



REGULATORY INTERPRETATION 2000-RI-25

Date: November 17, 2000

Subject: Acquired Member Assets Held for a Valid Business Purpose

Request Summary:

A Federal Home Loan Bank (Bank) has requested that the Federal Housing Finance Board (Finance Board) issue a No-Action letter confirming that the Finance Board will not take supervisory action should the Bank hold certain loans as acquired member assets (AMA) under the Finance Board's Acquired Member Asset regulation. *See* 12 C.F.R. part 955. The loans would be originated by entities outside of the Federal Home Loan Bank System (Bank System), but would be purchased from a Bank member that had acquired the loans in the ordinary course of its business. Because a response to this request necessarily involves an interpretation of the term "valid business purpose" as such term is used in section 955.2(b)(1)(ii) of the Finance Board's regulations, the Finance Board has determined to issue a regulatory interpretation to clarify the circumstances under which Banks may hold loans originated by non-members as AMA.

Background:

Finance Board regulations establish criteria whereby the Banks may acquire AMA loans, including loans originated or issued by, through, or on behalf of the Bank System (by members, housing associates or their affiliates), *see* 12 C.F.R. § 955.2(b)(1)(i), and loans that were held for a valid business purpose by a member or housing associate, or an affiliate thereof, prior to their acquisition by a Bank. *See* 12 C.F.R. § 955.2(b)(1)(ii).

The Bank has expressed a desire to acquire one-to-four family loans from its members under the Mortgage Partnership Finance (MPF®) program to the maximum extent possible. To this end, the Bank has requested that the Finance Board confirm that loans acquired by a member that conducts a wholesale mortgage operation and purchases loans for resale in the ordinary course of that business may be held by the Bank as AMA, regardless of the originating party. Further, the Bank requests confirmation that loans otherwise meeting the nexus requirement of section 955.2(b)(1) may be classified as AMA whether the member acquires such loans through traditional channels or through modern, electronic means and regardless of the length of time the member holds the loans.

The request followed a Finance Board letter to the Bank that addressed the practice of using Bank members as transitory, passive holders of mortgage loans originated by non-members so that such loans might qualify for the MPF® program. The letter indicated that the Finance Board has serious concerns regarding whether such a practice, including the use of an internet entity to funnel loans to members, would meet the "valid business purpose" test for AMA.

The Bank's request focuses on a particular member (Member) whose core business is servicing mortgages, primarily as a subservicer for the owner of the servicing asset. The Member does not originate one-to-four family mortgages, but rather purchases loans on a servicing released basis and then resells the loans servicing retained. The Member's balance sheet activities are directed at maximizing the scale advantages of its servicing activities. The Bank indicates that the Member's business strategy relies on exploiting technology and scale efficiencies.

As described in the Bank's request, the Member seeks to contract with a start-up internet company (Platform) providing a trading platform that will electronically link multiple loan originators to the servicing capacity of the Member. The Member believes that Platform will provide the efficiencies of e-commerce in assembling multiple origination sources. Under the proposed arrangement, Platform would administer pricing set by the Member and generate originator prospects for approval by the Member. The Member would set loan standards and enter into a delivery agreement with each origination participant. Software developed by Platform would be used to register loans, manage commitments and provide follow-up for trailing documentation. Ultimately, the Member intends to sell some or all of the loans acquired through Platform to the Bank under the MPF® program, while retaining the servicing and providing credit enhancements consistent with MPF® requirements.

The Bank argues that, because the proposed transaction is consistent with the Member's longtime, core business strategy of operating a wholesale bank, the Bank should be permitted to conclude that loans purchased and resold through Platform have been held by the Member for a "valid business purpose" under the AMA regulation.

Analysis or Discussion:

Part 955 establishes the criteria whereby the Banks may acquire mortgage assets from their members.¹ Section 955.2 of the AMA regulation sets forth a three-part test for determining whether an asset may qualify as AMA. Section 955.2 provides for (a) a loan type requirement (AMA must be whole loans or certain interests in whole loans); (b) a member or housing associate nexus requirement (AMA must be either originated, issued by, through or on behalf of, or held for a valid business purpose by a member or housing associate or affiliate thereof, and acquired from a member, housing associate, or another Bank (or a member or housing associate of another Bank, pursuant to an arrangement with that Bank)); and (c) a credit risk-sharing requirement (AMA must be structured such that the member or housing associate is responsible for a significant portion of the credit risk of the investment, and otherwise is in compliance with section 955.3).

The first part of the member or housing associate nexus requirement, which is the subject of this regulatory interpretation, is set forth in section 955.2(b)(1) as follows:

(b) Member or housing associate nexus requirement. The assets are: (1) Either: (i) Originated or issued by, through, or on behalf of a Bank System member or housing associate, or an affiliate thereof; or (ii) Held for a valid business purpose by a Bank System member or housing associate, or an affiliate thereof, prior to acquisition by a Bank; and ...

¹ This authority is an expansion and refinement of the authority granted to the Banks by a series of Finance Board resolutions. See Resolution Nos. 98-41 (September 23, 1998), 99-50 (October 4, 1999) and 99-66 (December 14, 1999).

This provision requires that the assets at issue have some association to or connection with the member or housing associate, or affiliate thereof (hence the term Acquired Member Asset) and provides two alternative means for meeting this nexus requirement. The first alternative is for the asset to be originated or issued by, through or on behalf of the member, housing associate or affiliate. For assets originated or issued outside of the Bank System, section 955.2(b)(1)(ii) provides a second nexus alternative tied to the circumstances under which the asset came to be held by the member, housing associate or affiliate. This is the "valid business purpose" alternative.

The "valid business purpose" alternative first appeared in Resolution Number 99-66, dated December 14, 1999, which modified a previous Resolution to expand the type of loans that were eligible to be acquired under member mortgage asset programs. The modification reads as follows:

Purchasing such loans or loan pools from or through the FHLBank's member or eligible nonmember borrower, provided that such loans or loan pools have been originated by the FHLBank's member or eligible nonmember borrower, or a subsidiary or affiliate (as defined in the Federal Reserve Act) thereof, or have been held for a valid business purpose by the member or eligible nonmember borrower or subsidiary or affiliate thereof, as demonstrated by the FHLBank, prior to acquisition by the FHLBank: or ...

The member nexus was intended to exclude any assets that are passed from a nonmember through a member to a Bank with the intent to extend the benefits of Bank membership to the nonmember. *See* 65 Fed. Reg. 25681 (May 3, 2000). The "valid business purpose" alternative was created in recognition of the fact that many Bank System members acquire assets from nonmembers in the normal course of business, and to allow such members to sell those assets to the Banks.² In fact, many large members maintain broad correspondent loan and banking services networks that involve nonmembers as an integral part of their businesses. The Finance Board codified the alternative nexus test so that members with correspondent networks would not be prevented from fully participating in member mortgage acquisition programs and thereby disadvantaged in relation to their peers, although the express requirement that the Bank demonstrate a valid business purpose on a transactional basis was eliminated from the AMA regulation. Accordingly, for section 955.2(b)(1)(ii) the connection or nexus between the asset and the Bank System is provided by the business relationship between a member and the nonmember from whom it acquires assets. To qualify under this alternative, such relationship must provide reasonable assurance that assets being provided by the nonmember have received the same or equivalent scrutiny as would have been the case had the assets been originated by a member of the Bank System. Again, assets that would merely be passed from a nonmember through a member to a Bank with the effect of extending the benefits of Bank membership to the nonmember, or for which a member would merely be serving as a passive, transitory holder between a nonmember and a Bank (without exercising reasonable or appropriate control or scrutiny) would not qualify as AMA.

² This represented a departure from previous Finance Board practice. The initial Resolutions authorizing a single Bank to fund and purchase loans under a pilot program referred only to loans originated by members. *See* Resolution Nos. 96-11 (December 26, 1996) and 98-41 (September 23, 1998). Resolution Number 99-50, dated October 4, 1999, which authorized all of the Banks to establish and operate member mortgage asset (MMA) programs, provided additional clarification by expressly stating that a Bank could purchase loans originated by the Bank's members, eligible nonmember borrowers, or their subsidiaries or affiliates.

A member would have to exercise meaningful influence over or control of the assets coming into the Bank System, or of the process by which the assets have come into the Bank System, in order to establish that assets generated from a business relationship are being held for a valid business purpose. Factors sufficient to evidence this would include but would not be limited to: (1) whether the correspondent operation represents a core business of the member; (2) how long the member has been involved in the correspondent operations; (3) whether the member is familiar with the nonmember(s) and experienced with the type, quality and volume of the assets being submitted by the nonmember; (4) whether the member has a clear opportunity to identify and address the potential for fraud on an operational level; (5) whether it is the member itself that approves and contracts with participants in its correspondent network; and (6) whether the member itself sets the terms of its contractual relationship with nonmember correspondents, including asset standards and pricing.

On the basis of the facts presented, Finance Board staff concludes that the Member's correspondent operations satisfy the standard for "valid business purpose" set forth above. We note in this regard that the purchase and resale of loans on a wholesale basis is and has been the Member's core business, that the Member will individually approve and contract with all participating nonmembers, and that the Member will control loan standards and pricing. These factors, together with the Member's experience in operating a correspondent network, demonstrate that the Member will be an active participant in the proposed transaction. The Finance Board also notes that the Bank is responsible for monitoring and evaluating a member's capacity to operate a correspondent network.³ This evaluation is both a critical and integral part of the Bank's initial review of the member's eligibility to participate in an AMA program, as well as an ongoing responsibility. Changes to the source, type or volume of loans that the member proposes to supply to an AMA program would require that the Bank reassess the member's eligibility and participation in the AMA program. The supervisory staff of the Finance Board will periodically examine the adequacy of a Bank's controls over the correspondent networks of members participating in AMA programs.

Regarding the involvement of Platform, which is a start-up internet company, as a trading platform, and the use of non-traditional, electronic means for executing certain transactions, while the Finance Board believes the use of third party internet portals raises supervisory issues that will merit heightened scrutiny, the utilization of this technology, in and of itself, is not a determinative factor in evaluating whether a business relationship establishes a "valid business purpose" under part 955. Likewise, the length of time a member holds a particular asset should not affect the ability of that asset to qualify as AMA.

Interpretation:

The valid business purpose requirement of 12 C.F.R. § 955.2(b)(1)(ii) will have been met if the business relationship between the Bank member, housing associate or affiliate thereof and the nonmember from whom it has acquired the assets, provides the same or equivalent scrutiny of the assets as would have been the case had the assets been originated or issued by, through or on behalf of the member, housing associate or affiliate thereof. Assets that would merely be passed from a nonmember through a member to a Bank with the effect of extending the benefits of Bank

³ While no longer required to demonstrate the existence of a valid business purpose on a transactional basis, as had been the case under Resolution Number 99-66, dated December 14, 1999, a Bank's ability to offer AMA programs to its members has been conditioned on the Bank's administrative office capability, including the Bank's demonstrated ability to put in place the necessary policies, procedures and controls. See Resolution No. 99-50 (October 4, 1999), Terms and Conditions, Sec. IV. D. (1).

membership to the nonmember, or for which a member would merely be serving as a passive, transitory holder between a nonmember and a Bank without exercising reasonable or appropriate control or scrutiny, would not qualify as AMA.

A member would have to exercise or demonstrate meaningful influence over or control of the assets being acquired by the Bank System, or of the process by which the assets have come into the Bank System, in order to establish that assets generated from the business relationship are being held for a valid business purpose. Factors sufficient to evidence this would include but would not be limited to: (1) whether the correspondent operation represents a core business of the member; (2) how long the member has been involved in the correspondent operations; (3) whether the member is familiar with the nonmember(s) and experienced with the type, quality and volume of the assets being submitted by the nonmember; (4) whether the member has a clear opportunity to identify and address the potential for fraud on an operational level; (5) whether it is the member itself that approves and contracts with participants in its correspondent network; and (6) whether the member itself sets the terms of its contractual relationship with nonmember correspondents, including asset standards and pricing.

A Regulatory Interpretation applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. part 907.