

Memorandum

To Mortgage Bankers Association and the Warehouse Lending Project

From Jeffrey P. Naimon, Buckley Sandler LLP

Re Permissibility for Government Sponsored Enterprises to Purchase Warehouse Loan Participations

Date June 19, 2009

In connection with your letter, dated June 19, 2009 (the “Letter”), regarding the critical need for increased residential mortgage warehouse funding in the United States mortgage market and exploring the possibility of The Federal National Mortgage Association (“Fannie Mae”) and/or the Federal Home Loan Mortgage Corporation (“Freddie Mac”, and each of Fannie Mae and Freddie Mac a “GSE”) purchasing participations in warehouse extensions of credit that have already been funded by a warehouse lender, you have asked us to analyze whether such purchases would be consistent with the GSEs’ respective Charter Acts.¹

In summary, although there is little extrinsic guidance upon which we can rely in interpreting the GSE Charter Acts, in our judgment, the GSEs have the requisite authority under the Charter Acts to purchase participations in warehouse extensions of credit extended by warehouse lenders as structured in the Letter.

Proposed Program

Warehouse extensions of credit are typically extended in one of two structures. The first structure is the traditional warehouse line of credit, which is a revolving commercial line of credit in which each advance on the line of credit is made for a specific new residential mortgage loan and the warehouse lender takes a pledge of the new mortgage loan. When the originator sells the loan into the secondary market, it pays off the related warehouse line advance. The second structure is a sale/repurchase. In this structure, rather than a mortgage loan originator pledging the loan as security for its obligations under a

¹ 12 U.S.C. 1716 et seq. (Fannie Mae) and 12 U.S.C. 1451 et seq. (Freddie Mac), (together, the “Charter Acts”).

traditional mortgage warehouse loan and security agreement, in the context of a repurchase agreement, the originator sells and assigns its entire interest in a mortgage loan to the warehouse lender, who pays a purchase price for such mortgage loan to such seller and agrees to sell such mortgage loan back to the seller or its designee on a specified future date not to exceed one year in exchange for repayment of the purchase price plus accrued price differential and applicable fees. If the seller of the mortgage loans enters bankruptcy, provided that the repurchase agreement falls within the ambit of and satisfies the elements of the definition of a repurchase agreement and/or a securities contract under the Bankruptcy Code, the lender (because the lender is a buyer under the repurchase structure) may exercise contractual rights to liquidate, terminate and accelerate a repurchase agreement and sell the collateral without obtaining relief from the automatic stay of the bankruptcy.

As described in the Letter, the Mortgage Bankers Association and the Warehouse Lending Project propose that, in connection with the sale/repurchase structure, a GSE would purchase from the warehouse lender a participation in the GSE-eligible mortgages held by the warehouse lender.

Legal Background

Fannie Mae and Freddie Mac are limited purpose entities whose charters are part of the United States Code. Their ties to the government through their special status have long gained them enhanced access to the capital markets, which have allowed the GSEs to borrow money at rates just a little above that of the United States Treasury. As noted in the Letter, this unique status allows the GSEs ongoing access to the capital markets, both for their corporate obligations and for mortgage-backed securities that they guarantee, access that the private market largely lacks.

An internal legal memorandum in FHFA's predecessor agency, the Office of Federal Housing Enterprise Oversight ("OFHEO"), noted that as "instrumentalities, imbued under their charters with a special relationship to the government, the Enterprises are instruments of federal policy and possess no authority other than that provided, explicitly or impliedly, by their enabling statutes."² The Charter Acts provide specific purposes intended to be effected by the GSEs. Among these, the five shared "core" purposes for the GSEs as enumerated in the Charter Acts are as follows:

- (1) provide stability in the secondary mortgage market for residential mortgages;
- (2) respond appropriately to the private capital market;
- (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the

² Internal legal memorandum, dated September 7, 2000, to Armando Falcon, Director of OFHEO the OFHEO's General Counsel and Deputy General Counsel, Alfred Pollard and David Roderer.

liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
(4) promote access to mortgage credit throughout the Nation (including central cities, rural area, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available to residential mortgage financing; and
(5) manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.”³

In connection with these broad purposes, the GSEs were granted express powers to engage in certain activities, and were made subject to express limits on their activities as well. Relevant to this memorandum, the Charter Acts provide the GSEs with a limited power both to purchase and deal in mortgage loans (including taking participations) and to lend on the security of mortgage loans.

The power to purchase mortgage loans is set forth in Section 302(b)(2) of the Fannie Mae Charter Act, which provides as follows:

For the purposes set forth in section 301(a), and with the approval of the Secretary of Housing and Urban Development, *the corporation is authorized, pursuant to commitments or otherwise, to purchase, service, sell, lend on the security of, or otherwise deal in mortgages which are not insured or guaranteed as provided in paragraph (1) (such mortgages referred to hereinafter as "conventional mortgages")*. No such purchase of a conventional mortgage secured by a property comprising one- to four-family dwelling units shall be made if the outstanding principal balance of the mortgage at the time of purchase exceeds 80 per centum of the value of the property securing the mortgage, unless (A) the seller retains a participation of not less than 10 per centum in the mortgage; (B) for such period and under such circumstances as the corporation may require, the seller agrees to repurchase or replace the mortgage upon demand of the corporation in the event that the mortgage is in default; or (C) that portion of the unpaid principal balance of the mortgage which is in excess of such 80 per centum is guaranteed or insured by a qualified insurer as determined by the corporation. The corporation shall not issue a commitment to purchase a conventional mortgage prior to the date the mortgage is originated, if such mortgage is eligible for purchase under the preceding sentence only by reason of compliance with the requirements of clause (A) of such sentence. The corporation may purchase a conventional mortgage which was originated more than one year prior to the purchase date only if the seller is the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration,

³ Section 301 of the Federal National Mortgage Association Charter Act, 12 USC 1716 and Section 301(b) of Freddie Mac Corporation Act, 12 USC 1451(b).

or any other seller currently engaged in mortgage lending or investing activities. For the purpose of this section, the term "conventional mortgages" shall include a mortgage, lien, or other security interest on the stock or membership certificate issued to a tenant-stockholder or resident-member of a cooperative housing corporation, as defined in section 216 of the Internal Revenue Code of 1954, and on the proprietary lease, occupancy agreement, or right of tenancy in the dwelling unit of the tenant-stockholder or resident-member in such cooperative housing corporation. *The corporation shall establish limitations governing the maximum original principal obligation of conventional mortgages that are purchased by it; in any case in which the corporation purchases a participation interest in such a mortgage, the limitation shall be calculated with respect to the total original principal obligation of the mortgage and not merely with respect to the interest purchased by the corporation.* [emphasis added].

The power to lend on the security of mortgage loans is set forth in Section 304 of the Fannie Mae Charter Act, which provides as follows:

"The Corporation is authorized to lend on the security of, and to make commitments to lend on the security of, any mortgage that the Corporation is authorized to purchase under this section. The volume of the Corporation's lending activities and the establishment of its loan ratios, interest rates, maturities, and charges or fees in its secondary market operations under this paragraph, shall be determined by the Corporation from time to time; and such determinations shall be consistent with the objectives that the lending activities shall be conducted on such terms as will reasonably prevent excessive use of the Corporation's facilities, and that the operations of the Corporation under this paragraph shall be within its income derived from such operations and that such operations shall be fully self-supporting. The Corporation shall not be permitted to use its lending authority under this paragraph (A) to advance funds to a mortgage seller on an interim basis, using mortgage loans as collateral, pending the sale of the mortgages in the secondary market; or (B) to originate mortgage loans. " (emphasis added) ⁴

Analysis

While there is relatively little guidance on the interpretation of the Charter Acts, when the Department of Housing and Urban Development was the GSEs' principal regulator for purposes of their activities, it analyzed a proposed new Fannie Mae activity as follows: "An activity is consistent with Fannie Mae's Charter Act (the 'Charter Act') only if: (a) it is authorized by Fannie Mae's express powers under the Charter Act and (b) it furthers one or more of the purposes set forth in Section 301 of the Charter Act. The statutory purposes in Section 301 of the Charter Act all relate to the creation, through Fannie Mae,

⁴ 12 U.S.C. § 1719(a)(2) [Fannie Mae] & 12 U.S.C. § 1454(a)(5) [Freddie Mac].

of secondary market facilities for residential mortgages.”⁵ In light of the fact that the GSEs were created to be limited purpose entities, we agree that this conservative, two-step analytical framework is the correct one.⁶

Is It Authorized?

As set forth above, Section 301 of the Fannie Mae Charter Act provides that “[f]or the purposes set forth in section 301(a), and with the approval of the Secretary of Housing and Urban Development, the corporation is authorized, pursuant to commitments or otherwise, to *purchase, service, sell, lend on the security of, or otherwise deal in mortgages* which are not insured or guaranteed as provided in paragraph (1) (such mortgages referred to hereinafter as ‘conventional mortgages’).” [emphasis added]. The provision provides further that “[t]he corporation [Fannie Mae] shall establish limitations governing the maximum original principal obligation of conventional mortgages that are purchased by it; *in any case in which the corporation purchases a participation interest in such a mortgage*, the limitation shall be calculated with respect to the total original principal obligation of the mortgage and not merely with respect to the interest purchased by the corporation.” [emphasis added]. As a result, the Fannie Mae Charter Act both expressly permits the purchase of residential mortgage loans eligible for sale to Fannie Mae, and expressly contemplates the purchase of participations in such loans.

Is It Consistent With The Core Purposes For Which The GSEs Were Chartered?

The proposed program is consistent with the core purposes of the GSE Charter Acts. By providing assistance to warehouse funders during a warehouse credit crunch, it is an appropriate use of its authority to respond to changes in the private capital markets. In addition, the program would promote access to residential mortgage credit by increasing the liquidity of warehouse lenders’ investments in their warehouse loans, thus increasing availability and reducing the risk for those lenders. That, in turn, can be expected to increase the availability of mortgage loans in the primary origination market.

Is It Otherwise Prohibited or Limited?

The greatest potential concern about the program described in the letter is the activity restriction set forth in Section 304, providing that “the Corporation shall not be permitted to use *its lending authority* under this paragraph (A) *to advance funds to a mortgage seller on an interim basis, using mortgage loans as collateral, pending the sale of the mortgages in the secondary market*; or (B) to originate mortgage loans.” This provision directly prohibits using the lending authority to advance funds to a mortgage seller on an interim basis using the mortgage loans as collateral – a clear description of warehouse lending. There is no relevant legislative history or other guidance from Congress that

⁵ Letter, dated January 9, 2006, from Assistant Secretary for Housing Brian Montgomery to Daniel Mudd, Chairman and CEO of Fannie Mae.

⁶ Because we conclude that the proposed activity is expressly authorized by the Charter Act, we do not further explore whether Fannie Mae is entitled to engage in this activity under its power to do all things “necessary or incidental” to its express powers. See Fannie Mae Charter Act Section 309(a).

provides further color or interpretative guidance on the exact parameters of the emphasized limitation.

However, there are two reasons why this restriction does not apply. First, it is a direct limitation on the GSE's lending power, not on the power to purchase obligations. The proposed purchase of participations would be undertaken using the GSE's power to purchase, not the power to lend. Second, and more substantively, this restriction prohibits the GSE from advancing funds to a mortgage seller for the interim period between origination and sale into the secondary market. To the extent that the proposed purchase of participations in the mortgage loans are likened to be functionally the same as warehouse advances, they are purchased from the equivalent of the warehouse lender, and not directly from the mortgage originator. Thus, in essence, the GSE would be supporting the warehouse lending market by creating liquidity for the warehouse advances, much as it does by creating a secondary market in mortgage loans. It would not be competing with primary warehouse lenders for the direct relationship with the mortgage originators who do not currently have sufficient access to warehouse funds. Thus, because the proposed participation activity is not directly with the mortgage originator that needs the warehouse advance but with the entity providing the originator with funding, this activity does not conflict with the limitation in Section 304.

Prudential Considerations

Two other issues merit mention. First, the proposed program is scheduled to terminate after two years. The proposed program has been created to address what is expected to be a temporary shortage of warehouse lending funds. The temporary nature of the proposed program helps the program meet the core purposes of the Fannie Mae Charter Act in that it is an appropriate response to what is expected to be a temporary disruption in the availability of warehouse lending funds.

Second, this memorandum does not discuss the percentage of the warehouse advance that can be participated to Fannie Mae or when the participation can occur. As noted above, there is no guidance on either of these questions. However, as the greatest legal risk to the program is the concept, described above, that the participations would be recharacterized as warehouse advances to the originating lender, we would recommend as a prudential matter that participations be limited to fifty percent of the associated advance and that they not take place until two business days following the provision of the funds by the warehouse lender to the residential mortgage loan originator.

Please call with any questions.