

# Federal Housing Finance Board

## Memorandum

June 13, 1991

TO: Philip L. Conover  
Director, District Banks Directorate

Donald Bisenius  
Deputy Director, Financial Analysis  
District Banks Directorate

FROM: Beth L. Climo  
General Counsel

SUBJECT: Proposed Change In REFCorp Expense Variable for AHP  
Calculation Formula

### ISSUE:

In calculating Affordable Housing Program (AHP) assessments, may the AHP expense be deducted from earned income in determining each Federal Home Loan Bank's (FHLBank's) net earnings for the purpose of calculating each FHLBank's proportionate share of the Resolution Funding Corporation (REFCorp) contribution, which in turn will be deducted from net income to determine the AHP contribution?

### CONCLUSION:

In calculating AHP assessments, AHP expense may be deducted from earned income in determining each FHLBank's net earnings for the purpose of calculating each FHLBank's proportionate share of the REFCorp contribution, which in turn will be deducted from net income to determine the AHP contribution.

### DISCUSSION:

#### 1. Introduction

The Federal Housing Finance Board (Finance Board) is considering a change in the formula for calculating each FHLBank's share of the FHLBank System's annual contribution to the AHP. AHP assessments are based on a statutorily prescribed formula which requires the FHLBanks to contribute

the greater of a percentage of net earnings or a minimum dollar amount.<sup>1</sup> For purposes of the AHP, the Federal Home Loan Bank Act, as amended, 12 U.S.C.A. §§ 1421 to 1429 (West & Supp. 1990) (Bank Act), defines "net earnings" as earnings after reduction for any payment required for REFCorp<sup>2</sup> or the Financing Corporation (FICO).<sup>3</sup>

A memorandum issued by this office on January 31, 1990 opined that the AHP contribution formula should be "...five percent of a mathematical construct of net income minus a proportionate share of the \$300 million annual contribution to FICO/REFCO." Gen. Couns. Mem. Fed. Hous, Fin. Bd. (Jan. 31, 1990).

1. Section 10(j)(5) of the Federal Home Loan Bank Act prescribes that AHP assessments are to be made as follows:

Each Bank shall annually contribute the percentage of its annual net earnings prescribed in the following subparagraphs to support subsidized advances through the Affordable Housing Program:

(A) In 1990, 1991, 1992, and 1993, 5 percent of the preceding year's net income, or such prorated sums as may be required to assure that the aggregate contribution of all the Banks shall not be less than \$50,000,000 for each such year.

(B) In 1994, 6 percent of the preceding year's net income, or such prorated sum as may be required to assure that the aggregate contribution of the Banks shall not be less than \$75,000,000 for such year.

(C) In 1995, and subsequent years, 10 percent of the preceding year's net income, or such prorated sums as may be required to assure that the aggregate contribution of the Banks shall not be less than \$100,000,000 for each such year.

12 U.S.C.A. § 1430(j)(5) (West Supp. 1990).

2. Section 10(j)(8) of the Bank Act provides: "The net earnings of any [FHLBank] shall be determined for purposes of [AHP contributions]--

(A) after reduction for any payment required under section 1441a or 1441b of this title, and

(B) before declaring any dividend... ." 12 U.S.C.A. § 1430(j)(8).

3. See 12 U.S.C.A. § 1441 (West Supp. 1990). Because the distinction between REFCorp and FICO obligations is not germane to the instant question, FICO is not discussed. For purposes of this memorandum, references to REFCorp expense subsume the FHLBanks' obligation for FICO.

Don Bisenius and other staff of the Financial Analysis Division, District Banks Directorate (DRD), have been in discussions with Diane Boyle, Secretary/Treasurer of the REFCorp, regarding a proposed change in the calculation for FHLBank contributions to the AHP. The proposed change would calculate net earnings after REFCorp assessments (and net earnings after AHP contributions) by simultaneously calculating AHP expense and the REFCorp assessment, then deducting the results from income before either AHP contributions or REFCorp assessments are determined. This is significantly different from the "mathematical construct" of net earnings in the January 1990 memorandum.

This opinion distinguishes the proposed "actual contributions" formula from the "mathematical construct" formula approved in the January 31, 1990 memorandum by differentiating between the interest and defeasance phases of REFCorp funding. In addition, this opinion addresses why the proposed AHP contribution formula also is consistent with law.

## 2. The REFCorp Expense Variable: Defeasance

Since REFCorp expense is deducted from income before determining each FHLBank's AHP assessment, we must understand the REFCorp expense in order to understand its relation to AHP costs.

The FHLBanks were required to contribute their aggregate accumulated reserves and undivided profits as of December 31, 1988 of approximately \$2.1 billion to pay initial costs of the Resolution Trust Corporation and to begin capitalizing REFCorp. This was accomplished by purchasing REFCorp stock. See 12 U.S.C.A. § 1441b(e)(3)(A). The FHLBanks also were required to contribute \$300 million per year to REFCorp. See 12 U.S.C.A. § 1441b(e)(3)(B) and (C). Except for \$1.2 billion used directly for resolutions, the FHLBank contributions to REFCorp were for defeasance of the \$30 billion principal obligation, until the defeasance was fully funded.

Until the defeasance on the REFCorp obligation was fully funded, each FHLBank's proportionate share of the System contributions to REFCorp was specified by statute. See 12 U.S.C.A. § 1441(e)(4) and (5). For the first \$1 billion in defeasance payments to REFCorp, section 21B(e)(4) of the Bank Act specifies a table of percentages for each FHLBank's

share.<sup>4</sup> Section 21B(e)(5) provides that the remainder of the defeasance be paid according to a formula based on the proportion of total SAIF assets held in the aggregate by the members of each FHLBank, 12 U.S.C.A. § 1441b(c)(5), subject to a maximum investment amount limitation (MIAL) for each FHLBank. 12 U.S.C.A. § 1441b(e)(6).

3. January 31, 1990 General Counsel's Memorandum

In 1989, the FHLBanks were required to make their \$300 million annual contribution and to contribute their accumulated retained earnings of approximately \$2.1 billion to defease the REFCorp bond issuance. The General Counsel was asked: 1) Whether AHP contributions could be deducted from income to determine net earnings for the AHP calculation, and 2) whether the FHLBanks should be given deductions from their income for the purpose of calculating AHP for REFCorp defeasance contributions made on behalf of other FHLBanks that were precluded by the statutory formula from contributing their full proportionate share of the REFCorp defeasance assessment when due.

A memorandum to the FHLBank presidents of January 31, 1990 interpreted the statute to permit the FHLBanks to deduct from income in determining the proper AHP contribution assessment: "... five percent of a mathematical construct of net income minus a proportionate share of the \$300 million annual contribution to FICO/REFCO." Gen. Couns. Mem. Fed. Hous. Fin. Bd. (Jan. 31, 1990). The January 31, 1990 memorandum also took the position that the FHLBanks should not deduct the one-time \$2.1 billion REFCorp contribution from their annual income for purposes of the AHP assessment.

The memorandum of January 31, 1990 gave a reasonable interpretation of the Bank Act. The rationale was that, since the \$2.1 billion in retained earnings had accumulated over several years, it was not appropriate to treat this one-time expense as a deduction from 1989 earnings. There is no explicit indication in the Bank Act or the legislative history that Congress intended for the REFCorp deduction, prior to the calculation of AHP, to apply to the initial \$2.1 billion contribution. Further, there is no indication that Congress intended the FHLBanks to make only the minimum \$50

4. 12 U.S.C.A. § 1441b(e)(4). The table of percentages had originally been provided in the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, 588 (Aug. 10, 1987).

million contribution to AHP in 1990 -- which would have been the result if the \$2.1 billion contribution had been deducted from the FHLBank System's high 1989 earnings. The spirit of the Financial Institutions Reform, Recovery, and Enforcement Act's (FIRREA's) AHP contribution calculation was clear, even though the language was capable of more than one interpretation: i.e., in years of high FHLBank earnings, such as 1989, the FHLBanks were expected to make contributions to AHP based on a percentage of those high earnings. See Sutherland, Statutes and Statutory Construction §54.03 (4th ed. 1984).

-- Second, REFCorp contributions made on behalf of other FHLBanks were merely inter-FHLBank loans to be repaid. The 'mathematical construct' employed in 1990 was designed to reflect each FHLBank's actual proportionate share of the aggregate annual \$300 million REFCorp payment -- regardless of any inter-FHLBank loan required to meet the payment.

Third, during funding of the REFCorp defeasance, each FHLBank's share of the REFCorp assessment was predetermined by the Bank Act, though the amount actually paid depended on the MIAL. Each FHLBank's AHP calculation was made after determining each FHLBank's proportionate share of the REFCorp expense. Since each FHLBank's share of the REFCorp expense was fixed by statute, that fixed REFCorp contribution could be deducted from income to determine net earnings for purposes of the AHP calculation. The mathematical construct was workable when each FHLBank's share of the REFCorp expense was a statutorily defined amount not tied directly to income. Now that the REFCorp contribution varies according to income and outstanding SAIF advances, the mathematical construct is no longer workable.

#### 4. The REFCorp Expense Variable: Interest

Now that the REFCorp defeasance is fully funded, all FHLBank contributions to REFCorp pay for the interest on REFCorp's obligations.<sup>5</sup> Thus, in contrast to 1990, the FHLBank assessments in 1991 are paying REFCorp interest costs rather than principal costs. This fact prompts the REFCorp directorate's inquiry as to whether the statute can be interpreted to replace the "mathematical construct" in the 1990 opinion with a more precise measure of each FHLBank's proportionate share of the REFCorp expense.

5. The FHLBanks' responsibility to fund the interest on the REFCorp debt is described at 12 U.S.C.A. § 1441b(f)(2)(C).

Unlike the defeasance payments, the REFCorp interest payments are based primarily on a percentage of net earnings and secondarily on advances to SAIF members. Each FHLBank's REFCorp contribution is based on net earnings up to twenty percent. If that is insufficient to meet the annual \$300 million requirement, then the remaining assessments are based on each FHLBank's percentage of total SAIF advances.<sup>6</sup>

The formula for contributions by each FHLBank when current earnings are insufficient to meet REFCorp obligations has changed as well. When a FHLBank reached its MIAL, it was not permitted to pay its share of the defeasance when due. A FHLBank that had been assessed up to its MIAL became "deficient"<sup>7</sup> and had to "borrow" from the other FHLBanks to pay its predetermined share of the defeasance. In contrast, those FHLBanks with higher earnings (and higher percentages of SAIF advances) will have to pay a greater proportion of the REFCorp interest obligation. There is no statutory MIAL for the REFCorp interest obligation.

#### 5. Proposed New Calculation Formula

The primary operational effect -- that is relevant to this opinion -- of REFCorp assessments becoming linked to income is that REFCorp and AHP expense now become interdependent. In addition to the requirement that each FHLBank deduct its REFCorp assessment from income to determine net earnings for purposes of its AHP assessment,<sup>8</sup> since AHP also is an expense, each FHLBank should deduct its AHP assessment from income to determine net earnings for purposes of its REFCorp assessment.<sup>9</sup>

6. *Id.* If 20 percent of the FHLBanks' earnings is insufficient to meet the FHLBanks' required contribution, the excess will be allocated according to each FHLBank's proportion of outstanding advances to SAIF members during the prior year.

7. 12 U.S.C.A. § 1441b(e)(6).

8. See supra note 2.

9. While we need not opine as to the specific calculation methodology, we observe that the interdependence of REFCorp assessments and AHP assessments causes operational difficulties because the proper assessments cannot be determined for one until the assessment amounts for the other are known. In order to address this mathematical problem, DBD and REFCorp staff have discussed iteration approaches as well as simultaneous equations.

A second effect of REFCorp assessments becoming linked to income is that there is no longer a need to employ the "mathematical construct" referred to in the January 31, 1990 memorandum. The currently proposed calculation would substitute the actual REFCorp expense of each FHLBank for the mathematical construct previously employed.

DBD and the REFCorp directorate propose that a given FHLBank's proportionate share of the REFCorp and AHP expense be defined as follows:

	AHP	REFCO
Net income before		
AHP and REFCorp	\$XXX,XXX	\$XXX,XXX
Less REFCorp assessment	<u>(xx,xxx)</u>	<u>(xx,xxx)</u>
Less AHP assessment		
Income base for applying		
assessment rate	xxx,xxx	xxx,xxx
AHP assessment rate (1991)	<u>5%</u>	<u>20%</u>
REFCorp assessment rate	xx,xxx	xx,xxx
Allocation of AHP or		
REFCorp "shortfall"	<u>+ x,xxx</u>	<u>+ x,xxx</u>
Total assessment	<u>\$xx,xxx</u>	Sxx.xxx

Section 10(j)(8) of the Bank Act provides that net earnings of a FHLBank shall be determined for the purposes of AHP assessments after deducting any payment required for REFCorp.<sup>10</sup> In accordance with that statutory requirement, the proposed calculation would determine AHP assessments after reducing earnings by the amount of REFCorp payments. The only difference between the "mathematical construct" AHP calculation formula and the proposed AHP calculation formula is the measure of earnings that is to be used in calculating each FHLBank's REFCorp payment. Rather than the earnings being measured by "five percent of a mathematical construct of net income minus a proportionate share of the \$300 million annual [REFCorp] contribution," the earnings now will be measured only after AHP contribution expenses have been deducted.

10. See supra note 2.

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The new AHP formula is at least as consistent with the statute as the prior formula because the new formula represents the FHLBanks' actual contributions. Just as the January 1990 memorandum took into consideration the legislative intent to adequately fund the AHP and divide the REFCorp burdens fairly, those same considerations support this interpretation which results in a more exact calculation than the "mathematical construct" formula. See Sutherland supra at § 49.01.

  
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Beth L. Climo  
General Counsel