Date: August 7, 2000

Subject: Applicability of Financial Management Policy to Equity Option Transaction

Request Summary:

A Federal Home Loan Bank (Bank) requested a regulatory interpretation that the Federal Housing Finance Board’s (Finance Board) Financial Management Policy (FMP) would permit the Bank to act as an intermediary in transactions that would be used by members to hedge the risk associated with certificates of deposit (CDs) issued by the Bank’s members, which CDs have a return linked to the Standard & Poor’s 500 Stocks Index (S&P 500 Index).

Background:

Members of the Bank have been working with a consultant to offer a long-term CD that will pay interest based upon the performance of the S&P 500 Index. The first such product that will be offered is a 10-year CD that will pay interest at maturity equal to 90 percent of the increase in the S&P 500 Index over the life of the CD. A depositor will be guaranteed the return of the principal invested in the CD and will receive no interest if the S&P 500 Index declines over the life of the CD. The equity-linked CD will be issued on the fifteenth of each month. This product has been designed to assist the member institutions in attracting core retail deposits. The Bank has indicated that other equity-linked CDs with structures that may differ from the CDs described in the submission are likely to be issued by its members in the future.

The Bank is not sponsoring or promoting the CD product, but rather intends to offer its members a hedging instrument that can be used to convert the members’ exposure to the S&P 500 Index into a London Interbank Offer Rate (LIBOR) interest rate exposure. The hedging instrument will be structured as a European call option, for which the premium payments will be spread over the life of the option. Specifically, every three months, the member would pay to the Bank an amount equal to three-month LIBOR plus or minus a fixed number of basis points multiplied

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1 The cost of liabilities linked to three-month LIBOR more closely match the expected earnings on the members’ assets than would a liability linked to the S&P 500 Index. Thus, the Bank, in providing a means for it members to enter into the options transaction at a reasonable cost will help its members profitably manage their balance sheets.

2 A European option is one that may be exercised only on the date or dates specified in the option.

The Bank also represents that the transaction can be analyzed as a swap transaction, in which the quarterly LIBOR payments due from the option buyer could be viewed as the variable payments required under a typical swap agreement and the one-time payment due from the option seller when the option is exercised could be viewed as the fixed payment required under such a swap agreement.
by the notional value of the hedging instrument. The three-month LIBOR rate will be recalculated every three months, although the spread to LIBOR will be fixed. The option’s strike price will be the closing price for the S&P 500 Index on the Effective Date of the transaction. The Bank will pay to the member 90 percent of the increase in the S&P 500 Index over the life of the option on the option’s exercise date.³

The Bank will hedge the equity exposure of writing these options by purchasing call options that exactly mirror those being sold to members (back-to-back transaction). All of the Bank’s counterparties in the back-to-back transactions will be eligible financial institutions as that term is defined in the FMP. The Bank will price the transaction with members at a spread over what it must pay to its capital market counterparty in the back-to-back transaction. It also will verify the price provided by its capital market counterparty using the Bank’s own internal model.

Members that enter into this hedging transaction with the Bank will be required to post collateral under the Bank’s Advance, Collateral Pledge and Security Agreement. The collateral will be the same as that which is eligible to secure the Bank advances to the member. The Bank represents that it also will require that “high quality” collateral be posted with regard to the back-to-back transaction under the Credit Support Annex to the applicable Master Agreement with the capital market counterparty.⁴ The Bank also represents that the collateral arrangement for the back-to-back transaction meets any applicable requirements under the FMP. The Bank indicated that in general, the options and the collateral supporting the transactions will be valued monthly; however, the Bank may implement more frequent valuations of swap and option transactions.

The Bank has represented that its only risk in the transactions is the risk that a counterparty to one of the transactions will not perform. The Bank manages this type of credit risk daily and believes that it has the capability to model the credit exposure arising under the transactions. The Bank represents that transactions will comply with all applicable federal securities and commodity futures laws and regulations. The Bank also represents that the S&P 500 Index options are financial instruments in which a fiduciary and trust funds may invest under the laws of the state in which the Bank is located. The Bank expects that its options transactions with its members could total from $50 million to $100 million per month, although the size of the program ultimately depends on the popularity of the underlying 10-year, equity-linked CD.

Analysis or Discussion:

I. Legal Background

Authority for the Bank to make investments (other than advances) can be found in various sections of the Federal Home Loan Bank Act (Bank Act), most notably sections 11(a), 11(e), 11(h) and 16(a), 12 U.S.C. §§ 1431(a), 1431(e), 1431(h) and 1436(a). Section 11(h) of the Bank Act authorizes the Banks, “subject to such regulations, restrictions, and limitations as may be

³ Specifically, the settlement amount will be based upon the arithmetic mean of the S&P 500’s quarterly closing price for the final 12 quarters of the swap.

⁴ As now envisioned, acceptable collateral for the back-to-back transaction is as follows: cash; direct obligations of the United States government; debt instruments of certain United States government agencies and government sponsored agencies, including those of the Bank system, Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac); certain mortgage backed securities guaranteed by the Government National Mortgage Association (Ginnie Mae); certain Fannie Mae guaranteed mortgage pass-through certificates; and certain Freddie Mac mortgage participation certificates.
prescribed by the [Finance] Board,” to invest in a broad range of instruments, including “in such securities as a fiduciary and trust funds may be invested under the laws of the state in which the [Bank] is located.” Similarly, section 16(a) of the Bank Act states in relevant part that “the reserves of each [Bank] shall be invested, subject to such regulations, restrictions, and limitations as may be prescribed by the [Finance] Board, . . . in such securities as a fiduciary and trust funds may be invested in [sic] under the laws of the state in which the [Bank] is located.” Section 11(a) of the Bank Act states that “each shall have power, subject to rules and regulations prescribed by the [Finance] Board . . . to do all things necessary for carrying out the provisions of [the Bank Act] and all things incidental thereto.” Section 11(e)(1) restates the incidental power language in the negative by providing, in relevant part, “no Bank shall transact any banking or other business not incidental to activities authorized by this chapter.”

Pursuant to its authority to regulate, restrict or limit the investment authority of Banks, see, e.g., 12 U.S.C. §§ 1422a, 1422b, 1431(a), 1431(h) and 1436(a), the Finance Board has adopted regulations and policies concerning permitted Bank investments. Most relevant to this request is section 956.2 of the Finance Board’s regulations, as amended by the Finance Board on June 29, 2000, see 12 C.F.R. § 956.2, as amended by 65 Fed. Reg. 43969, 43986 (July 17, 2000), which authorizes a Bank to invest in certain specific instruments, “subject to the applicable limitations set forth in this part [956], in the [FMP] and in part 980 of this chapter.” Among these instruments are any “that the Bank has determined are permissible investments for fiduciary or trust funds under the laws of the state in which the Bank is located.” The use of the word “instruments” in 12 CFR § 956.2 in place of “securities” reflects the Finance Board’s construction of the term “securities” as used in section 11(h) and 16(a) of the Bank Act, 12 U.S.C. §§ 1431(h) and 1436(a), to encompass a broad range of financial investment instruments and not merely those that fall within the technical definition of “securities” set forth in the federal securities laws. See 65 Fed. Reg. 25676, 25686 (May 3, 2000); see also Op. Gen. Counsel (Feb. 16, 1995).

II. Applicability of the FMP to an Option Transaction.

Given the terms of the contemplated transaction, Finance Board staff believes that the transaction is actually an option transaction rather than a swap transaction as the Bank asserts. As contemplated, the Bank will write a call option on the S&P 500 Index to be bought by the member and, in turn, will hedge the resulting risk by buying an S&P 500 Index call option with the same strike price from its capital market counterparty. The writer of the option faces a “one-way” risk exposure (i.e., the risk that the S&P 500 Index will rise over the life of the option) and will be liable under the transaction only if the S&P 500 Index is above the option’s strike price on the exercise date. The buyer of the option is required to make periodic premium payments to the option writer. Unlike a typical swap transaction in which both parties “swap” periodic payments based on changes in some underlying rate or index (so that either party could be

5 The Office of General Counsel has prepared an extensive analysis of the Bank’s incidental authority under sections 11(a) and 11(e) of the Bank Act. See Memorandum from Eric M. Raudenbush, Attorney-Advisor, to Bruce A. Morrison, Chairman (Dec. 18, 1996); see also Texas Sav. & Community Bankers Ass’n v. Federal Housing Finance Board, 1998 WL 842181 (W.D. Tex. June 25, 1998), aff’d 201 F.3d 551 (5th Cir. 2000); Memorandum from Brandon B. Straus, Attorney-Advisor to Deborah F. Silberman Deputy General Counsel (June 27, 1996).

6 On January 19, 2000, the Finance Board approved a reorganization of its regulations such that most sections of its regulations were redesignated. See 65 Fed. Reg. 8253 (Feb. 18, 2000). Current section 956.2 had been designated section 934.1, 12 CFR § 934.1 (2000), prior to the reorganization. All references to Finance Board regulations in this regulatory interpretation will be to the new designations adopted by the Finance Board.
required to make a net payment to other on a payment date), only the option buyer is required to make such periodic payments under the contemplated transaction. Further, the Bank represents that the transaction will be documented as a European-style call option on the S&P 500 Index.

As already mentioned, the Bank has provided an opinion of counsel that the contemplated transactions are permissible investments for a fiduciary and trust funds under the laws of the state in which the Bank is located. Therefore, the contemplated swap transactions would be authorized under 12 C.F.R. § 956.2 as long as the transactions are not prohibited by parts 980 or 956 of the Finance Board regulations or by the FMP. The FMP authorizes a Bank to “enter into interest rate swaps or options with a member to facilitate the member’s assets/liabilities management strategies.” FMP § V.B. The question is whether this provision would allow a Bank to enter into option transactions, other than interest rate options, that would facilitate a member’s asset/liability management strategies.

The history of this FMP provision does not indicate whether the Finance Board intended to limit the scope of the Bank’s authority to just interest rate options. Prior to 1996, the FMP allowed the Banks to enter into options transactions as part of a Bank’s own hedging strategy but did not authorize a Bank to enter into any type of option transaction to assist members in management of their asset/liability strategies. In July 1996, the current wording of the FMP allowing the Banks to intermediate option transactions on behalf of members was adopted. See Fin. Bd. Res. No. 96-45 (July 3, 1996). The Finance Board did not specifically indicate either why the Banks’ authority to intermediate transactions to assist members was extended to option transactions or if it intended to limit the scope of the authority to just interest rate options. Nor has the Finance Board had cause to interpret the meaning this FMP provision since its adoption. In the absence of any clear indication that the Finance Board intended to limit a Bank exclusively to acting as an intermediary in interest rate options, the term “option” may be interpreted to further the goal of the FMP provision in question (i.e., to allow a Bank “to facilitate the member’s assets/liability management strategies”) and of the FMP more generally (i.e., “to provide a framework within which the [Banks] are allowed to implement prudent and responsible financial management strategies that assist them in accomplishing their mission . . .”).

In acting as an intermediary in the equity option transaction, the Bank will assist its members in obtaining core deposits by allowing the members to manage the risks associated with issuing CDs linked to the S&P 500 Index. Thus, the transaction is consistent with the FMP’s requirement that the Bank intermediate option transactions only to facilitate members’ asset/liability management strategy. Further, the management of the risk associated with this type of option transaction is relatively straightforward and is not new to the Bank. The Banks already effectively write equity options which are embedded in consolidated obligations linked to the S&P Index and hedge the equity exposure, as required by Finance Board regulations and

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8 Such an approach, which applies the restrictive term “interest rate” just to the term “swaps,” also would be consistent with the general rule of statutory construction that referential and qualifying words and phrases only refer to the last antecedent, where no contrary intention appears. See Oneida Indian Nation of New York v. State of New York, 691 F.2d 1070, 1093 (2d Cir. 1982).
policy. See 12 C.F.R. § 956.4, as amended by 65 Fed. Reg. 43969, 43986 (July 17, 2000) and FMP § IV.C. Given these facts, and based upon the Bank’s description of the option transaction, the transaction also is consistent with the FMP provision that the Banks be allowed to implement prudent and responsible financial strategies to further their mission.

**Conclusion:**

The FMP authorizes a Bank to enter into a call option on the S&P 500 Index with a member where that option facilitates the member’s asset/liability management strategy with respect to funds raised through the issuance of long-term CDs linked to the S&P 500 Index and where the Bank will hedge any equity exposure that results from entering into the transaction.

A **Regulatory Interpretation** applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. See 12 C.F.R. part 907.

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9 We note that the Bank intends to hedge all equity exposure resulting from the transactions with its members. Therefore, the Bank will not be engaging in the equity option transactions for speculative purposes, which is specifically prohibited by Finance Board regulations and policy. See 12 C.F.R. § 956.4, as amended by 65 Fed. Reg. 43969, 43986 (July 17, 2000) and § V.B of the FMP.