



Federal Housing Finance Board

October 20, 1992

MEMORANDUM

TO: Beth L. Climo
General Counsel

THROUGH : Renie Y. Grohl *RYS*
Deputy General Counsel

FROM: Charles Szlenker

SUBJECT: Authority for Federal Home Loan Banks to Pledge
collateral Pursuant to Interest Rate Swap

ISSUE:

Does the Federal Home Loan Bank Act ("Bank Act"), or a Federal Housing Finance Board ("Finance Board") regulation or policy, authorize the Federal Home Loan Banks ("FHLBanks") to pledge and deliver collateral to a counterparty to secure an obligation under an interest rate swap?

CONCLUSION:

There is implied authority in the Bank Act, for a FHLBank to pledge and deliver collateral to a counterparty under an interest rate swap arrangement, as incident to its power to do interest rate swaps, otherwise permitted by Finance Board policy.

DISCUSSION:

1. Introduction

Dana Yealy of the FHLBank of Pittsburgh has inquired whether the FHLBank may pledge collateral to secure its obligations under an interest rate swap agreement pursuant to the Federal Home Loan Bank Act ("Bank Act") or Finance Board rules, regulations or policies. A prospective counterparty for an interest rate swap transaction requests this information. Mr. Yealy notes that the Finance Board's recently updated Funds Management Policy permits a FHLBank to receive collateral pledged by a counterparty to a swap arrangement but is silent on whether the FHLBanks can likewise pledge and deliver their collateral.

2. Background

An interest rate swap is usually a contractual arrangement between a financial institution holding a fixed rate debt or asset and one holding a variable rate debt or asset. For instance, the institution with the fixed interest rate asset agrees to exchange

the interest paid on its asset for the interest paid on the variable rate asset, and vice-versa. Each institution in effect transforms its asset from one type (e.g. fixed rate) to another type (e.g. floating rate). The interest rate swap can also involve exchanging interest rates on debt held by the respective institutions. See FED. RES. BANK, RICHMOND, INSTRUMENTS OF THE MONEY MKT. at 122-23 (T.Q. Cook & T.D. Rowe, 6th ed. 1986).

3. Regulatory authority

a. Finance Board policy

No Finance Board regulation or resolution addresses the issue of a FHLBank pledging its collateral as part of an interest rate swap. Moreover, no former Federal Home Loan Bank Board ("FHLBB") resolution or legal memoranda has addressed this specific issue.

However, there is precedent for the authority to engage in interest swaps, generally. A former FHLBB General Counsel found implied authority under the Bank Act for a FHLBank to be an intermediary for interest rate swaps arranged by its members. See OP. Gen. Couns. FHLBB "Interest Rate Swaps" (Feb. 16, 1984). He noted that section 11(a) permitted a FHLBank to do all things necessary for carrying out the [Bank Act]" 12 U.S.C. § 1431(a) (Supp. I 1989). The Finance Board, as the FHLBB's successor, uses such opinions as guidance.

Furthermore, this agency's Financial Management Policy permits interest rate swaps to control interest rate risk. See FHFBB Res. No. 91-214 (June 25, 1991). It also permits the FHLBanks to receive pledged collateral from countersigning parties in some circumstances, but it likewise fails to address the issue of a FHLBank pledging its collateral under a swap arrangement.

b. Bank Act

In order for the agency to permit the FHLBank of Pittsburgh to pledge its collateral pursuant to an interest rate swap, there must be either precise authority for this, or some other express authority to which such pledge may be deemed "incidental." See generally ADAPSO v. FHLBB, 568 F.2d 478 (6th Cir. 1977).

There is no provision in the Bank Act, or any other act affecting the FHLBank System, expressly permitting a FHLBank to pledge collateral under an interest rate swap arrangement. However, section 11(a) of the Bank Act can be construed to permit interest rate swap arrangements and the pledge of collateral can be interpreted as incident to the authority to engage in interest rate swap arrangements.

"Necessary" power

The Bank Act permits the FHLBanks "to do all things necessary for carrying out the [Bank Act]." 12 U.S.C. § 1431(a) (Supp. I 1989) ¹ It further makes all FHLBank powers subject to Finance Board approval. *Id.* at § 1432(a). The Finance Board has interpreted the Bank Act as permitting the FHLBanks to undertake interest rate swap agreements. ¹ This interpretation does not appear to be inconsistent with the Bank Act and appears to be an activity that falls within the scope of a FHLBank's "necessary" powers granted by the Bank Act.

The Bank Act also permits a FHLBank to do all things incident to the powers granted in the Bank Act. *Id.* at § 1431(a). ² Since the Finance Board, as the regulatory overseer of the FHLBanks, permits the use of interest rate swap arrangements, the FHLBank of Pittsburgh has implied authority to pledge its collateral to a countersigning party under a swap arrangement if it deems a pledge appropriate to accomplish the swap arrangement. ³

C. Finance Board approval

It should be pointed out that the legal authority to engage in an interest rate swap arrangement that involves a pledge of FHLBank collateral to a countersigning party is not an absolute

1. It has been recognized that Congress may empower regulators with discretion to permit newly developed financial activities for lending institution & under existing banking laws in lieu of constantly amending the latter. *Cf. A. G. Becker, Inc. v. Bd. of Gov. FRS*, 693 F.2d 136, 138-39 (D.C. Cir. 1982).

2. A liberal interpretation of FHLBank implied powers incident to an interest rate swap arrangement is consistent with the views of the supporters of a Financial Institutions Reform, Recovery and Enforcement Act of 1989 provision amending the Bank Act on FHLBank incidental powers. Supporters of that 1989 amendment to the Bank Act urged broader implied powers for the FHLBanks. See 135 Cong. Rec. H4994 (daily ed., Aug. 3, 1989) (remarks of Rep. Garcia).

3. The Bank Act permits the FHLBanks "all such incidental powers, not inconsistent with the provisions of [the Bank Act] as are customary and usual in corporations generally." 12 U.S.C. § 1432(a) (Supp. I 1989). A pledge is not inconsistent with the Bank Act since pledges by FHLBanks are not banned except when FHLBank consolidated debentures are outstanding. See *id.* at § 1431(b). The consolidated debentures have not been issued since 1945.

right of the FHLBanks. All powers legally enjoyed by the FHLBanks, whether expressed or implied, are subject to the approval of the Finance Board. Id. at § 1432(a). Accordingly, the Finance Board, as the regulatory overseer of the FHLBanks, may limit or deny this authority by amending its Financial Management Policy or otherwise by resolution or regulation.