



REGULATORY INTERPRETATION 1999-RI-08

Date: March 16, 1999

Subject: Federal Home Loan Bank Authority to Accept Eligible Collateral From a Member's Real Estate Investment Trust Subsidiary

Request Summary:

A Federal Home Loan Bank (FHLBank) has requested that the Federal Housing Finance Board (Finance Board) determine whether a FHLBank member may secure advances made to it by the FHLBank through a pledge of eligible mortgage assets held by its third-tier Real Estate Investment Trust (REIT) subsidiary.

Background:

According to the FHLBank, the member formed a wholly-owned direct state-chartered corporate subsidiary called [REDACTED] (Subsidiary). In turn, Subsidiary formed a wholly-owned Delaware corporation called [REDACTED] (Corporation), which, in turn, formed a wholly-owned Delaware Real Estate Investment Trust (REIT) called [REDACTED] (Company).

The FHLBank has indicated that the member conveyed to Subsidiary a 100 percent participation interest in certain pools of residential mortgage loans eligible to secure advances under section 10(a) of the Federal Home Loan Bank Act, 12 U.S.C. § 1430(a), and section 935.9(a) of the Finance Board regulations, 12 C.F.R. § 935.9(a). In turn, Subsidiary conveyed a 100 percent participation interest in the residential mortgage pools to Corporation, which then conveyed a 100 percent participation interest in the pools to Company. The FHLBank has stated that to secure FHLBank advances to the member: (1) Company will sign a hypothecation agreement pledging as security its 100 percent participation interest in the mortgage loans described above; (2) member itself will sign a modified Blanket Agreement for Advances and Security Agreement under which it will pledge as security the balance of any legal interest it retains in the described mortgage loans, all interests in mortgage loans not transferred and its interest in all voting shares of Subsidiary; (3) Subsidiary will sign a hypothecation agreement pledging as security its interest in all voting shares of Corporation and any residual interest it retains in the described mortgage loans; and (4) Corporation will sign a hypothecation agreement pledging as security its interest in all voting shares of Company and any residual interest it retains in the described mortgage loans. Additionally, the FHLBank has indicated that each parent corporation owns 100 percent of the voting stock of its subsidiary and that each entity will be limited to pledging no more than 99 percent of the fair market value of its assets.

Analysis/Interpretation:

Based upon the descriptions of the proposed transaction that the FHLBank has provided, Finance Board staff has no legal objection to the collateral arrangement that will exist if the proposed transaction is completed as described, provided that the FHLBank assures itself that: the REIT's and other subsidiaries' pledge of assets to secure obligations of their parent company is enforceable under applicable state law; adequate precautions have been taken to ensure that the hypothecation agreements with the REIT and REIT holding companies will remain legally enforceable if any of the parties become insolvent; and the FHLBank will be able to perfect and, in the case of default, access the collateral as expeditiously under the described arrangement as if all interests in the collateral were directly held and pledged to the FHLBank by the member. For future examination purposes, the FHLBank should have in its files an opinion letter from counsel covering these matters.

Finance Board staff also has indicated that it has no safety and soundness concerns regarding the proposed transaction, provided that the FHLBank maintains an enforceable security interest that will give it access to all collateral, should the need arise, and takes all steps necessary to minimize and manage the additional legal risks involved with accepting collateral from a third party, instead of from the member itself. Finance Board staff is relying on the FHLBank's representation that it will meet these conditions and will take additional steps to manage the risks associated with this transaction. Finance Board staff has not performed the underlying analyses to determine whether the FHLBank will maintain an enforceable security interest in the collateral, or whether the FHLBank has policies and procedures in place to manage the legal and operational risks.

Any changes in the factual descriptions of the proposed transaction that the FHLBank has provided to us, or any failure of the parties to fulfill the legal and factual contingencies described in this Regulatory Interpretation may result in reconsideration by the Finance Board of its conclusions regarding this matter. As with other aspects of the FHLBank's advances and collateral operations, this transaction will be subject to review through the examination process by the Finance Board's Office of Supervision.

If you have any questions concerning the issues raised in this letter, please feel free to contact Deborah F. Silberman at 202-408-2570 or Eric Raudenbush at 202-408-2932.

<p>This is a Finance Board regulatory interpretation within the meaning of the Procedures for Requests and Applications adopted by the Board of Directors of the Finance Board pursuant to Resolution Number 98-51, dated October 28, 1998. The regulatory guidance set forth herein may be relied upon subject to modification or rescission by action of the Board of Directors of the Finance Board.</p>
