

initiated by the Bank and a Bank System member or housing associate to share risks in compliance with the requirements of § 955.3(b); and

(3) The initiating Bank or Banks acquire substantially all of the certificates. It is the Finance Board's view that, in such a case, the use of a third party to securitize the whole loans would merely represent a vehicle to invest in certain types of AMA under more favorable terms and should therefore be permitted under the rule. However, if the certificates have been created as a security initially available to investors generally, they will not be considered to qualify as "whole loans" under § 955.2(a)(1).

*Id.* at 43974. The Finance Board further explained that mortgage financing instruments structured into senior and subordinated tranches also could be included in the general definition of AMA as long as the transaction was "implemented through a Bank's AMA program using assets that conform with the AMA requirements" and the member involved in the transaction "bore the risk of holding or selling the credit support tranches." *Id.* at 43977. The proposed rule would incorporate the above criteria, albeit in a less prescriptive form, into the three-part AMA test in §§ 955.3(c), 955.4(b) and 955.5.<sup>3</sup>

Section 955.3(c) of the proposed rule, first, would require any instrument that represents an interest in whole loans to be backed only by loans that would be eligible for a Bank to acquire as AMA. In order to qualify as AMA, any such interests also must be created by a member or housing associate, in cooperation with a Bank. To help assure that the Bank's purchase of such instruments is not a mere capital

markets transaction that would not advance the housing finance mission of the Bank System, the Bank cooperating in the creation of the instruments would be required initially to acquire substantially all of the assets issued under this arrangement.

Proposed § 955.3(c) also would make clear that interest only strips (IOs), principal only strips (POs), as well as other interests in the underlying loans that have risk characteristics similar to IOs or POs, would not qualify as AMA.<sup>4</sup> At this time, the Finance Board does not believe that these classes of assets would be consistent with the underlying purpose of the AMA rule, which is to allow a Bank to acquire a high-quality asset from or through its members and housing associates by transactions that support its statutory housing finance mission. See proposed AMA rule, 65 FR at 25681.

Second, § 955.4(b)(1) of the proposed rule would require that the whole loans underlying an AMA-qualified instrument may be acquired only from the same sources from which a Bank may acquire AMA-qualified whole loans. Thus, if a member were to use a trust or other special purpose entity to issue the AMA-qualified interests, the underlying loans must be purchased from: A member or housing associate of the Bank; a member of another Bank, pursuant to an arrangement with that Bank; or a Bank, if approved by the Finance Board. Section 955.6 of the proposed rule would prohibit the use of existing AMA assets to create an AMA-qualified instrument, without the prior approval of the Finance Board. To preserve the nexus between any such AMA-qualified interests in whole loans and the Bank System, the proposed rule also would allow a Bank to sell AMA-qualified interests in whole loans only to other Banks or to members of any Bank.

Finally, to qualify as AMA, an instrument representing an interest in whole loans would have to meet the same credit risk-sharing requirements as are applicable to other AMA-qualified assets. Thus, the instrument would need to be credit-enhanced to a credit quality

equivalent to one of the four categories of investment grade, as determined by the Bank. The proposed rule would differ from the prior guidance provided in the Final AMA Rule, in that it would not require an AMA-qualified interest in whole loans to receive a public rating from an NRSRO. If an NRSRO were to provide a public investment grade rating of the level required by the Bank, that rating would generally satisfy the requirements of proposed § 955.5(a). Further, under proposed §§ 955.5(b)(1) and (b)(2), the member that arranged the creation of the AMA-qualified interest would need to provide the required credit enhancement, and bear all of the economic consequences of the credit enhancement responsibility, as is the case with respect to whole loan AMA assets. The required credit enhancement could be provided through subordinated or credit support tranches. A member generally could meet its obligations under the proposed rule if it were to acquire these support tranches, even if the member later sold these interests.<sup>5</sup> The proposed rule also would allow forms of credit enhancement other than a credit support or subordinated tranche, subject to the Bank satisfying the Finance Board that the credit enhancement obligations of the member or housing associate would meet the requirements of proposed § 955.5(b).

<sup>5</sup> By acquiring the subordinated credit support tranches, the member would be bearing the direct economic consequences of losses from the underlying loans. Clearly, this will be true if the member holds the support tranches for the entire life of the pool of loans underlying the assets, because it will absorb all actual losses up to the required credit enhancement level. The member also will bear the economic consequence of these losses, however, if it sells some or all of the subordinated credit support interests, because of the price risk inherent in the sale of these instruments. Markets will reward low credit losses in the underlying pool of loans with higher prices, and penalize high losses with lower prices. Because of this, the member maintains a strong incentive to assure the credit quality of the loans that will back the senior, AMA-qualified tranches purchased by the Bank, even if the member intends to sell the credit support tranches.

Moreover, given that credit support tranches would be structured to absorb losses up to the initial required amount of the credit enhancement, a Bank that buys the senior investment grade tranches would have no credit exposure to the member that initially acquires the credit support tranches or to any subsequent party that may purchase these support tranches. A credit support tranche, therefore, would not be within the meaning of the phrase "direct obligation of a member or a housing associate" as used in proposed § 955.5(b)(3), and a member or housing associate would not need to provide collateral in connection with this form of credit enhancement. Because the member would not be required to post collateral for the credit support tranches, there also would be no need to restrict the member's sale of those tranches to other Bank members.

<sup>3</sup> The Finance Board's guidance in the final AMA rule was applied in reviewing the Federal Home Loan Bank of Chicago's (Chicago Bank) new business activity notice with regard to the Chicago Bank's Shared Funding™ Program (SFP), an AMA product offered under the Mortgage Partnership Finance Program™ (MPF). See Approval of New Business Activity Notice, 2002-APP-07 (Dec. 4, 2002) (available at [www.fhfb.gov](http://www.fhfb.gov)). Generally, under SFP, a member of the Chicago Bank will purchase AMA-eligible whole loans from other Bank members that have been approved to participate in the program. The Chicago Bank member will transfer these loans to a special purpose entity (SPE) that it establishes. The SPE, in turn, will issue certificates that represent senior investment grade securities and credit support tranches and that are backed by the whole loans. The member will acquire the credit support tranches. The Chicago Bank will acquire the senior investment grade securities, all of which will receive a credit rating from an NRSRO of the second highest investment grade or better. The approval permits the Chicago Bank, or any Bank that subsequently purchases these senior securities, to sell the securities only to other Banks or qualified Bank members. The new business activity approval does not apply to transactions that would involve any loans that a Bank previously purchased as AMA. *Id.* The Chicago Bank announced the completion of its first SFP transaction on March 21, 2003.

<sup>4</sup> The Finance Board recognizes that Banks have expressed interest in buying IOs or POs, specifically as hedging vehicles. This proposed provision would not prevent the Finance Board from removing restrictions that currently prohibit a Bank from acquiring these types of assets for investment or hedging purposes under authority in part 956 of the Finance Board's rules, should the Finance Board decide that such restrictions are no longer warranted. 12 CFR part 956. The proposed provision, instead, would merely clarify that these assets could not be considered AMA and could not be purchased under the authority granted in proposed part 955.