



Federal Housing Finance Board

September 17, 1998

OPINION OF THE OFFICE OF GENERAL COUNSEL

- ISSUES: 1. May a FHLBank that wishes to offer a MPF program to its members (FHLBank-Principal) employ another FHLBank (FHLBank-Agent) as agent to perform administrative and operational functions related to the operation of the FHLBank-Principal's MPF program and, if so, to what extent?
2. To what extent and under what circumstances may a FHLBank invest in MPF mortgage loans originated by another FHLBank's members under that other FHLBank's MPF program?

CONCLUSIONS:

1. Under section 12 of the Federal Home Loan Bank Act (Bank Act), a FHLBank may employ an agent to perform any function that it is not otherwise prohibited by statute from employing an agent to carry out. As such, a FHLBank-Principal may use a FHLBank-Agent to perform all purely administrative functions related to the operation of the FHLBank-Principal's MPF program. However, due to Bank Act restrictions upon the power of FHLBanks to make advances (from which power the authority to establish a MPF program arises), to accept deposits and generally to have contact with members of other FHLBanks, a FHLBank-Agent may not, as part of its responsibilities: fund MPF mortgage loans through, or purchase MPF mortgage loans from, a member of the FHLBank-Principal; establish a deposit account on behalf of a member of the FHLBank-Principal; or solicit interest in any MPF program from among the membership of any other FHLBank.
2. Under section 10(d) of the Bank Act, FHLBanks are permitted to purchase advances and advance participations from and sell advances and advance participations to other FHLBanks. Because the power of FHLBanks to establish MPF programs is incidental to their express authority to make advances, any FHLBank may purchase from a FHLBank-Principal any MPF mortgage, or a participation interest therein, once the MPF mortgage has been delivered to the FHLBank-Principal by its PFI.

I. Introduction

In December 1996, the Federal Housing Finance Board (Finance Board) authorized the Federal Home Loan Bank (FHLBank) of Chicago to establish a pilot program, called “Mortgage Partnership FinanceTM” (MPF), under which the FHLBank may purchase from, or fund through, participating member financial institutions (PFIs) up to \$750 million of one-to-four family residential mortgage loans originated by such members. See Finance Board Res. No. 96-111 (Dec. 26, 1996). Since June of 1997, when the FHLBank of Chicago funded its first mortgage loan under the MPF pilot program, several other FHLBanks have indicated an interest in seeking Finance Board approval to offer MPF, or pilot programs similar to MPF, to their members. To facilitate this, the Finance Board’s Office of Policy (OP) currently is has prepared recommendations for the Board of Directors (BOD) of the Finance Board regarding the establishment of Terms and Conditions (T&Cs) under which any FHLBank will be permitted to offer MPF, or programs substantially identical thereto,¹ on a pilot basis to its members without further approval of the BOD.

To promote efficiency in the operation of MPF programs by the FHLBanks and to allow FHLBanks to begin program operations more quickly, OP has recommend that the BOD permit FHLBanks to delegate certain administrative functions related to the operation of their MPF programs to another FHLBank.² In addition, OP has recommend that the BOD vote to permit any FHLBank to purchase from another FHLBank mortgage loans funded or otherwise acquired by a FHLBank as part of a MPF program (hereinafter referred to as “MPF Loans”), or participation interests therein. Accordingly, OP has asked OGC to opine as to: (1) the extent to which one FHLBank may use another FHLBank as agent to operate its MPF program; and (2) the circumstances under which one FHLBank may purchase MPF Loans, or participation interests therein, from another FHLBank.

A. Summary of the FHLBank of Chicago’s MPF Pilot Program

Under the existing MPF pilot program, as approved by the Finance Board and as currently operating at the FHLBank of Chicago, the FHLBank acquires from its PFIs interests in whole one-to-four family residential mortgage loans that comply with the conforming loan limits applicable to the secondary market housing GSEs (MPF loans). The FHLBank acquires these interests primarily by funding the MPF loans at the time of closing through its PFIs, who market, originate, underwrite, credit enhance and service the loans and who collect origination, servicing

¹ Although identical programs initiated by other FHLBanks may not have the “Mortgage Partnership Finance” moniker, all programs that are substantially identical to the FHLBank of Chicago’s MPF program, authorized under Finance Board Res. No. 96-111 (Dec. 23, 1996), are referred to herein as “MPF programs” for the sake of brevity.

² This is intended initially to permit FHLBanks to use the “back office” operations already in place at the FHLBank of Chicago so that they may more quickly and efficiently establish their own programs and benefit from the expertise that the FHLBank of Chicago has gained in operating its own MPF program. However, under the proposed T&Cs, a FHLBank would be permitted to delegate the operation of an MPF program to any administrative office that has been examined and approved by Finance Board staff.

and credit enhancement fees for their role in the MPF transactions. As an alternative, PFIs may elect to sell to the FHLBank mortgage loans that the PFI has already funded. In either case, the PFI continues to service the MPF loans for the FHLBank (subject to the FHLBank's right of removal), passing the principal and interest payments and prepayment fees therefrom on to the FHLBank (and any other FHLBank investors).³ The FHLBank of Chicago and other investors are entitled to income derived from any positive spread between the yield borne by the pools of MPF loans, less fees, excess yield to cover defaults and the investors' funding and administrative costs.

As a buffer against possible loans losses, the FHLBank of Chicago maintains a separate spread account (loss reserve) on behalf of itself and the other FHLBank investors, to be funded by excess yield on the mortgage loans. The amount of excess yield is calculated, after taking into account servicing and credit enhancement fees, so as to produce a loss reserve account that will cover all expected losses (based on historical norms) on each pool of loans.⁴ In addition to this loss account, PFIs are required to provide a second loss credit enhancement by means of a corporate guarantee that is approximately equal to the amount of subordination that would be required by ratings agencies to achieve a AA rating in the senior tranche for the particular pool of mortgage loans originate by that PFI. Any losses beyond those covered by the loss reserve and the credit enhancements would be directly expensed to the FHLBank of Chicago and, proportionately, to the other FHLBank investors in the current period.

B. Legal Bases Underlying Finance Board Approval of the MPF Pilot Program

Although the Bank Act does not expressly authorize FHLBanks to offer to their members services like the MPF program, the Finance Board determined that FHLBanks could be authorized to undertake such programs, pursuant to both the FHLBanks' incidental powers, set forth in sections 11(a) and 11(e)(1) of the Bank Act, 12 U.S.C. §§ 1431(a), (e)(1), and their investment powers, set forth in sections 11(h) and 16(a) of the Bank Act. *Id.* §§ 1431(h), 1436(a).

Prior to considering the FHLBank of Chicago's request for permission to undertake its MPF pilot program, the Finance Board already had determined that, pursuant to the FHLBanks' express investment authority set forth in sections 11(h) and 16(a) of the Bank Act, *id.*, an FHLBank may purchase and retain as investments both whole mortgage loans and participation interests therein, to the extent that such loans and participations constitute assets in which a fiduciary or trust could invest under the laws of the state in which the FHLBank is located. See Finance Board Res. No. 96-44 (July 3, 1996) (approving the FHLBank of New York's proposal to initiate a pilot program under which it would purchase mortgage loans from members); Memorandum from Deborah F. Silberman, Deputy G.C., to Bruce A. Morrison, Finance Board

³ Currently, the FHLBanks of Atlanta, Des Moines, Indianapolis, New York and Pittsburgh own 1% interests in each pool of mortgage loans acquired by the FHLBank of Chicago.

⁴ The spread account would be accessed only after any private or government insurance or guarantees are exhausted. PFIA ¶ 4.3.

Chmn. (May 13, 1996) (setting forth the legal basis upon which the FHLBank of New York's request could be approved). Section 11(h), 12 U.S.C. § 1431(h), which governs the investment of FHLBank surplus funds, and section 16(a), *id.* § 1436(a), which governs the investment of FHLBank reserves, each set forth a series of specific assets in which FHLBanks may invest and, in addition, permit FHLBanks to invest "in such securities as fiduciary and trust funds may be invested in under the laws of the State in which the [FHL]Bank is located." Based upon the legislative histories of sections 11 (h) and 16(a), OGC concluded that the meaning of the word "securities" should include "the broad class of financial investments" normally connoted by the term when used in the context of state fiduciary and trust law. See *also* Memorandum from Beth L. Climo, Finance Board G.C., to Gary B. Townsend, Director, Office of Examination and Regulatory Oversight (Feb. 16, 1995) (regarding the power of FHLBanks to invest in term federal funds). Because both mortgages and mortgage participations belong to "the broad class of financial investments," OGC considered them to be securities under the investment provisions of the Bank Act.'

Because the Board had previously acknowledged the power of a FHLBank to purchase mortgage loans or mortgage participations as investments, OGC did not opine separately on that topic in conjunction with the BOD's consideration of the FHLBank of Chicago's request to initiate its MPF pilot program. However, because, under the MPF program, the FHLBank of Chicago proposed to acquire mortgage loans primarily through direct funding -- a method not previously employed by the FHLBanks and not expressly addressed in the Bank Act -- and because of the extensive interface between the FHLBank and the originator of the loans, OGC did opine on the authority of the FHLBank to offer the MPF program as a product or service to its members. See Memorandum from Eric M. Raudenbush, Attorney-Advisor, through Deborah F. Silberman, Acting G. C., to Bruce A. Morrison, Finance Board Chmn. (Dec. 18, 1996) (MPF Memo). In the MPF Memo, OGC concluded that, although the Bank Act neither expressly permits nor prohibits direct funding of mortgage loans by FHLBanks through their members, the incidental powers, granted to the FHLBanks under sections 11(a) and 11(e)(1) of the Bank Act are broad enough to encompass the activities in which the FHLBank of Chicago would engage under its MPF program.

Section 11(a) of the Bank Act provides that "[e]ach Federal Home Loan Bank shall have power. . . to do all things necessary for carrying out the provisions of this chapter and all things incident thereto." 12 U.S.C. § 1431(a). Section 11(e)(1) restates the incidental powers language of section 11(a) in the negative by providing, in pertinent part, that "no [FHL]Bank shall transact any banking or other business not incidental to activities authorized by this chapter." *Id.*

' This conclusion was mirrored by the opinion of counsel for the FHLBank of Chicago in the May 15, 1996 legal memorandum provided to the Finance Board as part of the FHLBank's original request to undertake its MPF program. There, counsel concluded correctly that the FHLBank's investment in MPF was permissible under the "fiduciary and trust" clauses of sections 11(h) and 16(a) of the Bank Act, and that, under the prudent investor standard of the Illinois law for fiduciaries, see 760 ILCS 5/5 (Smith-Hurd 1995), investment in the MPF "would be authorized for purposes of the incorporation of Illinois law into the Bank Act." Any FHLBanks wishing to purchase mortgage loans must provide the Finance Board with a similar certification regarding the FHLBank's ability to invest in such loans under state law.

§ 1431 (e)(1). Because the legislative history of section 11(e)(1) indicated that the 1989 amendment thereto was intended to clarify that “the incidental activities of national banks and [FHL]Banks should now be viewed as similarly broad,” see 108 Cong. Rec. H4994 (daily ed. Aug. 3, 1989) (statement of Rep. Garcia), OGC referred to federal court opinions interpreting the incidental powers of national banks for guidance in determining how broadly the Finance Board could interpret the scope of the FHLBanks’ incidental powers. Under the National Bank Act cases, an activity may be considered to be within a national bank’s incidental powers, *inter alia*, if the activity is the “functional equivalent” of an expressly authorized power. See *NationsBank v. Variable Annuity Life Ins. Co.*, 130 L. Ed. 2d 740 (1995) (wherein the United States Supreme Court upheld the determination of the Comptroller of the Currency that national banks have incidental authority to broker annuities because, although annuities are structured technically as insurance, annuities have the “functional characteristics” of investment instruments, which national banks are expressly permitted to broker as part of the “business of banking”); *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) (holding that automobile leasing is a permissible activity for a national bank because it is the functional equivalent of the bank’s express power to “loan money on personal property”).

After reviewing the structure of the MPF program, OGC concluded that the funding aspects of an MPF transaction, when viewed in their entirety, serve a function substantially similar to that of a traditional advance expressly authorized under section 10(a) of the Bank Act, 12 U.S.C. 1430(a). Under MPF, the FHLBank provides to its member institutions a product or service that allows these members to leverage their mortgage assets to gain liquidity in order to make -- that is, to originate, underwrite, service and collect associated fees on -- additional home mortgage loans. In this way, despite the technical differences in the form of the transactions, an MPF loan is the “functional equivalent” of an advance in the same sense that an annuity is the functional equivalent of a financial investment and that an automobile lease is the functional equivalent of an automobile loan that is secured by the vehicle being purchased. Because an MPF transaction has the “functional characteristics” of an advance, OGC concluded that the Finance Board could approve the program, including its direct funding feature, as an appropriate incidental activity for a FHLBank.

In approving the FHLBank of Chicago’s request to initiate the MPF pilot program, the BOD adopted the legal position that the FHLBank’s authority to offer such a program to its members derived from its incidental authority to offer products and services that are the functional equivalent of a traditional advance. However, because an MPF transaction is technically distinguishable from an advance in that it results in the FHLBank’s legal ownership of whole mortgage loans -- as opposed to the security interest taken in mortgage loans as part of a section 10(a) advance transaction -- the BOD chose to analyze an MPF transaction primarily as a FHLBank investment activity for purposes of fulfilling its role as safety and soundness regulator of the FHLBank of Chicago. Accordingly, the BOD approved the FHLBank of Chicago’s MPF pilot program pursuant to the investment provisions of the Finance Board’s Financial Management Policy for the FHLBanks (FMP), see Finance Board Res. No. 96-45 (July 3, 1996), and specifically exempted MPF transactions from the definition of, “advance” set forth in section 935.1 of the regulations of the Finance Board. 12 C.F.R. § 935.1.

This dual analytical approach was affirmed in every respect by the United States District Court for the Western District of Texas in *Texas Savings & Community Bankers Ass'n v. Federal Housing Finance Board*, No. A-97-CA-421-SS (W.D. Tex. June 25, 1998). In its opinion granting the Finance Board's Motion for Summary Judgment and upholding the Finance Board's construction of the Bank Act, the *Texas Savings* court concluded that "financing under the [MPF] program is functionally equivalent to financing under traditional advances, and the technical differences are permitted under the investment powers and the incidental powers of the FHLBanks." *Texas Savings*, slip op. at 11, n. 11. Therein, the court specifically acknowledged both that the MPF program "is truly 'incidental' to 'carry[ing] out th[e] housing finance mission'" of the FHLBanks, see slip op. at 15-16, and that the FHLBanks clearly are permitted by statute to invest in mortgage loans. See *id.* at 13-14.

II. Analysis

A. Chronology of an FHLBank/PFI Relationship Under MPF

It having been established conclusively that a FHLBank may operate an MPF program, offer its members mortgage purchase and funding services thereunder, and hold the acquired mortgage loans as investments, OGC has been asked to opine whether and to what extent a FHLBank may offer MPF services to its members, while employing another FHLBank as agent in the management of the MPF program's operation. Currently, several FHLBanks wish to offer MPF to their members, yet desire to benefit from the two years' experience of the FHLBank of Chicago by using the FHLBank of Chicago as agent for various aspects of their programs' operations. In the future, other FHLBanks may wish to establish MPF programs and to access the operational structure of a FHLBank other than the FHLBank of Chicago. In order to determine precisely which MPF-related functions one FHLBank may delegate to another, OGC here sets forth a detailed chronology of events that typically occur under the MPF program, from solicitations for interest among members through the termination of a member's MPF Loan servicing responsibilities.

To be eligible to engage in MPF transactions with the FHLBank of Chicago, its members must first meet certain eligibility standards established by the FHLBank⁶ and must be approved by the FHLBank as an MPF PFI. Once the FHLBank approves a member as a PFI, the member and the FHLBank enter into a contract -- the "PFI Agreement" -- wherein both parties agree to the terms and conditions under which the PFI will originate and service mortgages for the FHLBank. At this time, the FHLBank provides to the PFI its MPF Origination and Servicing Guides (Guides), which set forth in more detail the respective parties' duties regarding the

⁶ Generally, to qualify as a PFI, a FHLBank of Chicago member must maintain as one of its principal business purposes the origination of mortgages of the type that are eligible for MPF funding or purchase; maintain the ability to at all time originate mortgages that meet the FHLBank's standards and standards generally imposed upon other GSEs; employ qualified mortgage origination staff and possess adequate facilities therefore; maintain adequate fidelity bond and errors and omissions (E&O) insurance; and agree to report any material changes in the foregoing areas as they occur. See PFI Agreement ¶ 2.1.

origination and servicing of MPF Loans and which are contractually binding in that they are incorporated by reference into the PFI Agreement. See FHLBank of Chicago Standard PFI Agreement (PFIA) ¶ 1.3; Origination Guide (OG) ¶ 1.2.1. Under the PFI Agreement, the PFI agrees, *inter alia*, to: provide certain financial information to the FHLBank, see PFIA ¶(2.3,6.3; permit the FHLBank to examine or audit certain books, records and information, *see id.* ¶¶ 2.4, 6.4; act as agent of the FHLBank in the origination of MPF Loans and assume all fiduciary duties connected with such status, *see id.* ¶ 3.6; and act as an independent contractor for the FHLBank in the servicing of MPF Loans, *see id.* ¶ 7.5.

Once the FHLBank establishes an account for its PFI on the MPF computer system, the PFI provides to the FHLBank pertinent data regarding its historical credit loss experience, which the FHLBank uses to calculate the percentage of the first-loss spread account that will apply to each pool of mortgage loans delivered to the FHLBank by that PFI. OG ¶ 18.2, 18.3.2. Thereafter, each MPF funding or purchase transaction is carried out pursuant to one of a series of “Master Commitments” (MCs) ⁷ entered into between the FHLBank and its PFI. The PFI initiates the establishment of a MC by proposing to deliver to the FHLBank a pool of mortgage loans with specific characteristics (i.e., pool size, loan type, geographical makeup) within a specified time frame. Based upon the characteristics of the mortgages that the PFI has proposed to deliver under the MC, the FHLBank calculates both a Target Credit Enhancement Amount (the amount of enhancement that would be required if the actual MC mortgages were to have the characteristics estimated by the PFI) and a Maximum Credit Enhancement Amount (the maximum credit enhancement amount that a PFI can be obligated for under a MC, which is set at 130% of the target amount). OG ¶ 18.3. The FHLBank also evaluates the creditworthiness of the PFI with respect to its potential obligation for the Maximum Credit Enhancement Amount. Assuming that the PFI is found to be creditworthy, the FHLBank prepares the MC, which is then signed by the PFI and the FHLBank.

A PFI’s obligation under a MC⁸ is fulfilled by delivering mortgage loans to the FHLBank under a series of “Delivery Commitments” (DCs), each of which constitutes ‘a binding agreement between the PFI and the FHLBank that defines the note rates, agent fees, closing time interval, product type, total dollar amount and other terms pertaining to the delivery of one or more specific mortgage loans that the PFI anticipates will close within a short time period. See OG ¶ 19.1. After underwriting one or more mortgage loans to its customers in conformity with the requirements set forth in the Guides,⁹ a PFI must submit to the FHLBank, either electronically, or via facsimile, information about the loans, including, *inter alia*: primary borrower and co-

⁷ There may be more than one MC outstanding between the FHLBank and a particular PFI at one time. See PFIA ¶ 3.3.

⁸ A PFI may have more than one MC outstanding at a given time.

⁹ If the underwriting is carried out by an agent of the PFI, the PFI will confirm that the loan has been underwritten in conformity with the Guides. For the sake of brevity it is assumed here that the PFI itself will originate the mortgage loans. The use of an originating agent would have no bearing on the legal conclusions reached in this memorandum.

borrower data; a description of the property; the type of loan product; the interest rate; the principal amount; the loan-to-value ratio; and the total debt ratio. The FHLBank evaluates this information using its credit enhancement models and determines an actual “Loan Level” credit enhancement amount and percentage for each loan. These amounts are then confirmed to the PFI electronically, or via facsimile. OG ¶ 20.1.

Every business day, the FHLBank makes available, either electronically, or via facsimile, Rate and Fee Schedules for each type of mortgage product that a PFI may deliver to the FHLBank.¹⁰ OG ¶ 19.3.1. After the PFI chooses a delivery option (that is, whether the FHLBank will fund the loan, or will purchase the loan after it is funded by the PFI) and obtains an actual credit enhancement figure, the PFI again contacts the FHLBank to obtain a DC. In order to obtain a DC, a PFI must telephone the FHLBank and specify, *inter alia*: the MC to which the DC is to be assigned; the applicable Rate and Fee Schedule and associated product type; a note rate for the DC; and the dollar amount of mortgage loans to be delivered thereunder. The FHLBank will then verify that the Rate and Fee Schedule is still valid, that the referenced MC is still open and that the fulfillment of the DC will not cause the PFI to exceed the Maximum Credit Enhancement Amount under the MC. If these items are verified, the FHLBank will issue a binding DC, which, along with the amount of the Agent Fee, will be confirmed to the PFI on the day of issuance—either electronically, or by facsimile. OG ¶ 19.3. Upon the FHLBank’s issuance of a DC confirmation, that DC is allocated to the MC that is specified in the DC. See PFIA ¶3.3. The DC confirmation is intended to establish conclusively the FHLBank’s ownership of the mortgage to which it relates. See PFIA ¶3.6.

Once the DC is established and the PFI is ready to close on a particular loan, the PFI may request funding from the FHLBank (this may be done simultaneously with the confirmation of the DC in the case of a DC for a single loan). OG ¶ 19.4. To fund a specific mortgage, the PFI must call the FHLBank within three days of the mortgage closing date. The PFI must furnish information to the FHLBank regarding the mortgage loan, including, *inter alia*: the principal amount; the interest rate; the closing date; the first payment date; the loan term; the maturity date; and the property address. Upon determination that the Loan Level Credit Enhancement previously calculated for the loan remains accurate and that the loan conforms to the terms of the corresponding DC and MC, the FHLBank will: confirm the acceptance of mortgage funding, either electronically, or via facsimile; and credit the PFI’s deposit account at the FHLBank for the mortgage principal amount, less interim interest, on the date that the loan is closed. OG ¶23.1. After either closing the mortgage loan using the FHLBank’s funds, or accepting the FHLBank’s funds as payment for the purchase of the mortgage loan, the PFI transmits the loan closing data to the FHLBank.

After checking the approved loan data against the funded loan data, the FHLBank debits or credits the PFI’s transaction account for the amount of the Agent Fee. The PFI sends the endorsed note and a blank mortgage assignment to the Master Servicer, which enters the loan

¹⁰ Each schedule applies to a specific PFI and expires at the end of the business day, but may be withdrawn or amended by the FHLBank at any time during the day.

into its servicing data base. Under the PFI Agreement, the PFI then is obligated to service the mortgage loan in accordance with the Guides and to remit the mortgagor's payments (minus the PFI's servicing fee) to the FHLBank. Each month, with respect to each MC pool, the FHLBank credits the PFI's FHLBank deposit account for a credit enhancement fee based on the principal amount then outstanding under each MC. See PFIA ¶4.6. The FHLBank also credits a portion of each mortgage payment to the first loss spread account that corresponds to the MC under which that mortgage was delivered to the FHLBank. See PFIA ¶¶ 3.3(f); 4.1. The PFI deals with the FHLBank or the Master Servicer on all subsequent servicing matters until the loan is repaid, or the real estate securing the loan is disposed of and the net proceeds or losses are determined.

At all times that mortgage loans remain outstanding, the FHLBank continues to monitor both the credit standing of the PFI and the aggregate amount of second loss credit exposure to the PFI on its MPF Loans.” The FHLBank may require the PFI to post collateral to secure the PFI's credit enhancement obligations to the FHLBank.¹² In addition, the FHLBank reserves the right to conduct a post-funding quality control review of any mortgage originated for and funded by the FHLBank, pursuant to which the FHLBank will seek to verify that each mortgage examined meets the FHLBank's definition of investment quality and conforms with the guidelines, policies and warrants set forth in the PFIA. The FHLBank will inform the PFI in writing to submit specified mortgage files to the FHLBank or its designee. After the quality control review is complete, the PFI will be notified in writing of those mortgages found to be deficient. At its sole discretion, the FHLBank may require purchase by the PFI of any deficient mortgage and/or to indemnify the FHLBank for any loss arising from such loan.

B. Legal Standards Applying to the Ability of FHLBanks to Employ FHLBank-Agents to Perform MPF Functions

Section 12 of the Bank Act, which addresses the general corporate powers of the FHLBanks, appears to vest in each FHLBank a power to delegate at least some of its functions to agents. See 12 U.S.C. § 1432(a). Each FHLBank is authorized thereunder, *inter alia*: (1) to make contracts; (2) to select, employ, and fix the compensation of such agents as shall be necessary for the transaction of business; (3) to define the duties of such agents and to dismiss them at the FHLBank's pleasure; (4) by their boards of directors, to prescribe the manner in which their affairs may be administered and their powers exercised and enjoyed; and (5) to have all such incidental powers, not inconsistent with the terms of the Bank Act, as are customary and usual in corporations generally. *Id.*

It also appears, by the general terms of the Bank Act, that Congress contemplated that FHLBanks would have some business relationships among themselves and with members of

¹¹ In the event that the second loss guarantee must be accessed, the PFI Agreement provides that the funds will be withdrawn from the PFI's account at the FHLBank and that any resulting deficit will be deemed an advance.

¹² This is likely to be covered by the blanket lien in most cases.

other FHLBanks. For example, the Bank Act authorizes FHLBanks: to purchase advances and advance participations from one another, and to assign security therefor, *id.* § 1430(d); to issue consolidated obligations that are the joint and several obligations of all FHLBanks, *id.* § 1431 (b),(c); to accept deposits from, and place deposits with, other FHLBanks, *id.* § 1431(e)(1); to engage in the collection and settlement of instruments of payment drawn on or issued by members of any FHLBank, *id.* § 1431(e)(2)(C); to rediscount the discounted notes of members held by other FHLBanks, *id.* § 1431(f); to makes loans to, or purchase the obligations of, other FHLBanks, *id.*; and to obtain financial reports from the primary regulator of any member of any FHLBank, *id.* § 1442(a).

As an initial matter, based on the foregoing statutory provisions, it appears that a FHLBank is permitted to employ an agent to perform any of its functions, including functions carried out in connection with an MPF program, unless otherwise prohibited by the terms of the Bank Act. Because the primary legal basis underlying the Finance Board’s authorization of the FHLBank of Chicago to initiate its MPF pilot program is the incidental power of a FHLBank to offer to its members a product or service that is the functional equivalent of a section 10(a) advance, a FHLBank’s authority to employ agents to perform various MPF program functions (and, conversely, a FHLBank’s power to administer aspects of a MPF program on behalf of another FHLBank) is necessarily limited by the statutory provisions regarding FHLBank advances.

In this regard, section 10(a) of the Bank Act provides that “[e]ach [FHL]Bank is authorized to make secured advances *to its members*,” 12 U.S.C. § 1430(a) (emphasis added), while section 4(b) states that “[a]n institution eligible to become [a FHLBank] member under this section may become a member only of, *or secure advances from*, the [FHL]Bank of the district in which is located the institution’s principal place of business.” *Id.* § 1424(b) (emphasis added). Based on this statutory restriction on the making of advances, it is the opinion of OGC that no FHLBank may fund mortgage loans through, or purchase mortgage loans from, any institution that is not a member of the funding/purchasing FHLBank. Logically implicit in this restriction is the corollary that no FHLBank may enter into any PFI Agreement, Master Commitment, Delivery Commitment or other contract or commitment to fund mortgage loans through, or purchase mortgage loans from, any institution that is not a member of the funding/purchasing FHLBank.

Also, because the Bank Act generally authorizes FHLBanks to accept only those deposits “made by *members of such [FHLB]ank* or by any other [FHL]Bank or instrumentality of the United States,”¹³ see 12 U.S.C. § 1431(e)(1) (emphasis added), it is the opinion of OGC that no FHLBank may accept deposits from any non-member institution (other than another FHLBank or instrumentality of the United States government) in connection with MPF program functions.

In addition to the provisions of the Bank Act that deal specifically with advances and deposit accounts, the structure of the statute as a whole evidences an intent on the part of Congress to limit the involvement of FHLBanks in the affairs of nonmembers. For example,

¹³ There are a few exceptions to this restriction, none of which are material to the issues addressed.

section 3 of the Bank Act authorizes the Finance Board to establish not less than eight, nor more than twelve FHLBank districts, which are to be apportioned “with due regard” for the convenience of institutions that are likely to become members of a FHLBank. *See id.* § 1423. Section 4 permits financial institutions to become members of only one FHLBank. *See id.* § 1424(b). Section 6 requires members to capitalize their FHLBank through the purchase of stock which may not be transferred or hypothecated, on which the member may receive dividends, *see id.* § 1426, and against which the FHLBank may obtain a lien to secure its member’s advance borrowings, *see id.* § 1430. Finally, section 7 of the Bank Act provides that each member institution is to have a role in the governance of the FHLBank of which it is a member/ shareholder through the election of a portion of that FHLBank’s board of directors. *See id.* § 1427. Given these general provisions, it is the opinion of OGC that no FHLBank may solicit any member of another FHLBank for interest in becoming a PFI under any FHLBank’s MPF program, except through the FHLBank of which the financial institution is a member.

It is the further opinion of OGC that, with the exception of the aforementioned restrictions, a FHLBank that wishes to offer MPF to its members (FHLBank-Principal) may use another FHLBank (FHLBank-Agent) to perform operational or administrative functions relating to the FHLBank-Principal’s MPF program. Functions that may be assumed by an FHLBank-Agent include, *inter alia*: the preparation of unexecuted PFI Agreements, MCs and DCs; monitoring of the status of MCs, DCs and funding requests; the calculation of all fees, rates, prices, spread accounts and credit enhancements; the management of the relevant MPF databases; and the operation of a processing center through which PFIs of the FHLBank-Principal may obtain pricing and other information, book MCs and DCs, and make funding requests.

With regard to the maintenance of transaction accounts at the FHLBank-Agent, although an FHLBank-Agent may not accept deposits directly from members of the FHLBank-Principal, the FHLBank-Principal may establish a deposit account at the FHLBank-Agent in which the FHLBank-Principal may hold funds on behalf of one or more of the FHLBank-Principal’s PFIs.

C. Legal Standards Applying to the Ability of a FHLBank to Invest in MPF Loans Originated by Members of Another FHLBank

OP has also asked OGC to opine as to the ability of one FHLBank (FHLBank-Investor) to purchase from a FHLBank-Principal whole mortgage loans, or participation interests in mortgage loans, that have been delivered to the FHLBank-Principal by one or more of its PFI/members as part of a MPF transaction. As discussed above, because a FHLBank may not make advances to members of another FHLBank, it may not fund all or part of a MPF loan originated by a PFI of another FHLBank. However, section 10(d) of the Bank Act grants any FHLBank, subject to the approval of the Finance Board, “power to sell to any other [FHL]Bank, with or without recourse, any advance made under the provisions of [the Bank Act], or to allow such [FHL]Bank a participation therein” and grants to all FHLBanks a corresponding power to purchase such advances or participations. *See* 12 U.S.C. § 1430(d); *see also* 12 C.F.R. § 935.16. As such, it is the opinion of OGC that any FHLBank may purchase from a FHLBank-Principal

any MPF Loan, or a participation interest therein, once the MPF Loan has been delivered to the FHLBank-Principal by a PFI.



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