quantitative standards the FHLBank will apply in deciding the types of Agency MBS to purchase as well as the Bank's strategy for funding those purchases and hedging the associated risks. In particular, the Bank's notice should identify any changes to the Bank's balance sheet management, interest rate risk management, and capital management policies and practices.

Balance Sheet Management. We expect the FHLBank and its board of directors to evaluate the effects of exercising the new MBS investment authority on the structure and composition of the Bank's balance sheet, particularly the Bank's liquidity and overall asset/liability management. The Bank's submission should indicate the relationship between purchases made under the new authority and the level of the Bank's advances, the maturity structure of its advances, its liquid assets, and its other investments.

Interest Rate Risk Management. Exercising the new MBS investment authority may introduce additional interest rate risk to the Bank. Before exercising the new authority, we expect the FHLBank and its board of directors to assess the adequacy of the Bank's interest rate risk policies and practices and, where appropriate, to make changes to those policies. An FHLBank should, at a minimum, perform pre-purchase analytics related to the MBS purchases and their associated funding and hedging positions. The Bank's notice should include an estimate of the effect of the purchases on its market value of equity and key risk metrics, *e.g.*, duration and convexity, under a range of interest rate scenarios.

Capital Management. An FHLBank must assess the adequacy of its capital level, capital composition, and retained earnings before exercising the incremental MBS investment authority. The Bank's notice should address any decisions by the Bank and its board of directors to increase leverage or change its policies or practices with respect to the repurchase of excess stock to use the increased MBS investment authority. In addition, the FHLBank's notice must include an updated retained earnings analysis using the framework set forth in Advisory Bulletin 2003-AB-08, *Capital Management and Retained Earnings*. The analysis should consider current and projected mortgage and financial market conditions. An evaluation of the Bank's MBS portfolio, including any additional risk the Bank may assume by purchasing additional Agency MBS, should be part of the retained earnings analysis. We expect an FHLBank will add to its retained earnings as its exposure to risk increases and as it realizes incremental earnings from the purchase of additional Agency MBS.

Internal Reporting. An FHLBank should submit with its notice a list of the data and information it will monitor through its internal reporting. The Bank's internal reports must include estimates of the profitability and risk profile of its MBS investments and specifically identify Agency MBS purchased under the incremental authority. Internal reports and documentation, including trade ticket data, must be available to the Finance Board upon request.

Submission of the Notice. An FHLBank electing to exercise the new MBS investment authority should submit its notice to Tony Cornyn, Associate Director, Office of Supervision, with a copy to the Bank's examiner-in-charge. A Bank may submit the notice and supporting documents electronically and should include a principal contact at the FHLBank. The Office of Supervision will acknowledge receipt of the notice electronically to the Bank-identified contact. The date of that acknowledgment to the Bank shall begin the 10 business day advance-notice period. If the Bank does not hear from its examiner-in-charge within 10 business days after having received the acknowledgement, it may proceed with its purchases.

Related Guidance: Resolution 2008-08 of the Board of Directors of the Federal Housing Finance Board, *Temporary Authorization to Invest in Additional Agency Securities*; 2003-AB-08, *Capital Management and Retained Earnings*; 2004-AB-05, *Interest Rate Risk Management*; 2005-AB-05, *Risk Management Oversight*; 2007-AB-01, *Nontraditional and Subprime Residential Mortgage Loans.*

Principal Finance Board Contacts:

Anthony Cornyn, Associate Director, Office of Supervision, 202-408-2522, cornyna@fhfb.gov.

Attachment:

Questions and Answers

ATTACHMENT

Questions and Answers
Temporary Increase in Mortgage-Backed Securities Investment Authority

1. When may an FHLBank use the temporary authority to purchase additional Agency MBS established by Resolution 2008-08?

   An FHLBank may begin to make purchases pursuant to that authority ten business days after submitting a notice to the Finance Board, unless informed otherwise by its EIC.

2. Must an FHLBank wait for the Finance Board to "approve" its notification (of its intent to purchase additional MBS under the temporary investment authority) prior to the Bank making its initial purchase of Agency MBS under the temporary authority?

   If the Bank does not hear from its EIC within 10 business days following the Finance Board's receipt of the Bank's submission, the Bank may proceed with its purchases.

   If, within 10 business days, the EIC informs the Bank that its submission is deficient, the Bank may not purchase additional Agency MBS under the temporary authority until the deficiencies in the submission are addressed. The Office of Supervision will work with the Bank in an effort to assist the Bank in preparing a notice that adequately addresses the requirements set forth in Resolution 2008-08.

3. After its initial purchase under the temporary investment authority, would an FHLBank be expected to notify the Finance Board prior to purchasing additional Agency MBS?

   A Bank must submit a notification at least 10 days before its <u>initial</u> purchase of Agency MBS. The submission must present an acceptable strategy for the purchase of Agency MBS, including appropriate risk metrics and limits. So long as that notice is acceptable to the Finance Board and the Bank's initial and subsequent purchases are consistent with the strategy set forth in that notice, no further submission is required. However, if the Bank changes its strategy, a new notification would be appropriate.

4. When does the temporary authority expire?

   The temporary authority to invest in additional Agency MBS expires on March 31, 2010.

5. What MBS may an FHLBank purchase under this authority?

   A Bank may purchase MBS under this authority only to the extent that <u>all</u> the underlying loans are guaranteed by Fannie Mae or Freddie Mac or <u>all</u> the underlying MBS were issued by Fannie Mae or Freddie Mac. In addition, the loans underlying any security purchased under this authority must be originated after January 1, 2008 and conform to the underwriting standards imposed by federal banking agencies in the guidance cited by the Finance Board in Resolution 2008-08.

6. May a Bank purchase whole-loan pass-through agency securities?

   Resolution 2008-08 does not prohibit a Bank from purchasing whole-loan pass-through agency securities, but we would expect a Bank planning to purchase such securities to demonstrate that the purchases would not increase the market risk exposure of the Bank to an unacceptable level.

7. Are the FHLBanks prohibited from purchasing private-label MBS if they exercise the incremental investment authority granted by the Finance Board in Resolution 2008-08?

   Purchases of private-label MBS would be permissible if, after the purchase, the Bank's MBS does not exceed three times capital. However, if a Bank's MBS exceeds three times capital, the Bank may not acquire additional private-label MBS.

8. Should the Bank update its capital management and retained earnings policy prior to submitting its notice to the Finance Board?

   The Bank should update its capital management and retained earnings policy using the framework established in Advisory Bulletin 2003-AB-08, Capital Management and Retained Earnings. We expect the Bank's board of directors to reevaluate its retained earnings in light of a decision to increase its MBS, taking into account any additional risk the Bank may assume. The Bank should identify any changes to its target level of retained earnings and establish the time the Bank will need to achieve its retained earnings target.

9. Does the Finance Board expect a resolution from the Bank's board of directors?

   We would expect that an FHLBank's board of directors will consider fully the risks and returns associated with the temporary investment authority prior to making a decision to expand its MBS purchases. A resolution reflecting this consideration would be appropriate.

10. Must an FHLBank sell MBS that is in excess of 300 percent of its capital upon expiration of the temporary authority?

    No.

An Advisory Bulletin is an Office of Supervision staff document that provides guidance to the Federal Home Loan Banks and the Office of Finance regarding particular supervisory issues. Although an Advisory Bulletin does not have the force of a regulation or an order, it does reflect the position of the Office of Supervision on the particular issue, and will be followed by examination staff. If non-compliance with an Advisory Bulletin is cited as the basis for a supervisory determination, any such determination will be subject to review by the Board of Directors pursuant to the procedures of 12 CFR 907.9. Advisory Bulletins are effective upon issuance.