



FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2013 - 10

**COLLATERALIZATION OF ADVANCES AND OTHER CREDIT PRODUCTS;
PERFECTION AND CONTROL OF COLLATERAL**

This Advisory Bulletin (AB-2013-10) applies only to the Federal Home Loan Banks.

PURPOSE

The Federal Home Loan Bank Act, as amended (the Bank Act), requires that each advance to a member or housing associate from a Federal Home Loan Bank (FHLBank) be fully secured. The regulations of the Federal Housing Finance Agency (FHFA) further require that each FHLBank execute a written security agreement with each borrowing member that, at a minimum, gives the FHLBank a “perfectible” security interest in the pledged collateral and allows an FHLBank to perfect its security interest at any time.¹ These and other provisions of the regulations recognize that each FHLBank generally may determine how and when to perfect its security interest. Depending on the particular circumstances, however, such as the financial condition of the member, the type of member, or the nature of the collateral, safety and soundness considerations may dictate that an FHLBank take steps beyond those minimal steps required by the regulations to ensure that it will have access to the collateral in the case of default. This advisory bulletin communicates FHFA’s expectations on credit risk management practices that ensure FHLBank advances remain “fully secured,” as required by statute, relative to perfection and control of collateral, when accepting particular types of collateral. FHFA examiners will consider these

¹ 12 C.F.R. § 1266.2(b)(3), § 1266.9(a)(3).

practices when assessing how the FHLBanks obtain and perfect their security interests in collateral.

ISSUE

Perfection and Control of Security Interests in Collateral

The manner in which an FHLBank obtains and perfects its security interest is governed by the Uniform Commercial Code (UCC), as enacted by the laws of the appropriate state. As a matter of practice, most FHLBanks allow members to pledge collateral in three ways: (1) by a blanket lien, in which the security interest attaches to particular categories of a member's balance sheet assets; (2) by a listing arrangement, in which a member lists specific assets that are pledged to secure its advances; or (3) by delivery, in which the member delivers the collateral to the FHLBank or its custodian. An FHLBank can perfect its security interest in any securities collateral or loan collateral by filing a UCC-1 financing statement in the appropriate jurisdiction, regardless of whether the collateral has been pledged via a blanket lien, listing, or delivery.

In most cases, a security interest that has been perfected by filing will be enforceable against third parties who assert a competing interest in the collateral, including a receiver or bankruptcy trustee and other creditors of the failed member. However, for both whole loan collateral and securities collateral, the UCC provides alternative methods of perfection that give a secured creditor a perfected security interest that is superior to the security interests of nearly all other competing creditors, including those who have perfected their security interests through filing. An FHLBank can obtain such as a "first-priority" perfected security interest in mortgage loan collateral by obtaining possession of the promissory notes, and in securities collateral by acquiring "control" of securities through one of the methods specified in the UCC. In nearly all circumstances, an FHLBank that obtains a first-priority perfected security interest will have placed itself in the most secure possible position with respect to the pledged collateral.

BACKGROUND

Mortgage Loan Collateral

Under the UCC, a secured lender can perfect its security interest in mortgage loans (including those secured by residential or commercial real estate) either by filing a UCC-1 financing statement that describes the notes that are subject to the security interest or by taking possession of the promissory notes. While either approach would result in the FHLBank being "fully secured" for purposes of the FHFA regulations, taking possession of the notes provides the highest level of protection for an FHLBank. An FHLBank that perfects its security interest through possession generally will have a security interest that is superior to those of all competing creditors, including those who had perfected their security interest in the same notes through filing before the FHLBank took possession of the notes. In most cases, possession of the notes will give an FHLBank a first-priority security interest even if it knows of a prior UCC-1 filing by another creditor for the same collateral. Possession of the promissory notes also

protects an FHLBank by preventing a member from selling loans that are pledged to the FHLBank as collateral for advances.

Investment Securities Collateral

The UCC provisions regarding security interests in investment securities differ depending on whether the beneficial owner holds the security directly as the owner of record on the books of the issuer or indirectly through a custodian, broker, or other securities intermediary. The UCC refers to an investment security that is held directly as a “security,” which may be either “certificated” or “uncertificated.” The UCC refers to an interest in a security that is held indirectly through a securities intermediary as a “security entitlement,” and to the person having the security entitlement as the “entitlement holder.” Most securities collateral pledged by FHLBank members will be in the form of “security entitlements,” rather than in the form of “certificated securities” or “uncertificated securities.”

A secured party may perfect its security interest in each of these types of securities collateral either by filing a UCC-1 financing statement or by obtaining “control” of the securities collateral through one of the methods specified in the UCC. Either approach would result in an FHLBank being “fully secured” for purposes of the FHFA regulations. However, for safety and soundness purposes, FHLBanks should not rely solely on a UCC-1 filing to be “fully secured.” Instead, the FHLBank should take “control” of the securities collateral, creating a first-priority security interest in the collateral that is senior to those of all competing creditors.

Generally speaking, an FHLBank may obtain control of a security entitlement by becoming the “entitlement holder” or by entering into a “control agreement” with the member and its securities custodian. An FHLBank can become the entitlement holder of a member’s security entitlements by requiring the member to transfer them to the FHLBank or to the FHLBank’s account with its securities custodian. An FHLBank that allows a member to keep the securities collateral with its own securities custodian may obtain control of that collateral by entering into one or more agreements with the member and the member’s securities custodian, under which the member authorizes the FHLBank to direct the custodian to liquidate the collateral without further consent of the member; the member authorizes the custodian to follow the FHLBank’s directions; and the custodian agrees to follow the FHLBank’s directions.

Because security entitlements are intangible and can be transferred electronically, the main risks to an FHLBank that does not obtain control of such securities collateral is that the member may later sell the collateral or pledge it to another creditor. If a subsequent creditor were to obtain control of the collateral, the FHLBank’s claim would likely be subordinate to that of the other creditor.

Priority of Security Interests

The UCC includes provisions to determine the respective priorities among the claims of competing creditors to the same collateral. A perfected security interest will always have priority over an unperfected security interest, regardless of the method of perfection. Among

security interests that have been perfected in the same manner, priority is determined by the order in which the secured creditors perfected their respective security interests. Among security interests that have been perfected by different methods, a security interest that has been perfected by the means required to obtain a first-priority security interest will have priority over security interests that have been perfected in a different manner. Thus, an FHLBank that perfects its security interest in mortgage loan notes through possession, or that perfects its security interest in securities collateral by control, generally will have a security interest that is superior to all unperfected security interests and security interests that have been perfected solely by filing.

GUIDANCE

Credit Management Practices for Mortgage Loan Collateral

In the case of whole mortgage loan collateral, an FHLBank should obtain and perfect its security interest in the manner that the FHLBank determines to be most appropriate to protect its financial interests, given the financial condition of the borrowing member. If a member's financial condition deteriorates to a point where an FHLBank believes that the member may soon default or fail, then the FHLBank should consider whether it would be appropriate to obtain possession of the collateral.

While the securities industry has developed an electronic recordkeeping and transfer system that allows an FHLBank to "control" member securities collateral with relative ease, ownership and transfer of mortgage loans is still evidenced in most cases through a physical promissory note. Because of the large volume of mortgage notes needed to secure FHLBank advances, taking possession of and monitoring a member's mortgage loan collateral is a cumbersome process. Most FHLBanks, therefore, have concluded that the additional safety provided by the possession of whole loan collateral does not in many cases justify the time and expense involved in obtaining possession of the notes. Indeed, the "lien priority" provision of Section 10(e) of the Bank Act was enacted, in part, to give the FHLBanks the equivalent of an automatic perfected security interest in advances collateral at a time when possession was the only method through which a creditor could perfect its security interest in promissory notes under the UCC. That lien provision has been of less benefit to the FHLBanks since 2001, when the UCC was amended to permit a creditor to perfect its security interest in promissory notes through filing. Despite the existence of that statutory priority, most FHLBanks also file a UCC-1 for all pledged whole loan collateral. That is an important practice to resolve any question of priority between an FHLBank and a competing secured creditor who files a subsequent UCC-1.

FHFA expects each FHLBank to have established procedures and criteria to determine whether it will take physical possession of whole loan collateral, including but not limited to commercial real estate (CRE) loan collateral, in a particular situation. These criteria may include, for example, the financial condition of the member, the extent of advances borrowings, the nature of the member's collateral, the use of other forms of secured borrowing by the member, whether the FHLBank has a blanket lien on all or most of the member's assets, the size of the loan, and the extent to which the FHLBank is granting a member borrowing capacity against such collateral. A decision by an FHLBank not to take possession of the underlying CRE loan promissory note

for any particular member should be consistent with its credit and collateral risk management policies, procedures, and practices, which should include provisions for managing the risks inherent in high-balance loans, such as CRE loans.

Credit Management Practices for Investment Securities Collateral

Because of the significant benefit of a first-priority security interest and the relative ease through which an FHLBank can take a first-priority security interest in securities collateral through electronic “control” of the securities, an FHLBank should in all instances obtain “control” of securities collateral when granting a member borrowing capacity against this form of collateral. Such action would be further warranted by the fact that securities and “security entitlements” may be more easily transferred or pledged to another creditor than other types of collateral. FHFA examiners will assess the extent to which an FHLBank has obtained a first-priority perfected security interest in securities collateral pledged by its members.

Examiners will review policies, procedures, and practices when examining the FHLBanks’ collateralization of advances and other credit products. Each FHLBank should maintain documented analysis to support decisions regarding actions to perfect and control collateral.

Advisory bulletins communicate guidance to FHFA supervision staff and the regulated entities on specific supervisory matters pertaining to the Federal Home Loan Banks, Fannie Mae, and Freddie Mac. This bulletin is effective immediately upon issuance. Contact Joseph A. McKenzie, Associate Director, Bank Analysis Branch, at Joseph.McKenzie@fhfa.gov or (202) 649-3270, or Kari Walter, Senior Associate Director, Office of Supervision Policy, at Kari.Walter@fhfa.gov or (202) 649-3405, with comments or questions pertaining to this bulletin.