FHFA Allows Federal Home Loan Banks to Take PPP Loans as Collateral

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Original post here.

On April 23, the FHFA announced that Federal Home Loan Banks (FHLBs) could take Paycheck Protection Program (PPP) loans guaranteed by the Small Business Administration as collateral for their advances providing some financial institutions two channels through which to finance such loans.

The FHFA (the Federal Housing Finance Agency) implements this new policy through its supervisory responsibilities over the 11 regional FHLBs that make up the FHLB system. The FHLBs are each separately chartered, member-owned institutions. The system as a whole has over 6,000 financial institutions as members. Most members are banks and credit unions, but the membership also includes 60 community development financial institutions and nearly 500 insurance companies.

The FHLB system provides liquidity to its members to promote housing finance. It acted extensively as a "lender of next-to-last resort" during the Global Financial Crisis. A YPFS blog noted, based on discount note and bond utilization rates, that the system is stepping into a similar, though smaller, role now during the COVID-19 crisis.

The PPP, authorized by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, was originally established as a $349 million program pursuant to which the SBA guaranteed loans to small businesses whose operating expenses were affected by COVID-19 due to social distancing guidelines.The principal of the loans may be forgiven if certain criteria are met, e.g., if borrowers maintain payrolls for employees. The U.S. government recently expanded the PPP with an additional $310 million allocation.

On April 9, the Federal Reserve established the Paycheck Protection Program Lending Facility (PPPLF), meant to provide liquidity to depository institutions that originated PPP loans by permitting the use of such loans as collateral when borrowing from the Fed. In the PPPLF term sheet, the Fed stated that it was working to expand the group of eligible borrowers. On April 30, the Fed announced that nondepository institutions originating PPP loans would also be eligible to participate in the PPPLF providing two channels for such lenders wishing to finance their PPP loans.

FHLBs' PPP collateral terms differ from the Fed's PPPLF terms. FHLB members seeking advances from an FHLB by pledging collateral must have at least a CAMELS rating of 3 or higher or a credit rating in the top 60% of all members; the lower rating of the two is used to determine eligibility. (Bank examiners use CAMELS to rate banks' condition). In comparison, all originators of PPP loans may borrow from the PPPLF.

Bank regulators said they will not require banks to hold capital against PPPLF loans. The FHFA did not mention capital forbearance in announcing its PPP policy.

While the Fed doesn't require any haircuts on collateral, FHLBs must apply at least a 10 percent haircut on any unpaid balances of PPP loans pledged as collateral (a rate lower than the FHLBs apply to other collateral). However, the haircut increases should a member lose eligibility. If an FHLB member loses eligibility to use PPP loans as collateral by either receiving a CAMELS

rating of 4 or falling into the bottom 20-40% of members by credit rating, the lending FHLB must apply an 80 percent haircut to the collateral. If an FHLB member receives a below 5 CAMELS rating or falls into the bottom 20% of members by credit rating, the lending FHLB must apply a 90 percent haircut to the collateral.

PPP loans may only constitute 20% of a member's collateral with its FHLB, and a member may not pledge more than $5 billion of PPP loans as collateral.

As FHLB banks may accept agency securities as collateral for FHLB advances, FHFA interpreted PPP loans as agency securities, given that the Small Business Administration (SBA) guarantees the principle on all unpaid balances of PPP loans. The SBA published an interim final rule clarifying that lenders could pledge their PPP loans to the Fed or an FHLB as collateral, without the SBA's prior consent. The FHFA determined that, in the event of default, FHLBs could sell any PPP loans received as collateral to another SBA lender, with the SBA's consent, preserving the benefit of the SBA guarantee.

Non-depository institutions originally ineligible for the PPPLF may utilize the FHLB system to finance PPP loans and improve liquidity. However, with the PPPLF's new expansion of eligibility, such institutions have two channels to choose between in financing PPP loans, with the PPPLF's terms being less restrictive, as shown in the table:

	PPPLF	FHLB System
Haircut	0%	10%
Eligibility	All institutions originating PPP loans	All FHLB Members originating PPP loans
Required Supervisory Rating (banks)	CAMELS Rating < 5	CAMELS Rating ≤ 3
Rate	35 bps	Determined by FHLB Banks
Limit	N/A	$5 billion
Capital Risk Weighting (banks)	0%	N/A

In explaining the new policy, FHFA said that "accepting PPP loans will provide additional liquidity for small and community banks to borrow from their FHLBank to support the small businesses in their communities." The FHFA earlier relaxed standards for mortgage servicers facing liquidity constraints. By permitting the FHLBs to take PPP loans as collateral, FHFA can increase liquidity for small community financial institutions, providing additional support to small businesses.