

Federal Housing Finance Board

Memorandum

April 18, 1991

MEMORANDUM

TO: Philip L. Conover
Director of District Banks Directorate

FROM: Beth L. Climo
General Counsel

SUBJECT: Membership Application for _____ National Bank,

Issue: Whether Collateral Mortgage Obligations ('CMOs') may be included in the calculation of the 10% eligibility requirement test under section 4(a)(2)(A) of the Federal Home Loan Bank Act ("Bank Act").

Conclusion: For the reasons discussed below, CMOs may be included in the calculation of the 10% eligibility requirement under section 4(a)(2)(A).

Discussion:

_____ National Bank, _____ ("National") is a federally chartered commercial bank. It has applied for membership in the Federal Home Loan Bank ("Bank") of _____ National has total assets equal to \$26,662,000.

In order to be eligible for membership, _____ National, under section 4(a)(2)(A) of the Bank Act, must have at least 10% of its assets in residential mortgage loans.¹ The 10% eligibility requirement was added to the Bank Act by section 704(a) of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") when the Bank Act opened membership up to institutions other than savings associations.* Neither the Bank Act nor any existing implementing regulations define the phrase "residential mortgage loans."

Prior to FIRREA, the Bank Act did not impose any type of quantitative or minimum amount requirement regarding either the dollar or numerical volume of home residential mortgage activity of any applicant. In fact, the term "residential mortgage loans" did not appear as a standard in the pre-FIRREA Bank Act.

¹. 12 U.S.C.A. §1424(a)(2)(A) (West Supp. 1990).

². Pub. L. No. 101-73, 103 Stat. 412 (August 9, 1989).

The old version of section 4 of the Bank Act only required that an applicant make "home mortgages."

The _____ Bank's proposed calculation of the 10% eligibility requirement under section 4(a)(2)(A) is as follows (data as of 9-30-90 FDIC call report):

1-4 family residential loans	\$ 1,504,000
Multi-family residential loans	0
Government CMOs	1,125,000
Privately Issued CMOs	959,000
<u>Total Residential Related Assets</u>	<u>\$ 3,588,000</u>

$$\frac{\text{Total Res. Rel.}}{\text{Total Assets}} = \frac{3,588,000}{26,662,000} = 13.46\%$$

The _____ Bank included CMOs in its proposed calculation of the 10% eligibility requirement for membership. If the CMOs are excluded from the above calculation of the 10% eligibility requirement, _____ National will not have 10% of its total assets in residential mortgage loans. Thus, the key issue is whether the term "residential mortgage loans" in section 4(a)(2)(A) of the Bank Act may be interpreted to include CMOs.

In 1988, Julie Williams, Deputy General Counsel of the former Federal Home Loan Bank Board ("FHLBB"), addressed the issue of whether the purchase of guaranteed participation certificates ("PCs") of Federal Home Loan Mortgage Corporation ("FHLMC") and certain modified pass-through certificates of the Government National Mortgage Association ("GNMA") could be considered as satisfying the "makes . . . home mortgage loans" requirement under the old version of section 4.3 Ms. Williams concluded that both PCs and pass-through certificates may be regarded as "home mortgage loans" for purposes of the "makes" criteria under the old version of section 4(a)(1)(C) of the Bank Act.⁴ She reasoned that such certificates represent interests in first mortgages on real estate with single family and multiple family dwellings. The FHLMC certificates were found not to be an investment security, which would have made FHLMC directly liable to the certificate holder for payment, while the GNMA certificates were found to obligate GNMA only to "pass through" the principal and interest of the underlying mortgages to the certificate holder.

This reasoning is equally applicable to the question as to whether pass-through securities may be considered "residential mortgage loans" for purposes of section 4(a)(2)(A), as amended by FIRREA.

3. FHLBB Memorandum, Julie L. Williams, Office of General Counsel, January 25, 1988.

4. Section 4(a)(1)(C) of the Bank Act requires that an institution applying for membership to make "home loan mortgages." 12 U.S.C.A. §1424(a)(1)(C) (West Supp. 1990).

The purchaser of pass-through securities owns the underlying residential mortgage loans. Therefore, an applicant's investment in pass-through securities may be included in its calculation of whether it has 10% of its total assets in residential mortgage loans.

Ms. Williams limited her opinion to "pass through" securities. As to other types of mortgage-backed securities she stated:

Whether the purchase of other types of securities of FHLMC or GNMA, or the purchase of any types of securities of FNMA, also could be regarded as the making of "home mortgage loans" within the meaning of the "makes" criteria would depend on their similarity to the FHLMC/GNMA certificates discussed above.

CMOs are hybrid securities--which combine the beneficial features of pass-through and debt obligations--that are considered to be debt obligations of the issuer.⁵ CMOs are issued as debt obligations collateralized by mortgages and issued in several tranches.

Although CMOs are structured as debt obligations, their role in mortgage finance is fundamentally the same as pass-through securities? Both instruments are used to promote mortgage financing by providing funds and liquidity to mortgage lenders, who use the funds to make additional mortgage loans. Thus, investment in CMOs provide the type of service to the mortgage industry that Congress intended. For example, the FIRREA Conference Report provides:

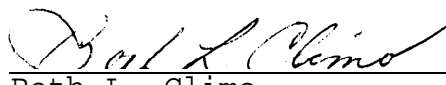
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5. The creation of the CMO structure was tax driven and helped eliminate the prepayment risk associated with pass-through securities. The traditional pass-through security used grantor trust tax laws in order to pass-through the income from the mortgages to the certificate holders. However, a pass-through security could not be structured in different tranches because it would require the managerial efforts of the issuer/servicer of the mortgages, which would forfeit the special grantor trust pass-through tax treatment. The inability to structure pass-through securities in levels of tranches resulted in risk that the underlying mortgages would be prepaid and the proceeds immediately passed-through to the investors.
 6. Conversely, the fact that CMOs are structured as a secured financing arguably leads to the conclusion that the owner of a CMO tranche simply owns a security interest in mortgages rather than an ownership interest in such mortgages. Thus, it could be argued that the owner of a CMO does not own home mortgage loans.

... This expansion of Bank membership is intended to promote and sustain housing finance and the Banks. The Committee believes that the extension of membership to insured commercial banks and credit unions that engage in mortgage lending will strengthen the Banks and their ability to support the mortgage market.'

Thus, including CMOs in the 10% eligibility requirement for membership is consistent with Congressional intent, in that the institutional investors are promoting and sustaining housing finance. In addition, investing in CMOs is a form of mortgage lending. The funds invested are used to extend additional mortgage loans to borrowers.

The proposed membership regulations provide that CMOs will be included in the 1% minimum membership stock purchase. It is important to provide consistency in defining terms under the Bank Act. In fact, it would be inconsistent and unfair to exclude CMOs for the purposes of membership eligibility, but include them in calculating the amount of stock required to be purchased. Furthermore, the draft advances regulations allow CMOs as eligible collateral for advances. The Banks incur more risk by accepting CMOs as collateral than they do by allowing an applicant to include them in calculating its eligibility for membership.

Thus, we believe that CMOs may be considered residential loans for the purposes of the 10% membership eligibility requirement under section 4(a)(2)(A) of the Bank Act. Therefore, _____ National may include CMOs in its calculation of the 10% test for membership.


Beth L. Climo
General Counsel

7. Joint Explanatory Statement of the Committee of Conference, H.R. Conf. Rep. No. 222, 101st Cong., 1st Sess. 428 (1989).