



Federal Housing Finance Board

January 11, 1995

MEMORANDUM

TO: Beth L. Climo
General Counsel

THROUGH: Deborah F. Silberman *DS*
Deputy General Counsel

FROM: Brandon B. Strauss *BBS*
Attorney-Advisor

SUBJECT: FHLBank Authority Under the Financial Management Policy
To Offer Caps, Collars, and Floors To Members

ISSUE:

- I. Whether the Financial Management Policy For the Federal Home Loan Bank System (FMP) authorizes the Federal Home Loan Banks (FHLBanks) to offer caps, collars, and floors to members to facilitate the members' asset/liability management strategies.
- II. If not, may the Federal Housing Finance Board (Finance Board) acting without a quorum amend the FMP to grant the FHLBanks such authority.

CONCLUSION:

- I. The FMP does not authorize the FHLBanks to offer caps, collars, and floors to members to facilitate the members' asset/liability management strategies.
- II. The Finance Board acting without a quorum may not amend the FMP to grant the FHLBanks such authority.

DISCUSSION

I. Background

In a letter of December 8, 1994, to Rita I. Fair, Managing Director of the Finance Board, James D. Roy, President of the FHLBank of Pittsburgh, requested confirmation that the FMP authorizes the FHLBanks to offer caps, collars, and floors to

members.¹ Mr. Roy provided a legal memorandum (Pittsburgh memorandum) prepared by Dana A. Yealy, General Counsel of the FHLBank of Pittsburgh, which concludes that the FMP authorizes the FHLBanks to offer caps, collars, and floors to members to facilitate the members' asset/liability management strategies.

II. Analysis

A. FHLBank Authority Under The FMP

The FHLBanks' authority to engage in cap, collar, and floor transactions is governed by the Hedge Transaction Guidelines, which appear in section V of the FMP. See FMP § V at 7. Section V.B. states that:

Long and short positions in the cash, forward, futures, and options markets (including caps and floors), and the purchase and sale of interest rate exchange agreements (swaps) are permitted if they assist a Bank in achieving its interest rate and/or basis risk management objectives.

Id., § V.B. at 7. Thus, section V.B. of the FMP expressly authorizes the FHLBanks to engage in cap and floor transactions for their own accounts in order to achieve interest rate and/or basis risk management objectives. This also necessarily includes the authority to engage in collar transactions, because a collar is the combination of a cap and a floor. See supra note 1.

However, section V of the FMP does not expressly authorize the FHLBanks to engage in cap, collar, and floor transactions to facilitate members' asset/liability management strategies. Section V.B. states:

"[a] Bank may also enter into swaps as an intermediary between a member and a non-member counterparty to facilitate the member's asset/liability management strategies.

Id.

1. Caps, floors, and collars are option-based contracts. The buyer of a cap pays a premium for the right to receive from the seller an amount based on the difference, if positive, between the rate of return on a specific underlying asset and a previously agreed upon fixed (capped) rate of return. The buyer of a floor pays a premium for the right to receive from the seller an amount based on the difference, if negative, between the rate of return on a specific underlying asset and a previously agreed upon fixed (floor) rate of return. A collar is the simultaneous purchase of a cap and sale of a floor.

Since section V.B. refers only to "swaps"² in describing permissible transactions into which a FHLBank may enter to facilitate a member's asset/liability management, the plain language of the FMP arguably excludes other instruments, such as caps, collars, and floors, from the category of instruments that a FHLBank may use for this purpose. This reading of section V.B. is consistent with the rule of statutory construction known as "espressio unius est exclusio alterius," which holds that there is an inference that all omissions from a statute should be understood as exclusions.³

Notwithstanding the absence of a specific mention of caps, collars, and floors as permissible transactions that a FHLBank may enter into to facilitate a member's asset/liability management, the Pittsburgh memorandum argues that the FMP nonetheless authorizes the FHLBanks to use caps, collars, and floors for such purposes because the meaning of the term "swap" encompasses caps, collars, and floors.

The Pittsburgh memorandum cites the definitions of "swap transaction" and "swap agreement" adopted by the International Swaps and Derivatives Association (ISDA) and reflected in the United States Bankruptcy Code, respectively, as evidence that, in the context of the financial derivatives industry, the technical definition of "swap" is understood to include caps, Collars, and floors.⁴ Therefore, the Pittsburgh memorandum argues, analogizing to the rule of statutory construction that technical terms used are presumed to have their technical meaning, the term "swaps" in the FMP should be interpreted consistent with the broad definitions adopted by the ISDA and reflected in the Bankruptcy Code. See Sutherland § 47.29.

However, continuing the statutory construction analogy, the presumption that technical terms are to be construed according to their technical meaning is overcome where there is statutory intent to the contrary or other overriding evidence of a different meaning. See id. The plain language of the FMP indicates that the Finance Board intended the term "swap" to have a different meaning from cap, collar, or floor, because in

2. A swap is a type of forward contract in which two parties agree to exchange the cash flows, such as interest payments, from two underlying assets during a fixed period.

3. See 2A N. Singer, Sutherland Statutory Construction (Sutherland) § 47.23 (Sands 5th ed. 1992). Although the FMP is a regulatory, rather than a statutory, rule, the canons of statutory construction are equally applicable. See id. § 31.06. Further, the Pittsburgh memorandum relies on rules of statutory construction to support its conclusions.

4. See 1991 ISDA definitions at v; 11 U.S.C. § 101(SS).

describing the permitted instruments and strategies for hedge transactions, the FMP lists "long and short positions in the cash, forward, futures, and options markets (including caps and floors)" separately from "the purchase and sale of interest rate exchange agreements (swaps)." See FMP § V.B. at 7. Therefore, even if the accepted technical definition of "swap" were to include caps, collars, and floors, the plain language of the FMP indicates that the Finance Board did not intend the technical meaning to apply.⁵

The regulatory history of the FMP also overcomes any presumption that the definition of "swap" includes caps, collars, and floors. A staff memorandum accompanying proposed amendments to the FMP presented to the Finance Board on December 15, 1993 stated that:

This document [the proposed amended FMP] is substantially the same as the draft package provided to the Finance Board in its December 3 mailing. However, in addition to minor editorial changes, there are three variations from the December 3 package that are noteworthy:
2) In the Hedge Transaction Guidelines section, authorization for the Banks to offer options (e.g., caps and floors) as a product to assist their members' asset/liability management has been deleted. The Finance Board's Office of Legal and

5. Further, it is not clear that the definition of "swap transaction" adopted by the ISDA is accepted universally in the derivatives industry as the technical meaning of "swap." A recent study published by the Global Derivatives Study Group of the Group of Thirty stated that:

Every derivatives transaction can be built up from two simple and fundamental types of building blocks: forwards and options. Forward-based transactions include forwards and swap contracts, as well as exchange-traded futures. Option-based transactions include privately negotiated, OTC options (including caps, floors, collars, and options on forward and swap contracts)

See Global Derivatives' Study Group, Group of Thirty, Derivatives: Practices and Principles 29-30 (1993). This statement indicates that there is a recognized distinction between swap contracts and caps, collars, and floors, since swaps are forward-based transactions while caps, collars, and floors are option-based. Consequently, the presumption that technical terms used in a regulation should be construed according to their technical meaning may not support interpreting "swaps" to include cap, collar, and floor transactions.

External Affairs believes there may be insufficient statutory authority to allow the use of options other than for a Bank's own asset/liability management. However, legal analysis will continue. It is likely this issue will be brought before the Finance Board at a later date.

Federal Housing Finance Board, Board Meeting Materials, Tab 8 at 8-4 (December 15, 1993).

Thus, the Finance Board had specific notice of the limitation on the FHLBanks' use of caps, collars, and floors contained in the 1993 proposed amendments to the FMP, which the Finance Board ultimately adopted. See Board Res. No. 93-133 (December 15, 1993). Accordingly, the regulatory history of the FMP supports the view that the Finance Board did not intend the FHLBanks' authority to enter into swap transactions for members' asset/liability management to include the authority to enter into cap, collar, and floor transactions for that purpose.

B. Finance Board Authority In The Absence Of A Quorum

In the absence of a quorum of Directors, the Finance Board retains the authority to carry out: the day-to-day operations of the agency; functions prescribed by statute and regulation; and the implementation of existing policy. In carrying out these activities, the Finance Board may take action requiring the exercise of professional judgment or discretion under the statute, regulation, or policy. However, the Finance Board may not create **new** agency policy. See Brown v. District of Columbia, 127 U.S. 579, 586 (1988); Braniff Airways v. CAB, 379 F.2d 453, 460 (D.C. Cir. 1967); California Livestock Production Credit Ass'n v. Farm Credit Admin., 748 F. Supp. 416, 422 (E.D. Va. 1990).

The FHLBanks' participation in cap, collar, and floor transactions is governed specifically by section V of the FMP, which does not authorize the FHLBanks to offer caps, collars, and floors to members to facilitate their asset/liability management strategies. See FMP § V. The FMP was adopted by the Finance Board acting with a quorum. See Board Res. No. 93-133 (December 15, 1993). Since the Finance Board, acting without a quorum, may implement existing policy, but may not create new policy, it may not change the existing policy in the FMP excluding caps, collars, and floors from the category of permissible transactions that the FHLBanks may enter into to facilitate members' asset/liability management strategies.

CONCLUSION:

The FMP does not authorize the FHLBanks to offer caps, collars, and floors to members to facilitate the members' asset/liability management strategies. In the absence of a quorum, the Finance Board may not amend the FMP to grant the FHLBanks such authority.