FHLB Chicago
Federal Home Loan Bank of Chicago

October 15, 2010

VIA ELECTRONIC MAIL

Alfred M. Pollard, General Counsel
Federal Housing FHFA, Fourth Floor
1700 G Street, NW
Washington, D.C. 20552

Re: Comments on Private Transfer Fee Covenants Proposed Guidance; No. 2010-N-11

Dear Mr. Pollard:

The Federal Home Loan Bank of Chicago ("Bank") appreciates the opportunity to comment on the Federal Housing FHFA ("FHFA") notice of proposed "Guidance on Private Transfer Fee Covenants" ("Proposed Guidance"). The FHFA has indicated that the entities it regulates should not deal in mortgages on properties encumbered by Private Transfer Fee Covenants ("PTFC") because, in its view, such covenants appear adverse to liquidity, affordability and stability in the housing finance market and to financially safe and sound investments. The Proposed Guidance would extend to mortgages and securities held by the Federal Home Loan Banks ("FHLBanks") as investments or as collateral for advances.

PTFC Background:

Private transfer fees were originally designed to recoup discounts offered to original owners of New York City apartment buildings that converted to a co-op ownership structure, also referred to as a "flip tax". The original owners were typically renters who took advantage of favorable discounted "insider" pricing and then quickly re-sold or "flipped" the units to make a profit by selling them at market rates.

Co-op boards' revenue streams are typically limited to monthly maintenance from shareholders and rental from commercial units. PTFC fees can serve as another source of revenue, typically used to fund reserves for capital improvements and building repairs. In addition, shareholders experience the benefit of lower maintenance fees which are subsidized by the PTFC payments. Income derived from PTFC fees allow for a more stable reserve fund to keep up with the ongoing maintenance and improvement of these aging structures, and in so doing, preserve and improve upon the value of the shareholder's investment. Over time, the PTFC fees can provide

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for adequate reserves to keep pace with the increasing cost of funding significant improvements and repairs because the fixed-percent fees are generated on the sale of co-op units that also appreciate in value. Strong reserve funds also diminish the need for "special assessments" on shareholders to cover major, unexpected building repairs.

To a much lesser extent, PTFCs have also been adopted to benefit Home Owners Associations ("HOAs") of condominium and planned unit development (PUD) projects. Similar to coops, the PTFC fees in this case benefit the homeowners as they are used to fund the maintenance and repairs of the common areas under the control of HOAs. However, more recently a new trend has surfaced whereby housing developers have begun imposing PTFC (known also as capital recovery fees, resale fees, or re-conveyance fees) on new homes which do not benefit the homeowners of these properties ("Unmerited PTFC"). This particular practice requires sellers to pay a percentage of the sale price of their home to the developer when the homeowners sell their home. Unmerited PTFC appear to only benefit either the developer by providing a lucrative and long lasting revenue stream, or benefit the investors in securities backed by these revenue streams. The practice of securitizing Unmerited PTFC income streams has also begun. However, though there are PTFC which serve beneficial purposes as opposed to Unmerited PTFC, the "FHFA's draft Guidance does not distinguish between private transfer fee covenants which purport to render a benefit to the affected property and those which accrue value only to unrelated third parties." 75 F.R. 49932 (August 16, 2010).

Investments Impact – The FHFA's Proposed Guidance notes that the "draft Guidance is based on the view that investments in mortgages on properties with private transfer fee covenants *and securities designed to generate income from the fees* are not acceptable for the regulated entities." *Id.* at 49932 [Emphasis added]. In describing the Proposed Guidance, the FHFA states the Proposed Guidance directs the regulated entities not to purchase or invest in "*securities backed by private transfer fee revenue*." *Id.* at 49933 [Emphasis added]. However, the text of the Proposed Guidance itself not only prohibits the purchase of, and investment in, securities backed by private transfer fee revenue, but expands the prohibition to *all securities* backed by a mortgage encumbered by PTFC.

The text of the Proposed Guidance states that Fannie Mae and Freddie Mac "should not purchase or invest in any mortgages encumbered by private transfer fee covenants *or securities backed by such mortgages*." *Id.* at 49934 [Emphasis added]. The provision is expanded to the FHLBanks by stating "The Banks should not purchase or invest in such mortgages or securities or hold them as collateral for advances." *Id.* The text of the Proposed Guidance prohibits the purchase or investment in securities backed by "such mortgages," presumably referring to the immediately preceding phrase which prohibits the purchase or investment in "any mortgages encumbered by private transfer fee covenants." Thus, the text of the Proposed Guidance appears to

unnecessarily expand the coverage of the Proposed Guidance as expressed by the FHFA in the Supplementary Information and is unnecessary to achieve the FHFA's goals.

The Bank supports the FHFA's prohibition expressed in the Supplementary Information on purchasing, investing in or accepting as collateral securities backed by PTFC revenue. However, with the exception of securitizations of PTFC revenue, the Bank has significant concerns with the difficulty of determining whether a mortgage backed security ("MBS") is backed by a mortgage that may be subject to a PTFC, as typical securities prospectuses do not contain representations and warranties with respect to whether mortgages are subject to PTFC.

Since we expect that the other FHFA regulated entities will comply with FHFA issued guidance prospectively from the date of the guidance ("Final Guidance") issuance, we would expect that agency MBS would be exempt from any investment or collateral prohibitions contained in the Final Guidance. The text of the Proposed Guidance would appear to require the FHLBanks to examine the files for the mortgages backing every security, prior to purchasing or investing in that security or accepting such security as collateral, to determine whether any of the mortgages backing that security are encumbered by a PTFC. However, such pre-purchase reviews are neither practicable nor in most cases, even possible. Even the FHFA recognizes that PTFC "often are not disclosed by sellers and are difficult to discover through customary title searches." *Id.* at 49933.

Acquired Member Assets Impact – Even if the FHFA were to limit its prohibition to Unmerited PTFC with respect to loans acquired under the MPF® Program, actually being able to detect the presence of PTFCs in the mortgage documents will be difficult as there is no uniform market convention on how these fees are disclosed and documented. Other than formally prohibiting the sale of such loans and documenting this in the MPF Program Origination Guide by expanding existing representations and warranties provided by participating financial institutions, and instructing the quality control service provider to look for the presence of PTFCs during their Quality Control review process, the FHLBanks are limited in their ability to detect such loans. The FHLBanks could benefit from an industry standardization initiative in the disclosure of PTFCs within the closing documents.

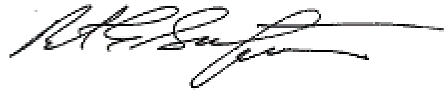
Collateral Impact – Monitoring and testing for the presence of PTFC will be no less challenging for mortgage loans pledged as collateral because, as the FHFA has acknowledged, PTFC "are difficult to discover through customary title searches." *Id.* at 49933. With respect to Unmerited PTFC, we do believe that realistic and reasonable efforts can be applied to ensure adherence to the spirit and primary objective of the Proposed Guidance. This can include informing members of the prohibition on pledging such loans as collateral, requiring enhanced member certifications that such loans are not pledged, and conducting reasonable assessments of

loans reviewed during on-site visits. Expectation to pursue compliance verification much beyond these standard practices will not be practical or meaningful.

Prospective Application – The Proposed Guidance does not mention when the Final Guidance would be effective. The Bank recommends that the FHFA make clear that the Final Guidance would apply prospectively only, and only to Unmerited PTFC encumbering mortgages loans originated and MBS issued 120 days after the effective date of the Final Guidance so that the Bank's members and investment counterparties can have sufficient time to revise their underwriting and origination guidelines as necessary. Retroactive application of the Final Guidance to previously originated mortgage loans or issued mortgage-backed securities could have significant unintended consequences for the FHLBanks and their members. The application of the Final Guidance prospectively only to Unmerited PTFC would meet the spirit and primary objective of the Proposed Guidance.

On behalf of the Federal Home Loan Bank of Chicago, we thank the FHFA for its consideration of these comments.

Sincerely,



Peter E. Gutzmer
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