December 4, 2002

Mr. Alex Pollock
President
Federal Home Loan Bank of Chicago
111 East Wacker Drive
Chicago, Illinois 60601

Re: Approval of New Business Activity Notice: Shared Funding Program (2002-APP-07)

Dear Mr. Pollock:

This responds to the notice of new business activity (Notice) filed by the Federal Home Loan Bank of Chicago (Chicago Bank) on September 27, 2002, regarding its proposal to offer a new Mortgage Partnership Finance Program (MPF) product referred to as the Shared Funding Program (SFP). The SFP is designed to create a method for Participating Financial Institutions (PFIs)[1] to transfer MPF loans into collateralized mortgage obligations (CMOs) through the use of a third party trust.

Federal Housing Finance Board (Finance Board) staff has reviewed the Notice, as supplemented by correspondence from the Chicago Bank dated November 6 and 20, 2002, and by telephone conversations between the Chicago Bank's General Counsel and Finance Board staff. Based on the information provided by the Chicago Bank, we approve the Notice, subject to satisfaction of the conditions set forth below.

Description of the SFP Transactions

Under the SFP, PFIs will sell MPF-eligible loans[2] to a Chicago Bank member (Depositor). The Depositor concurrently will sell those loans to a special purpose trust that it has organized for the purpose of securitizing the mortgages into CMOs.[3] The trust will issue two certificates – an A Certificate and a B Certificate. The A Certificate will represent the senior investment-grade securities created by the transaction while the B Certificate will the represent the credit support

[1] PFIs may be Chicago Bank members or members of other Federal Home Loan Banks (Banks). As described in the Notice and consistent with the Finance Board's acquired member assets (AMA) regulation, a PFI from another Bank will take part in the SFP only pursuant to an agreement among the PFI, its Bank, and the Depositor, that also will be acknowledged by the Chicago Bank.

[2] MPF-eligible loans are those mortgage loans that meet the criteria established under part 955 of the Finance Board's AMA regulation and the Bank's MPF Guides.

[3] The trust would qualify as a real estate mortgage investment conduit (REMI") under U.S. tax laws. Under the SFP, separate trusts will be created monthly for 30-year mortgages and for 15-year mortgages.

tranches. Each Certificate may consist of multiple tranches (A Certificate CMOs and B Certificate CMOs), with each tranche having individual duration characteristics as well as individual interest rate, prepayment and market risk characteristics. The Depositor initially will acquire both the A and B Certificate CMOs and subsequently will sell all of the A Certificate CMOs to the Chicago Bank.[4] The Chicago Bank has represented that it never will acquire any class of SFP instrument that would be an interest-only or principal-only strip or a residual or interest-accrual class of security.

The Depositor either may hold the B Certificate CMOs in its own portfolio or sell all or a portion of them to other investors, which may or may not be Bank members. The Chicago Bank has represented that it may sell its interests in A Certificate CMOs it acquires, but only to other Banks or to Bank members. Similarly, the Chicago Bank has affirmed that other Banks will limit any subsequent sales of A Certificate CMOs that they acquire to other Banks and Bank members. The Chicago Bank will accomplish sales of the A Certificate CMOs by using its Treasury Department. The Chicago Bank has represented that it will be responsible for assuring that it undertakes activities with regard to the SFP in a manner that complies fully with applicable securities laws.[5]

The Chicago Bank has represented that the trust will prepare an Offering Memorandum for all SFP transactions that will meet the standards established by private issuers of mortgage-backed securities and will meet or exceed the Securities and Exchange Commission (SEC) standards for mortgage securities registered under the Securities Act of 1933 (1933 Act).[6] The Offering Memorandum will be provided to purchasers of the A Certificate and B Certificate CMOs. Further, the trustee will update information monthly on the performance of the mortgage pools that comprise each trust and will post this information on a website to which investors will have access. Sales of both the A Certificate and the B Certificate CMOs will be accomplished pursuant to an exemption from registration under the 1933 Act.

All certificates issued by the trusts will receive a public credit rating from a Nationally Recognized Statistical Rating Organization (NRSRO). The A Certificates will have a rating of

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[4] All mortgage loans that are to compose the pool may be transferred to the trust in a single transaction. In this case the trust will issue permanent A and B Certificates to the Depositor at the time of transfer. Alternatively, the Depositor may transfer loans to the trust over the course of a month. In this case, the Depositor will receive temporary A and B Certificates for each transfer. At the end of the month, all temporary certificates will be dissolved and permanent A and B Certificates will be issued. The Chicago Bank may purchase the temporary A Certificates from the Depositor after they are issued.

[5] [redacted] The Chicago Bank recognizes that it would need to seek advice of securities law counsel concerning its responsibilities to register as a broker or dealer under state and federal law before undertaking any repurchase or resale activity that may go beyond an incidental accommodation of a member's request for help.

[6] The Chicago Bank understands that the Finance Board is considering regulations that may establish additional disclosure requirements.

the second highest investment grade rating (AA) or better, and the B Certificate will have a lower rating, which will depend on the degree of credit support required from the B Certificate to provide the necessary rating for the A Certificate. To the extent an A Certificate consists of multiple tranches, all tranches will have a rating of AA or better.

The Bank's Role in the Transactions

The SFP transactions will be arranged cooperatively by the Chicago Bank and the Depositor, pursuant to agreements negotiated between the Chicago Bank and the Depositor, such that the Chicago Bank will act as agent for the Depositor. In its capacity as agent for the Depositor, the Chicago Bank will work closely in the acquisition, pricing and credit analysis of the loans acquired by the Depositor. The Chicago Bank will receive compensation in connection with such services.

The Chicago Bank has represented that its duties under the SFP will correspond closely to those functions it already undertakes with respect to other MPF products. Among its duties, the Chicago Bank will issue a Shared Funding Master Commitment to the PFI on behalf of the Depositor, estimate the required credit enhancement for loans sold by PFIs[7] and collect loan-level information from PFIs on pools of loans for possible sale under the master commitment. The Chicago Bank will review potential loans that are available for sale based on provisions established in the MFP Origination Guide, Servicing Guide, Underwriting Guide, Custody Manual, and any other published MPF guides to determine the acceptance or rejection of each loan. Pricing will be an iterative process between the Depositor, the PFI and the Chicago Bank. Once a PFI accepts a price, the loans will become part of a delivery commitment issued by the Chicago Bank on behalf of the Depositor. The Chicago Bank will accumulate required loan-level data from the PFIs through the eMPF website and forward such data to the Depositor. After the pool of loans is set, the Chicago Bank and the Depositor will work cooperatively in the structuring of the Certificate tranches.

Risks Associated with the SFP

The Chicago Bank states that the fundamental risks associated with the SFP are virtually identical to the risks the Chicago Bank has managed in the MPF program. These fundamental risks include interest rate risk, credit risk and operational risk.

[redacted].[8] The delivery system for the SFP will be the existing MPF program operational system, and the Chicago Bank represents that it has the capacity to manage the anticipated volumes in the SFP. The current systems in place for day-to-day activities will be enhanced and expanded to separately record, account for, and monitor MPF assets that will be separately pooled under the SFP.

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7 [redacted]

8 As of October 31, 2002, outstanding MPF loans for the Bank System totaled $36 billion and outstanding master commitments totaled $21 billion. Total outstanding MPF loans were $25 billion and $15 billion as of December 31, 2001, and December 31, 2000, respectively.

The Chicago Bank further represents that it has established controls, processes and procedures to ensure that these actions occur in a safe and controlled manner. Since this process is automated, the Chicago Bank believes that any business or operations risk in connection with doing business with the trust is minimal and not substantially in excess of the risk that the Chicago Bank currently has in performing this service for other Banks with respect to other MPF products.

Analysis

Based on the representations contained in the Chicago Bank's submissions, we have concluded that the A Certificate CMOs meet the requirements of 12 C.F.R. part 955 and, therefore, qualify as AMA. In this respect, section 955.2 of the Finance Board rule sets forth a three-part test for determining whether assets qualify as AMA, and, therefore, whether the Chicago Bank may invest in such assets under the authority granted in part 955.[9] This section provides that AMA must be: (a) whole loans or certain interests in whole loans; (b) originated or held for a valid business purpose by a member or housing associate, and acquired from a member, housing associate or another Bank; and (c) structured such that a member or housing associate is responsible for a significant portion of the credit risk of the investment and is otherwise in compliance with the credit enhancement requirements of the regulation.

In particular, we have relied on the Chicago Bank's representations that the loans deposited in the trust will be MPF-eligible loans, that the Depositor will be a Chicago Bank member, that the trust certificates will receive a public rating from an NRSRO, that the A Certificate CMOs will have a rating of AA or better from an NRSRO and that the Depositor will acquire the B Certificate and thereby bear the risk of holding or selling the credit support tranches of the SFP CMOs. Further, we have relied on the Chicago Bank's representations that all loans deposited in the trust will be originated by the Depositor or by other PFIs, and that all acquisition of the loans by the Depositor will be in compliance with 12 C.F.R. § 955.2(b)(1)(ii) as that provision has been interpreted in relevant Regulatory Interpretations. We also have relied on representations that the Chicago Bank will acquire all of the A Certificate CMOs directly from the Depositor and that it will sell these interests only to other Banks or Bank members. Such sales will be accompanied by disclosure that equals or exceeds SEC standards for mortgage-backed securities that are registered under the 1933 Act.

Because the A Certificates will qualify as AMA, the Chicago Bank may invest and hold the A Certificate CMOs without regard to the limits placed on the purchase of CMOs by the Financial Management Policy (FMP). Further, the sale of these instruments to other Banks will not change their status from AMA, and thus, other Banks may buy and hold these instruments under their authority to invest in AMA. Finally, the Chicago Bank has authority to act as agent for the Depositor and the trust in activities that support the SFP because the program is an AMA activity designed to support and encourage members' housing finance activities.

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[9] *See* 12 C.F.R. § 955.2; 65 Fed. Reg. 43969, 43974 (July 17, 2000) (Final Rule: Federal Home Loan Bank Acquired Member Assets, Core Mission Activities, Investments and Advances).

Notice Approval Conditions

This approval applies only to the SFP transactions that are fully described in the Chicago Bank's submissions. It does not extend to any other SFP product that would involve MPF loans that already have been purchased by the Chicago Bank or other Banks and are credit-enhanced in accordance with the terms of already-existing MPF products. Further, the sale of any A Certificate CMOs by the Chicago Bank or any other Bank is conditioned on such Bank providing the purchaser of these A Certificate interests with the disclosure information described by the Chicago Bank in its submissions and on the Banks limiting their sales of the A Certificate CMOs to other Banks and Bank members.

The foregoing analysis and approval conditions are dependent on the facts, circumstances and assurances represented to Finance Board staff in the Chicago Bank's submissions. Any material change in such facts, circumstances or assurances could nullify or require a modification of this letter. This letter expresses the position of the staff only and may be modified or superseded by the Board of Directors of the Finance Board. If you have any questions, please contact me at 202/408-2536.

Sincerely,

/s/ Arnold Intrater

Arnold Intrater
General Counsel