



## Federal Housing Finance Board

June 27, 1996

### MEMORANDUM

TO: Deborah F. Silberman  
Deputy General Counsel

FROM: Brandon B. Straus   
Attorney-Advisor

SUBJECT: Authority Of The FHLBanks To Act As Counterparties In Derivative Contracts

### ISSUE:

Whether the Federal Home Loan Banks (FHLBanks) have statutory authority to act as counterparties in derivative contracts.

### CONCLUSION:

The FHLBanks have statutory authority to act as counterparties in derivative contracts under sections 11(h) and 16(a) of the Federal Home Loan Bank Act (Bank Act), provided such contracts are legal investments for fiduciaries and trust funds under the laws of the state in which the particular FHLBank is located. The FHLBanks also have authority to act as counterparties in derivative contracts pursuant to their' incidental statutory authority under section 11(a) of the Bank Act,

## **DISCUSSION**

### **I. BACKGROUND**

The FHLBanks currently act, or are interested in acting, as counterparties in derivative contracts to: 1) manage the financial risk associated with their own asset/liability portfolios; and 2) help members manage financial risks associated with the members' asset/liability portfolios.

#### **A. Definition Of Derivative Contracts**

In general, a derivative contract is a bilateral payment exchange agreement, the value of which derives from the value of an underlying asset or an underlying reference rate or index. See Global Derivatives Study Group, Group of Thirty, Derivatives: Practices and Principles, 28 (I 993). Derivative contracts include, among other things, forwards, futures, swaps, options, caps, floors, and collars.

A forward contract obligates one counterparty to buy, and the other to sell, a specific underlying asset at a specific price, amount, and date in the future. Futures contracts are standardized forward contracts traded on established markets.

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. The parties usually agree to net the difference in cash flows at set intervals during the contract term, with one party paying the difference to the other.

An option is a contract giving the option purchaser the right, but not the obligation, to buy or sell a specified underlying asset at a certain price during a fixed period or on a specific date. If the right is not exercised by the agreed-upon time, the option expires, and the option purchaser forfeits money paid for the option.

Caps and floors 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. A cap therefore limits the exposure of a floating-rate borrower (the buyer of the cap) to the risk of a rise in interest rates.

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 floor therefore limits the exposure of a floating-rate investor (the buyer of the floor) to the risk of a decline in interest rates.

A collar is the simultaneous purchase of a cap and sale of a floor. A collar limits a party's exposure to the risk of movements of interest rates in either direction.

B. Treatment Of Derivative Contracts By The Federal Home Loan Bank Board (Bank Board) And The Federal Housing Finance Board (Finance Board)

In 1987, the Bank Board (predecessor agency to the Finance Board) adopted Interest Rate Swap, Cap, Collar, and Floor Policy Guidelines (Guidelines), which authorized the FHLBanks to participate in specified kinds of interest rate swap, cap, collar, and floor transactions for their own asset/liability management and with members in order to reduce the members' interest rate risk exposures. See Guidelines §§ I - III. The FHLBanks' use of derivative contracts currently is governed by the Financial Management Policy for the FHLBank System (FMP), issued by the Finance Board in 1991, as amended. The FMP permits the FHLBanks to act as counterparties in specified "swap and option" transactions for their own account "if these transactions assist a FHLBank in achieving its interest rate and basis risk management objectives," The FMP also permits the FHLBanks to act as intermediaries between member and nonmember counterparties in swap, but not option, contracts to facilitate the members' asset/liability management strategies.'

II. ANALYSIS

A. The FHLBanks Have Authority To Act As Counterparties In Derivative Contracts Under Sections 11(H) And 16(a) Of The Bank Act. Provided Such Contracts Are Legal Investments for Fiduciaries And Trust Funds Under The Laws Of The State In Which The Particular FHLBank Is Located

Sections 11(h) and 16(a) of the Bank Act provide that "subject to such regulations, restrictions, and limitations as may be prescribed by the [Finance] Board" the surplus and reserves of each FHLBank shall be invested in certain enumerated obligations and securities, including "such securities & fiduciary and trust funds may be invested in under the laws of the State in which the Federal Home Loan Bank is located." 12 U.S.C. § 1436(a). In an opinion dated February 16, 1995, the General Counsel of the Finance Board concluded that the term "securities," as used in, the above-quoted provision of section 16(a), "is used not in a technical or restrictive sense, but in a generic fashion to signify 'the broad class of investments' in which fiduciaries may invest." See Op. Gen Couns, Fin. Bd. (February 15, 1995). Consequently, subject to such limitations as the Finance Board may prescribe, a FHLBank may act as a counterparty in a derivative contract if that contract would be a security or other investment permissible for fiduciaries and trusts to invest in under the law of the state in which the FHLBank is located. See id. at 10.

<sup>1</sup> See FMP part V.B. .at 7 (as amended by Bd. Res. No. 93-133 (Dec. 15 1993)). Interest rate risk is the risk that a fixed-rate debt instrument will decline in value as a result of a rise in interest rates. Basis risk is the risk that the interest rates on a liability and an asset will change at different rates.

<sup>2</sup> See id When a FHLBank acts as an intermediary, it enters into a swap contract with a member and immediately matches the swap by entering into an opposing transaction. Thus, the FHLBank takes on only credit risk,

B. The FHLBanks Have Authority To Act As Counterparties in Derivative Contracts Pursuant To Their Incidental Statutory Authority Under Section 11(a) Of The Bank Act

The incidental power of the FHLBanks is defined in section 11(a) of the Bank Act, which provides that:

Each Federal Home Loan Bank shall have power, subject to rules and regulations prescribed by the Board to borrow and give security therefor and to pay interest thereon, to issue debentures, bonds, or other obligations upon such terms and conditions as the Board may approve, and to do all things necessary for carrying out the provisions of this chapter and all things incident thereto.

Id. § 1431(a) (emphasis added).

The FHLBanks' authority under section 11(a) "to do all things necessary for carrying out the provisions of this chapter and all things incident thereto" must be read in conjunction with section 11(e)(1) of the Bank Act, which provides that:

Each Federal Home Loan Bank shall have power to accept deposits made by members of such bank or by any other Federal Home Loan Bank or other instrumentality of the United States, upon such terms and conditions as the Board may prescribe, but no Federal Home Loan Bank shall transact any banking or other business not incidental to activities authorized by this chapter.

Id. § 1431(e)(1) (emphasis added).

The prohibition in section 11(e)(1) against the transaction of "any banking or other business not incidental to activities authorized by this chapter" does not appear to limit the broad statement of incidental authority in section 11 (a). In fact, section 11(e)(1) appears only to restate the incidental powers language of section 11(a) in the negative. That is, while section 11(a) authorizes the FHLBanks to engage in activities necessary or incidental to carrying out the provisions of the Bank Act, section 11(e)(1) prohibits the FHLBanks from engaging in activities that are not incidental to activities authorized by the provisions of the Bank Act. See id. This dual grant incidental authority to the FHLBanks under sections 11(a) and 11(e)(1), appears broad."

<sup>3</sup> Under section 12(a) of the Bank Act, the FHLBanks also have certain incidental powers associated with their legal status as corporations. See 12 U.S.C. § 1432(a). Section 12(a) provides that the FHLBanks have corporate powers, such as the power to use a corporate seal; to make contracts; to purchase or lease real property; and to sue and be sued. See id. These powers also include "such incidental powers, not inconsistent with the provisions of this chapter, as are customary and usual in corporations generally." Id. In 1984, the General Counsel of the Bank Board opined that the incidental corporate powers provision of section 12(a) authorizes the FHLBanks to engage in interest rate swaps with members and nonmembers. See Op. Gen. Couns. Fed. Home Loan Bank Bd. (Raiden opinion) (Feb. 16, 1984) at 5. However, an argument can be made that the phrase "incidental powers . . . as are customary and usual in corporations

Nonetheless, since it is not clear from the plain language of either section whether the activities authorized under those sections include engaging in derivative transactions, it is appropriate to look to the legislative history of the Bank Act for guidance on this issue. See 2A N. Singer, Sutherland Statutory Construction (Sutherland) §§ 46.01,48.01 (Sands 5th ed. 1992).

1. Legislative History of Sections 11(a) and 11(e)(1)

Although the legislative history of the incidental powers language in section 11(a) is silent on the scope of that provision,<sup>4</sup> the legislative history of the incidental powers language of section 11(e)(1), which pre-dates the incidental powers provision of section 11(a), provides guidance on this issue. The language in section 11(e)(1) prohibiting the FHLBanks from transacting “any banking or other business not incidental to activities authorized by this chapter” is based on former section 11(g) of Sank Act of 1932, which stated:

No Federal Home Loan Bank shall transact any banking or other business not expressly authorized by this Act.

See Pub. L. No. 304, ch. 522, § 11(g), 47 Stat. 733 (1932). The Report of the House Committee on Banking and Currency, which accompanied the original Bank Act, states, in relation to then-section 11(g), that:

The banks are specifically restrained from doing any general banking or commercial banking business. Their functions are confined solely to serving member institutions.

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generally must be read in the context of section 12(a) to refer to powers that are incident to the FHLBanks’ legal status as corporations -- such as the power to contract and to sue and be sued -- that are customary and usual in corporations chartered under state law. Therefore, the FHLBanks incidental powers set forth in section 12(a) probably would not provide the strongest legal basis from which to argue that the FHLBanks have authority to enter into derivative contracts.

<sup>4</sup> The incidental powers language of section 11(a) was added to the Bank Act by the National Housing Act of 1934, Pub. L. No. 479, ch. 847, § 503,48 Stat. 1246, 1261, without explanatory comment in the legislative history, and has not since been amended. Prior to the 1934 amendment, section 11(a) provided:

Each Federal Home Loan Bank shall have power, subject to the approval of the board, (1) to borrow money, to give security therefor, and to pay interest thereon, and (2) to issue bonds and debentures having such maturities as may be determined by the board, secured by the transfer of eligible obligations of borrowing institutions on advances made by the bank to borrowing institutions and by the deposit of home mortgages.

Pub. L. No. 304, § 11,47 Stat. 725 (July, 22, 1932).

H.R. Rep. No 1418, 73d Cong., 1st Sess. 6 (1932). This suggests that section 11(e)(1), as originally enacted by Congress in section 11(g), was intended to prohibit the FHLBanks from engaging in commercial banking business with individual members of the general public, but was not necessarily intended to limit the types of activities the FHLBanks could undertake in serving their members.

In the National Housing Act of 1934, Congress redesignated section II (g) as section 11(e) and removed the word “expressly,” so that the prohibition in new section 11(e) read:

No Federal Home Loan Bank shall transact any banking or other business not authorized by this Act.

Pub. L. No. 479, ch 847, § 503, 48 Stat. 1246, 1262 (1934). Although the legislative history of the National Housing Act provides no explanation for this change, the effect of the change was to broaden the FHLBanks’ authority under section 11(e). By removing the requirement that activities be “expressly” authorized, Congress freed the FHLBanks to engage in activities for which they possess implied authority under the Bank Act. Simultaneous with this change to section 11(e), Congress added the incidental powers language in section 11(a) to the Bank Act, granting the FHLBanks broad implied authority “to do all things necessary for carrying out the provisions of this chapter and all things incident thereto.” National Housing Act of 1934, Pub. L. No. 479, ch 847, § 503, 48 Stat. 1246, 1261. Thus, it appears that Congress narrowed the scope of the prohibition in section 11(e) in order to take into account the grant of implied authority to the FHLBanks under the incidental powers provision in added section 11(a).

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<sup>5</sup> Notwithstanding this statutory change, two federal courts had interpreted former section 11(e), even as amended by the National Housing Act, as substantially limiting the FHLBanks’ incidental powers under section 11(a). In Association of Data Processing Serv. Org., Inc. v. Federal Home Loan Bank Board (ADAPSO), 568 F.2d 478 (6th Cir. 1977), the Sixth Circuit held that the FHLBanks lack incidental authority to sell on-line data processing services to members. See *id.* at 485-86. In Central Bank N.A. v. Federal Home Loan Bank of San Francisco (Central Bank), 430 F. Supp. 1080, 1684 (N.D. Cal. 1977), vacated on other grounds, 620 F.2d 309 (9th Cir. 1980), the court held that the FHLBanks lack incidental authority to provide money order services to members. See at 1084. There is an internal memoranda of the Bank Board’s Office of General Counsel that analyzes the scope of the FHLBanks’ incidental powers in light of these cases. See Mem. from R. Laird, Senior Associate General Counsel to J. Silkensen, Acting Director, Office of District Banks, “Authority of FHLBanks to Offer Financial Futures Services,” at 4 (March 18, 1983) (FHLBanks Jack incidental authority to act as joint obligor with members on futures contracts). See also Mem. from J. Plapinger, Associate General Counsel to Elmer Callahan Deputy Director, Office of Federal Home Loan Banks, “Advisory Investment Functions of Federal Home Loan Banks (Feb. 23, 1976) (concluding that the FHLBanks do not have incidental authority to provide investment advisor services for their members). However, as discussed further below, the ADAPSO and Central Bank cases no longer are persuasive because they were decided prior to the 1989 amendment to section 11(e)(1) by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). Pub. L. No. 101-73, 103 Stat. 133 (August 9, 1989). See discussion, infra.

The prohibition in section 11(e) was moved to section 11(e)(1) by the Depository Institutions Deregulation and Monetary Control Act of 1980. See Pub. L. NO. 96-221, § 311, 94 Stat. 132 (1980). In 1989, section 11(e)(1) was amended by FIRREA, which added the following underscored language:

Each Federal Home Loan Bank shall have power to accept deposits made by members of such bank or by any other Federal Home Loan Bank or other instrumentality of the United States, upon such terms and conditions as the Board may prescribe, but no [FHL]Bank may transact any banking or other business not incidental to activities authorized by this chapter.

Pub. L. No. 101-73, § 709, 103 Stat. 418. This amendment appears to be a further attempt by Congress to harmonize the broad grant of incidental authority in section 11(a) with the "limitation" on the FHLBanks' transacting banking or other business in section 11(e)(1). The Conference Report accompanying FIRREA states that, under amended section 11(e)(1), "the [FHL]Banks are permitted to engage in activities that are incidental to those expressly authorized by the Bank Act. . . ." H.R. Conf. Rep. No. 222, 101st Cong., 2d Sess. 426 (1989) (FIRREA Conference Report).

Further, a colloquy between Representative Garcia and Representative Gonzalez during the House floor debate on FIRREA specifically addresses the FHLBanks' authority to provide products such as derivative contracts to their members. In an unchallenged floor statement, Representative Garcia stated:

The reason that the [FHLB]anks' incidental power was intended to be viewed broadly is that it supports the primary purpose of the [FHLB]anks; namely, housing finance. It also permits the Federal Home Loan Banks to help their members control operating costs and interest rate and credit risk . . . Incidental activities do not need to be strictly necessary to the Home Loan Bank's exercise of their express powers. . . The amendment is intended to ensure that the [FHLB]anks may provide a variety of products and services . . . .

See 108 Cong. Rec. H4994 (daily ed. Aug. 3, 1989) (statement of Rep. Garcia). As discussed further below, derivative contracts are financial products that assist FHLBank members in controlling interest rate risk associated with their asset/liability portfolios. Consequently, it appears that Congress intended the use of derivative contracts by the FHLBanks for this purpose to come within the scope of the FHLBanks' incidental powers.

In his floor statement, Representative Garcia also commented on the general scope of the FHLBanks' incidental powers as a result of the FIRREA amendment:

[i]t is my understanding as author of this provision [section 709], that the amendment is intended to permit the [FHL]Banks to engage in activities incidental to their express powers, and that Congress contemplated this incidental power to be broadly read . . . Under the current statute, it is possible to construe the [FHL]Banks' incidental activities more narrowly than those permitted for national banks. Section 709 is intended to clarify this point. It is

my understanding that the incidental activities of national banks and [FHLBank should now be viewed as similarly broad.

Id. This statement appears to clarify that the 1989 amendment to section 11(e)(1) was intended to overturn those portions of the ADAPSO and Central Bank decisions adopting narrow interpretations of the FHLBank's incidental powers prior to FIRREA. See supra. note 6. For example, in ADAPSO, the court interpreted section 11(e) to mean that "the activities of the home loan banks under their 'incidental' statutory authority are even more restricted than the activities of national banks . . . ." ADAPSO, 568 F.2d at 486. Representative Garcia's statement that "the incidental activities of national banks and [FHL]Banks should now be viewed as similarly broad" suggests that the ADAPSO court's holding on this issue no longer is good law.

In sum, the legislative history of FIRREA suggests that providing products and services that assist members in controlling interest rate risk, such as derivative contracts, is within the FHLBanks incidental authority under the Bank Act. Furthermore, Congress intended the scope of the FHLBanks incidental powers - as set forth in section 11(a) and limited by 11(e)(1) - to be interpreted as broadly as the scope of the incidental powers enjoyed by national banks. See 12 U.S.C. § 24 (Seventh). Therefore, it is reasonable to refer to the scope of authority enjoyed by national banks under the incidental powers provision of the National Bank Act to determine whether the FHLBanks' incidental powers under the Bank Act include the authority to engage in derivative transactions.

## 2. Case Law Governing The Incidental Powers Of National Banks Under The National Bank Act

The National Bank Act provides that national banks shall have the power:

To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; by obtaining, issuing and circulating notes according to the provisions of title 62 of the Revised Statutes.

12 U.S.C. § 24(Seventh) (emphasis added).

The Supreme Court most recently interpreted the incidental powers provision of the National Bank Act in NationsBank of North Carolina v. Variable Annuity Life Ins. Co., 115 S.Ct. 810 (1995). At issue in NationsBank was the Comptroller of the Currency's decision to permit NationsBank, a national bank, to act as an agent in the sale of annuities through one of its subsidiaries. See id. at 812. In interpreting section 24(Seventh) to authorize national banks to sell annuities, the Comptroller determined that: 1) the powers of national banks under section 24(Seventh) are not limited to those specifically enumerated in the statute; 2) although not a specifically, enumerated power, the brokerage of financial investment instruments is one the

incidental powers of national banks under Section 24(Seventh) because it is part of national banks' traditional role as financial intermediaries (i.e., brokers of financial investment instruments); and 3) the sale of annuities comes within the national banks' incidental power to broker financial investment instruments because annuities are widely recognized as investment products, See id. at 814.

The Variable Annuity Life Insurance Company (VALIC) brought suit under the Administrative Procedure Act, challenging the Comptroller's action as "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," See 5 U.S.C. § 706(2)(A). on the ground that "brokering financial investment instruments" is not a power expressly enumerated in section 24(Seventh.). See 115 S.Ct. at 813.

In reviewing the Comptroller's action, the Supreme Court stated that "[a]s the administrator charged with supervision of the National Bank Act, the Comptroller bears primary responsibility for surveillance of the 'business of banking' authorized by section 24(Seventh)." *Id.* Therefore, the Comptroller's judgment is entitled to "controlling weight" if his interpretation of the statute "fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design." *Id.* In upholding the Comptroller's action, the Court agreed with his interpretation of section 24(Seventh.) as an illustrative, rather than exclusive, enumeration of the powers enjoyed by national banks, and found that the Comptroller "reasonably concluded that the authority to sell annuities qualifies as, part of or incidental to, the business of banking." *Id.* at 814.

As discussed above, the legislative history of section 11(e)(1) of the Bank Act suggests that Congress intended the scope of the FHLBanks' incidental powers to be determined by reference to the scope of national banks' incidental powers. See supra part II.B.1. Consequently, it is reasonable to conclude that a reviewing court would apply the Supreme Court's holding in NationsBank in determining the scope of the FHLBanks' incidental powers under the Bank Act."

Applying the principles of the NationsBank decision to the Bank Act, it is reasonable to conclude that a reviewing court would accord substantial deference to the Finance Board's determination whether an activity is one that is "necessary for carrying out the provisions of [the Bank Act]" or "incident thereto." 12 U.S.C. § 1431(a). Furthermore, under the NationsBank decision, an activity need not be specifically enumerated in the statute in order to be within the FHLBanks' incidental authority under section 11(a). See 115 S.Ct. at 814. According to

<sup>6</sup> There is line of cases developed in the lower federal courts that also interpret the scope of national banks' incidental powers under section 24(Seventh). These cases, beginning with Arnold Tours, Inc. v. Camp 472 F.2d 427 (1st Cir. 1972), generally hold that a national bank's activity is authorized as an incidental power under the National Bank Act if the activity is "convenient or useful" in connection with the performance of one of the bank's express powers and is directly related to the express power. *Id.* at 431-32. See also M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377,1382-83 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978); Securities Industry Ass'n v. Clarke, 885 F.2d 1034, 1048-49 (2d Cir. 1989); First Nat'l Bank of Eastern Arkansas v. Taylor, 907 F.2d 775,778 (8th Cir. 1990). The Supreme Court did not address the Arnold Tours line of cases in NationsBank.

NationsBank, the standard is whether the Finance Board reasonably concludes, in accord with Congressional intent, that “all things necessary for carrying out the provisions of this chapter and all things incident thereto” includes the activity in question. See *id.* at 815.

### 3. Incidental Authority Of The FHLBanks To Act As Counterparties In Derivative Contracts

Under the standard established in NationsBank, the FHLBanks have incidental authority under section I I(a) of the Bank Act to act as counterparties in derivative contracts if the Finance Board determines, in accord with congressional intent, that such contracts are necessary, or incidental to, carrying out the provisions of the Bank Act. See 115 S.Ct. at 815; 12 U.S.C. § 1431 (a). An argument can be made that the use of derivative contracts by the FHLBanks, both for the FHLBanks’ own account and for assisting members in asset/liability management, is necessary, or incidental to, carrying out several of the provisions of the Bank Act.

#### a. FHLBanks’ Use of Derivative Contracts For Their Own Account

Section 2A(a)(3)(B) of the Bank Act provides that one of the duties of the Finance Board is “to ensure that the FHLBanks carry out their housing finance mission” See 12 U.S.C. § 1422a(a)(3)(B)(ii). The Bank Act also provides that among the FHLBanks’ express powers are the power to acquire certain assets (advances and investments) and to take on certain liabilities (consolidated obligations (COs) and member deposits). See *id.* §§ 1430(a) and (c), 1431(g), (e)(1), and (h), 1436(a).

A FHLBank can use derivative contracts such as swaps, caps, and floors to manage the financial risks associated with maintaining a portfolio of otherwise unmatched assets and liabilities. For example, the FHLBanks use the income generated by advances and investments to make principal and interest payments on COs and to pay interest on members’ deposits. Since the flow of interest payments received by the FHLBanks from advances and investments does not perfectly match the flow of required payments on COs and member deposits, the FHLBanks’ activities are subject to financial risk. Through the use of a swap, a FHLBank can match the required repayments on a CO to the income from advances by exchanging the stream of interest payments it receives on advances (minus a spread) for a stream of interest payments equal to the interest payable on the CO. Alternatively, the FHLBank could maintain the unmatched position and use a collar (a cap and a floor) to limit the associated risk.

In some cases, derivative contracts may enable a FHLBank to acquire funds at a lower cost than would otherwise be possible without the use of such contracts. For example, in some instances, a potential purchaser of a CO may be willing to receive a lower rate of return if the repayment terms are customized to the purchaser’s needs. However, the structure of these repayment terms may not match the terms on which FHLBank members are willing to borrow advances or the expected income flows from a FHLBank’s investments. As discussed above, the FHLBank could use a swap to match the required repayments on a CO that is customized to the

purchaser's requirements with the income stream from advances customized to members' requirements.

In sum, the FHLBanks can use swaps, caps, and floors in connection with the issuance of COs and the making of advances in order to limit the financial risk that may result from structuring the terms of COs to meet the customized needs of potential purchasers. This, in turn, enables the FHLBanks to have access to lower-cost funds with which to make advances for housing finance. The FHLBanks also can use derivative contracts to control the financial risks that arise in the course of performing their statutory functions of acquiring certain assets and taking on certain liabilities. Therefore, an argument can be made that there is a reasonable basis for the Finance Board to conclude that the FHLBanks have incidental authority to act as counterparties in derivative contracts for their own account, because such activity is necessary, or incidental-to, the FHLBanks fulfilling their role, under the provisions of the Bank Act, as intermediaries in the capital markets that provide funding for housing finance through advances to members. This view is consistent with Congress' intent that the FHLBanks' incidental powers be viewed broadly in order to "support[] the primary purpose of the [FHLB]anks; namely, housing finance." See 108 Cong. Rec. H4994 (daily ed. Aug. 3,1989) (statement of Rep. Garcia).

b. FHLBanks' Use of Derivative Contracts to Assist Members In Their Asset/Liability Management

An argument can be made that the use of derivative contracts by the FHLBanks to assist members in their asset/liability management is necessary, or incidental to, those provisions of the Bank Act related to the making of advances and the fulfillment of the FHLBanks' housing finance mission.'

For example, there are instances where a member may wish to protect the earnings of a portfolio of floating-rate home mortgage loans from a decline in interest rates over a fixed period. One way to accomplish this is to purchase a floor, giving the member the right to receive an agreed-upon "floor" rate of interest, based on the aggregate principal amount of the loans, over a fixed period if the floating rate on the loans falls below the floor interest rate. As a counterparty in such contracts, a FHLBank could assist its members in controlling the financial risks they incur in the course of conducting the business of home mortgage lending which, in turn, promotes housing finance.

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<sup>7</sup> In 1984, the General Counsel of the Bank Board opined that the FHLBanks have incidental authority under the Bank Act to act as counterparties in swap transactions, based on their express powers to make advances and to accept deposits, because a swap transaction between a FHLBank and its member is the functional equivalent of the FHLBank making a long-term, fixed-rate advance to the member and the member placing the proceeds of the advance in a short-term deposit at the FHLBank. See Raideen Opinion at 2, 3. The Raideen opinion did not address whether the FHLBanks have authority to engage in derivative transactions other than swaps, such as options transactions. See *id.* Some of the FHLBanks have relied on the Raideen opinion as the legal basis for entering into both swap and option contracts designed to assist members in their general asset/liability management.

The FHLBanks also could assist members in managing financial risk through the use of derivative contracts in connection with their authority under sections 9 and 10 of the Bank Act to make advances to members and to determine the terms on which advances will be made.’ For example, a FHLBank could incorporate a cap into a floating rate advance, so that the advance rate would not exceed an agreed upon “cap” interest rate. The derivative contract -- the cap -- would be incorporated in the terms of the advance; and the price of the cap would be reflected in the interest rate and amortized over the term of the advance. Alternatively, the FHLBank could make an uncapped, floating rate advance to a member, and, in separate derivative contract, the member and the FHLBank could agree that if the advance rate rises above an agreed upon interest rate, the FHLBank will pay the member an amount based on the difference between the advance rate and the “capped” interest rate. These types of transactions would be attractive, for instance, to a member wishing to fund floating-rate mortgage loans that also have caps.

In sum, an argument can be made that acting as a counterparty in derivative contracts with members is necessary, or incidental to, carrying out the FHLBanks’ housing finance mission under section 2A(a)(3)(B) of the Bank Act and the FHLBanks’ authority to make advances under sections 9 and 10 of the Bank Act, because these contracts help members reduce financial risks associated with home mortgage lending. This view is consistent with Congress’ intent that the FHLBanks use their incidental authority to help members control interest rate risk. See 108 Cong. Rec. H4994 (daily ed. Aug. 3, 1989) (statement of Rep. Garcia).

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<sup>8</sup> See 12 U.S.C. §§ 1429, 1430. More specifically, section 9 authorizes each FHLBank to grant a member’s application for advances on such conditions as the FHLBank may prescribe, subject to the approval of the Finance Board. See id. § 1429. Section 10(c) of the Bank Act states that advances “shall be made upon the note or obligation of the member . . . bearing such rate of interest as the [Finance] Board may approve or determine . . .” See id. §. 1430(c). Under this provision, the FHLBanks have discretion to determine the interest rates charged on advances, pursuant to criteria established by the Finance Board. See 12 C.F.R. §§ 935.6, 935.7.