



Federal Housing Finance Board

August 12, 1999

OPINION OF THE OFFICE OF GENERAL COUNSEL

ISSUES: May the FHLBank of ■ acquire whole mortgage loans from members and eligible nonmember borrowers; pool the loans; divide the pools into tranches; and sell the tranches to members and eligible nonmember borrowers?

CONCLUSIONS:

Yes. Under the incidental powers provisions of the Bank Act, the FHLBank is permitted to create and sell the tranches both as a means of assisting its members in a loan participation program and as a means of managing its portfolio of authorized investments.

I. Introduction

On July 3, 1996, the Board of Directors of the Federal Housing Finance Board (Finance Board) adopted a resolution (Res. 96-44) approving the request of the Federal Home Loan Bank (FHLBank) of New York to establish, under section II.B.12 of the Financial Management Policy for the FHLBank System (FMP),<sup>1</sup> a pilot program-called "Community Mortgage Asset Activities" (CMAA). See Fin. Bd. Res. 96-44 (July 3, 1996). Res. 96-44 authorizes the FHLBank to "acquire up to \$250 million in participation interests in housing and community development loans originated by members and eligible non-member mortgagees" and meeting the income targets established for the Community Investment Program (CIP).<sup>2</sup> The resolution requires that

<sup>1</sup> Res. 96-44 reflects the conclusion of the Board of Directors of the Finance Board that the CMAA pilot program, as approved, satisfied the criteria for approval of mission-related FHLBank investments set forth in section II.B.12 of the Financial Management Policy for the FHLBank System (FMP). See Fin. Bd. Res. No. 96-45 (July 3, 1996).

<sup>2</sup> Section 10(i) of the Federal Home Loan Bank Act (Bank Act) authorizes the each FHLBank to establish a CIP program to "provide funding for members to undertake community-oriented mortgage lending." See 12 U.S.C. § 1430(i). Paragraph (2) of section 10(i) defines "community-oriented mortgage lending" to mean:

[P]roviding loans-

(A) to finance home purchases by families whose income does not exceed 115 percent of the median income for the area,

the originator of each CMAA loan maintain at least a 20 percent interest therein and, in addition, encourages the FHLBank to offer shares of the FHLBank's CMAA participations to its members.<sup>3</sup>

## II. Analysis

### A. Sequential Participation Program Proposal

The FHLBank of [REDACTED] has requested that Res. 96-44 be modified, inter alia, to permit the FHLBank to establish as part of its CMAA operations, a "Sequential Participation Program." Thereunder, the FHLBank proposes: (1) to acquire whole residential mortgage loans, originated by its members (including subsidiaries and affiliates of such members) and eligible nonmember borrowers, that have an original

(B) to finance purchase or rehabilitation of housing for occupancy by families whose income does not exceed 115 percent of median income for the area,

(C) to finance commercial and economic development activities that benefit low- and moderate-income families or activities that are located in low- and moderate-income neighborhoods, and

(D) to finance projects that further a combination of the purposes described in subparagraphs (A) through (C).

Id. § 1430(i)(2).

<sup>3</sup> Res. 96-44 established the following requirements for the CMAA program:

- 1) The subject loans shall meet the income targets established for community investment program advances;
- 2) The purchase of such loans shall not count toward satisfaction of the Bank's Community Investment Program requirements;
- 3) The Bank shall ensure that the originator of the loan maintains at least a 20 percent interest in the loan participated, with higher minimum retention levels required where appropriate;
- 4) The Bank shall limit participations in construction loans to an amount no greater than 10 percent of the pilot program authorization
- 5) The Bank shall make an effort to share its participation interests in such loans with FHLBank members, ensuring that such members understand their responsibility to undertake due diligence separate and apart from that performed by the FHLBank,
- 6) The board of the Bank shall ensure, and certify to, the existence of appropriate expertise, policies, procedures, and controls prior to program implementation;
- 7) The board of the Bank shall establish, prior to program implementation and on an ongoing basis, adequate reserves;
- 8) The board of the Bank shall take appropriate precautions, in structuring its program oversight, to avoid the appearance of a conflict of interest for board directors with direct responsibility for approving transactions under the program;
- 9) The board of the Bank shall require monthly program progress reports from management during the first year of the program (and at least quarterly reports thereafter), shall file written evaluations of such reports, and shall provide copies of its evaluations and the management reports to the Finance Board.

Res. 96-44 (July 3, 1996).

principal balance falling within the conforming loan limits established pursuant to 12 U.S.C. 1717(b)(2); (2) to pool these mortgages and divide each of the resulting mortgage pools into three tranches, consisting of a short cashflow tranche, a longer cashflow tranche and a credit support tranche that would be sufficient to enhance the pool at least to the level of subordination afforded double-A rated mortgage-backed securities and that would act as first loss coverage for the life of the pool or until the position is exhausted; (3) to sell the credit support tranche of the pool back to the member or eligible nonmember borrower that originated (or whose subsidiary or affiliate originated) the loans; and (4) to sell the short cashflow tranche to the member or eligible nonmember borrower that originated the loans, or to sell either of the non-credit support tranches to any member or eligible nonmember borrower of the FHLBank.<sup>4</sup> See letter from ██████ James L. Bothwell (Jan. 20, 1999); Fin. Bd. Reg. Int. No. 99-RI-10 (Apr. 7, 1999).

#### B. Previous Finance Board Actions Relating to CMAA

In approving the original CMAA program, the Finance Board concluded that, pursuant to the FHLBanks' statutory investment authority set forth in sections 11(h) and 16(a) of the Bank Act, 12 U.S.C. §§ 1431(h), 1436(a), the FHLBank ██████ may purchase either whole loans, pools of loans and participations in loans or pools, to the extent that such loans, pools, or participations are legal investments for fiduciary and trust funds in the state of New York. See Res. 96-44; Memorandum from Deborah F. Silberman, Deputy G.C., to Bruce A. Morrison, Chmn. (May 13, 1996) (CMAA Memo).

Since its original approval of the CMAA program, the Finance Board also has concluded that the incidental powers granted to the FHLBanks under sections 11(a) and 11(e)(1) of the Bank Act, 12 U.S.C. §§ 1431(a), (e)(1), are broad enough to permit a FHLBank to acquire and hold mortgage assets in transactions that are, as a whole, the economic and functional equivalent of an advance in that: (1) the mortgage assets are obtained from members and eligible nonmember borrowers; (2) the member or nonmember borrower has originated the mortgages and maintains all direct contact with the consumer; (3) the purpose of the transaction is to allow the members and eligible nonmembers to use mortgage assets in their portfolios to gain liquidity for further mortgage lending; and (4) the member or nonmember borrower retains a significant portion of the credit risk arising from the mortgage assets. See Fin. Bd. Res. 96-111 (Dec. 23, 1996); Fin. Bd. Res. 98-41 (Sept. 23, 1998); Op. Fin. Bd. OGC (Sept. 17, 1998); and Memorandum from Eric M. Raudenbush, Attorney-Advisor, through Deborah

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<sup>4</sup> In addition to its request to operate the Sequential Participation Program, the FHLBank ██████ has also requested that the Finance Board amend Res. 96-44 by: (1) lifting the CIP targeting restrictions; (2) defining the term "member" to include affiliates and subsidiaries of members; (3) allowing the FHLBank, under the general CMAA program, to purchase whole loans and to sell a 20 percent participation back to the originating member or nonmember mortgagee (as opposed to the FHLBank buying an 80 percent participation initially); and (4) making clear that, under CMAA, the FHLBank may purchase FHA- and VA-insured mortgages. See Letter from ██████ President of FHLBank ██████ to Bruce A. Morrison, Chairman of the Finance Board (May 28, 1999). These issues are not addressed in this opinion.

F. Silberman, Acting G.C., to Bruce A. Morrison, Finance Board Chmn. (Dec. 18, 1996) (1996 MPF Memo). Both of these legal approaches were upheld 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), appeal filed.

In January 1999, the FHLBank of ██████ submitted a request to implement a product called the Sequential Participation Program (SPP) to be offered under the FHLBank of New York's CMAA program. In April 1999, Finance Board staff responded to the FHLBank of ██████'s request by issuing a Regulatory Interpretation authorizing the FHLBank to offer the SPP under the terms of the CMAA approval resolution (99-RI-10), which presumed that the FHLBank would be acquiring tranches of pools created by its members and eligible nonmember borrowers. However, as described above, the FHLBank now intends to buy whole mortgages and pools of mortgages and to create and sell the tranches itself.

As mentioned, the Finance Board has previously addressed the legal questions regarding the acquisition of loans, pools and participations from members and eligible nonmember borrowers and the retention of credit risk by the member/nonmember. However, the Finance Board has not previously addressed the issue of whether the FHLBank of ██████ may divide into tranches a pool of mortgage assets in its portfolio and sell the tranches to its members and eligible nonmember borrowers (hereinafter "members"). As discussed below, OGC finds that the sale of the tranches as part of the SPP is within the incidental powers granted to the FHLBank under the Bank Act.

#### C. The Sale of Tranches Under the SPP Program Is Within the FHLBank's Incidental Powers

Section 11(a) of the Bank Act authorizes each FHLBank to "do all things necessary for carrying out the provisions of this chapter and all things incident thereto." See 12 U.S.C. § 1431(a). This grant of incidental authority is restricted by section 11(e)(1) of the Bank Act, which prohibits any FHLBank from "transact[ing] any banking or other business not incidental to activities authorized by this chapter." See *id.* § 1431(e)(1).

##### 1. Assistance of Members in Loan Participation Programs is Specifically Mentioned as a Permissible Incidental Activity in the Legislative History of the Bank Act's Incidental Powers Provision

The incidental power restriction found in section 11(e)(1) of the Bank Act was amended as part of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to add the words "incidental to activities." See Pub. L. No. 101-73, § 709(1) (1989). The sponsor of this FIRREA provision, Rep. Robert Garcia of New York made a detailed statement on the floor of the House of Representatives regarding this amendment, explaining that the incidental powers of the FHLBanks should be

"broadly read" because such a reading would "support the primary purpose of the [FHLB]anks; namely, housing finance," and would permit the FHLBanks to assist their members in "control[ling] operating costs and interest rate risk and credit risk." See 135 Cong. Rec. H4994 (Aug. 3, 1989) (emphasis added). More specifically, Rep., Garcia explained that "the amendment was intended to . . . permit [the FHLBanks] to assist members in loan participation programs." See *id.* Because SPP qualifies as both a loan participation program and a means of assisting members to control risk, and because the sale of the tranches is essential to both of these purposes, the sale of the tranches appears to fall squarely within the class of incidental powers that Congress intended to permit by amending section 11(e)(1) in 1989.

2. The Sale of the Tranches is Also Incidental to the FHLBank's Express Statutory Investment Powers

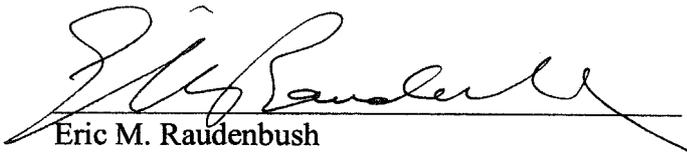
Even if SPP is viewed only as a means through which the FHLBank would manage its investment portfolio, the sale of the tranches would still be a permissible incidental activity because it would be "convenient and useful" in carrying out the FHLBank's express investment power. Both the Finance Board and the courts have looked to cases litigating the powers of national banks under the National Bank Act in order to determine the scope of the FHLBanks' incidental authorities under the Bank Act. See 1996 MPF Opinion; *Texas Savings*, *supra*. Under this line of cases, an activity may be considered to be within a bank's incidental powers if it is "convenient and useful" in carrying out an expressly-authorized power. See *Arnold Tours v. Camp*, 472 F.2d 427 (1st Cir. 1972) (holding generally that a national bank's activity is authorized as an incidental power "necessary to carry out the business of banking" 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).

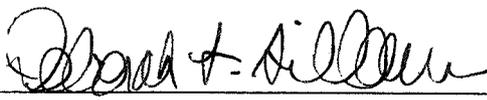
Under section 11 (h) of the Bank Act, the FHLBanks are expressly authorized to invest in certain assets "to such extent as the [FHLB]ank may deem desirable." See 12 U.S.C. § 1431(h). Through SPP, the FHLBank could tailor-make the type of mortgage investment that it wants to retain in its portfolio by dividing a mortgage pool into tranches and retaining only the investment desired by the FHLBank. The sale of the tranches is a method by which the FHLBank would divest itself of interests in pools of whole mortgages that it has acquired, which interests would be created based on the interest in the pools that the FHLBank wishes to retain, as opposed to corresponding to whole interests in specified mortgage notes or other loans. Thus, the sale of the tranches would be a "convenient and useful" means by which the FHLBank could exercise its express authority to invest in a permissible class of investments "to such extent as the [FHLB]ank may deem desirable." As such, the sale of the tranches under SPP is incidental to investment authority of the FHLBank under section 11(h) of the Bank Act, 12 U.S.C. § 1431 (h), and is therefore a permissible activity for the FHLBank.

III. Conclusion

Based on the information that the FHLBank has presented and the analysis set forth above, OGC concludes that the Finance Board may authorize the FHLBank of ██████████ ██████████ to pool mortgage assets, create tranches from the pools and to sell the tranches to members and eligible nonmember borrowers. As stated above, the legal conclusions set forth herein are predicated not only upon SPP's nature as an investment vehicle for the FHLBank, but also upon the fact that the FHLBank will sell tranches only to its members and eligible nonmember borrowers and on the SPP's role as a means of enhancing the cooperative nature of the FHLBank System by assisting beneficiaries of the cooperative (i.e., FHLBank members and eligible nonmember borrowers) to gain liquidity in exchange for their whole loans, to acquire the interests in mortgage assets that they are best qualified to manage and otherwise to manage their balance sheets. We have not been asked to address, and this opinion does not address, the sale of SPP tranches outside the cooperative.

Finally, the FHLBank has not provided the Finance Board with any information regarding the precise form that the tranche sale transactions will take-for example, whether the tranches would be sold as securities and, if so, of what type. This opinion concludes that the FHLBank may be permitted to sell the tranches under SPP, regardless of the precise form of the transaction. However, the reasoning and conclusions contained in this opinion may require expansion or modification depending on how the FHLBank ultimately decides to sell the tranches.

  
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Concur:   
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