

Federal Housing Finance Board

Memorandum

May 3, 1991

TO: J. Stephen Britt
Michael J. Higgins
Philip L. Conover
Sylvia Martinez

FROM : Beth L. Climo
General Counsel

SUBJECT: Secondary Mortgage Market Opinions

The Affordable Housing Advisory Council of the Federal Home Loan FHLBank of New York ("FHLBank-NY") has developed a proposal to create a secondary mortgage market for affordable housing mortgage loans under which the FHLBank-NY would purchase and/or guarantee mortgages on affordable housing units. The credit enhancement provided by the proposed program would make mortgages on affordable housing units more attractive as investments.

We were asked to examine a number of legal issues which arise in this, as well as any other, secondary mortgage market proposal. The principal issues reviewed were: (1) whether the Federal Home Loan Banks ("FHLBanks") have the authority to purchase and sell whole mortgages and issue securities backed by such mortgages and (2) whether the FHLBanks are authorized to issue standby letters of credit; whether those letters of credit may be unsecured; and whether the FHLBanks may issue standby letters of credit on behalf of nonmembers.

We have provided an analysis of these issues in the two attached legal opinions. The opinions reflect the following conclusions:

- 1) The Federal Home Loan Bank Act ("Bank Act") provides legal basis for the purchase and sale of mortgages and the issuance of securities backed by such mortgages.

The FHLBanks' authority to purchase and sell mortgages is derived from their investment authority in sections 11(h) and 16 of the Bank Act. Under those sections, the FHLBanks may invest their surplus funds and reserves in "such securities as fiduciary and trust funds may be invested in under the laws of the State in

which the (FHLBank) is located." The Reves and Mercer cases -- which are fully discussed in the attached legal opinion -- provide a legal basis (for which we have found no persuasive countervailing cases) for the proposition that the purchase of mortgages constitutes investments in "securities" for purposes of the Bank Act and Federal securities laws,

Thus, if authorized under the fiduciary and trust laws of the 12 states in which the FHLBanks are located, a good case can be made for the FHLBanks' authority to invest in whole mortgages. Any such investment authority may be subject to regulations, restrictions or limitations that the Federal Housing Finance Board ("Finance Board") may choose to impose. Thus, it would be within the authority of the Finance Board to further shape and define these State-derived powers.

Section 11(a) of the Bank Act authorizes-the FHLBanks to issue bonds and other debt obligations and to give security for such borrowings, subject to approval by the Finance Board. This section seems to provide the FHLBanks with the express authority to issue bonds and to collateralize such issuances -- including, presumably, collateralizing with their section 11(h) and 16 investments in mortgages.

Thus, as discussed in the attached opinion, a good case can be made for the proposition that the FHLBanks have the legal authority under section 11(a) to issue mortgage-backed bonds, collateralized-mortgage obligations ("CMOs") and REMICs. In addition, the FHLBanks may rely on the rationale in SIA v. Clarke which also is discussed in the opinion -- for the authority to issue pass-through securities and REMICs. The issuance of any of these forms of securities backed by mortgages also would be subject to regulations, restrictions or limitations that the Finance Board may choose to impose.

2) The FBLBanks' clearly may issue and confirm standby letters of credit, but the authority to issue unsecured letters of credit and to issue letters of credit to nonmembers is much less certain.

The FHLBanks' existing authority to issue standby letters of credit has been derived from their lending authority. Due to the structure of, and limitations on, the FHLBanks' advances authority, reliance on that authority would preclude the issuance of unsecured letters of credit and the offering of letters of credit to nonmembers by the FHLBanks.

However, section 11(e)(2)(A) of the Bank Act may provide an alternative legal basis for FHLBank issuance of standby letters of credit. Section 11(e)(2)(A) authorizes the FHLBanks to offer check clearing and collection services to institutions "eligible to make application" for membership and grants the FHLBanks the incidental authority necessary to exercise such authority. As discussed thoroughly in the attached opinion, standby letters of credit could involve a FHLBank paying drafts presented by a third party Beneficiary upon a FHLBank's member/depositor's default or guaranteeing a member/depositor's money obligation. Under this theory, the disbursement process under the letter of credit would have to be linked directly to a FHLBank demand deposit account of a member or nonmember depositor at whose request the letter of credit is issued.

Thus, section 11(e)(2)(A) provides a legal theory under which the FHLBanks would rely on their-check processing and payment authority to issue unsecured standby letters of credit and to issue them on behalf of nonmembers that are eligible to make application for membership. However, the better, and certainly more conservative, analysis is that the FHLBanks -- based on their lending authority -- are required to fully collateralize all standby letters of credit and may not issue them on behalf of nonmembers.