Federal Housing Finance Board

Memorandum

May 7, 1991

TO: J. Stephen Britt
Executive Director

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FROM: Beth L. Climo
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SUBJECT: Legal Issues Raised By Draft Community Support Regulations

ISSUES:

1. Whether Federal Home Loan Bank ("FHLBank") incentive programs, as proposed in section 936.7(a) of the draft community support regulations, would violate the fair and impartial treatment and nondiscrimination requirements of section 7(j) of the Federal Home Loan Bank Act ("Bank Act"). 12 U.S.C.A. § 1427(j).

2. Whether the proposal for Federal Housing Finance Board ("Finance Board") review of members' compliance with action plans in section 936.8(h) of the draft community support regulations would constitute Finance Board involvement in individual member credit decisions beyond the scope of the Finance Board's authority under the Bank Act.

CONCLUSION:

For the reasons set forth below, we conclude that the two proposed community support provisions would not violate the requirements of the Bank Act.

DISCUSSION:

I. Proposed Section 936.7(a) -- Incentive Programs

A. Bank Act Section IO(g) - Community Support Requirement

Under section 10(g) of the Bank Act, as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the Finance Board is required to "adopt regulations establishing standards of community investment or service for members of [FHL]Banks to maintain continued access to long-term advances." 12 U.S.C.A. § 1430(g)(1). Section 936.7(a) of the draft community support regulations, which would implement section 10(g), provides that:

> Each [FHL]Bank shall adopt, subject to Finance Board review and approval, an incentive program for community support by members. The community support incentive program shall include discounts and/or preferred terms on long-term advances, except Affordable Housing Program advances, for members with outstanding records of community support.

The question arises whether this provision violates section 7(j) of the Bank Act, which provides that each FHLBank's "board of directors shall administer the affairs of the [FHL]bank fairly and impartially and without discrimination in favor of or against any member borrower . . . ." 12 U.S.C.A. § 1427(j).

The plain language in section 10(g) suggests that only FHLBank members meeting certain established standards of community investment or service should be entitled to continued access to long-term FHLBank advances. Thus, the statute itself seems to contemplate that members be treated differently depending on their records of community investment or service.[1] In addition, the recent enactment of section 10(g), subsequent to the enactment of section 7(j), suggests that Congress intended section 10(g) to supersede, or at least to apply coequally with, section 7(j).

B. The FHLBanks Have Broad Discretionary Authority To Approve Or Deny Advances Under Incentive Programs

Sections 9 and 10(a) of the Bank Act confer broad authority on the FHLBanks to make advances to members. Id. at §§ 1429, 1430(a); see Fidelity Financial Corporation v. Federal Home Loan Bank of San Francisco, 792 F.2d 1432, 1436 (9th Cir. 1986), cert. denied, 479 U.S. 1064 (1987). Section 9 of the Bank Act provides

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1. No discussion of disparate or discriminatory treatment of members for purposes of section 10(g) was found in the legislative history of that section.

that any member of a FHLBank is entitled "to apply . . . for advances," and the FHLBank "may at its discretion deny any such application, or, subject to the approval of the Board, may grant it on such conditions as the . . . [FHL]Bank may prescribe." 12 U.S.C.A. § 1429. Section 10(a) states that "[e]ach . . . [FHL]Bank is authorized to make secured advances to its members upon collateral sufficient, in the judgment of the [FHL]Bank, to fully secure advances obtained from the [FHL]Bank . . . ." Id. at § 1430(a).

The requirement in the draft community support regulations that the FHLBanks establish incentive programs is in accord with this broad discretionary authority afforded the FHLBanks under the Bank Act to make advances to members. In fact, section 940.1(a) of the Finance Board's policy guidelines for FHLBank advances states generally that "the [FHL]Banks should offer to all members as wide a range of advances programs as is prudent and profitable." 12 C.F.R. § 940.1(a).

Pursuant to this broad authority to make advances to members, the FHLBanks over the years have established incentive programs designed to encourage members to take full advantage of the FHLBanks' financial products and to reward loyal and committed FHLBank customers. For example, the San Francisco FHLBank currently administers a volume discount loan program. That program allows reduced rates on loans that are in excess of a designated percentage of assets for members meeting certain financial viability standards.[2] A similar type of discount loan program might be adopted by the FHLBanks under proposed section 936.7(a) of the community support regulations. Under such a program, the FHLBanks could offer reduced loan rates for members that finance more than a certain percentage of assets with community support advances.

While the FHLBanks have very broad discretionary authority in making advances to members, that authority is limited by several restrictive provisions of the Bank Act, Finance Board regulations and FIRREA amendments. However, none of these limitations -- including the nondiscrimination requirements of section 7(j) of the Bank Act that are discussed further below -- would appear to constrain the FHLBanks' authority to establish incentive advances programs under section 10(g).

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2. In order to be eligible for the program, members must meet regulatory core and tangible capital requirements, as well as other financial viability standards deemed appropriate by the FHLBank. Eligible members that finance more than 10 percent of assets with advances receive loan rates reduced by 10 basis points on all advances exceeding the 10 percent-of-assets threshold.

For example, section 10(c) of the Bank Act restricts the ratio of advances to capital stock that may be held by a member. 12 U.S.C.A. § 1430(c). Section 935.1(b) of the Finance Board regulations sets forth the reduced eligibility of members who are not qualified thrift lenders to receive advances. 12 C.F.R. § 935.1(b). Section 935.6 limits advances to members to a maximum term of 20 years. Id. at § 935.6. Section 935.3 delegates to the FHLBanks' boards ofdirectors the Finance Board's authority to determine interest rates on FHLBank advances under section 10(c), within a range set by the Finance Board. Id. at §§ 935.3, 940.5; 12 U.S.C.A § 1430(c).

In addition to the section 10(g) community support requirements, FIRREA placed other new qualifications on FHLBank advances. Section 10(i) of the Bank Act requires the FHLBanks to establish community investment programs providing advances to members for community-oriented mortgage lending that are priced generally at the cost of funds. 12 U.S.C.A. § 1430(i). New section 10(j) requires the FHLBanks to establish, pursuant to Finance Board regulations, an Affordable Housing Program that subsidizes the interest rates on advances to members engaged in interest rate-subsidized lending for long-term, low- and moderate-income, owner-occupied and affordable rental housing. Id. at § 1430(j).

The only other limitations on the FHLBanks' discretionary authority over advances are the Finance Board's general policy guidelines for FHLBank advances, see 12 C.F.R. Part 940, and the requirement in section 7(j) of the Bank Act that each FHLBank's board administer the affairs of the FHLBank fairly and impartially and without discrimination in favor of or against any member borrower. 12 U.S.C.A. § 1427(j).

C. Incentive Programs Are Not Discriminatory

1. Standard of Conduct Under Section 7(j)

The terms "fairly," "impartially" and "discrimination" in section 7(j) are not defined in the Bank Act or Finance Board regulations. In addition, no legislative history interpreting these terms has been located. See San Francisco FHLBank Memorandum from W.K. Black to J.A. Cardamone (May 23, 1988) ("San Francisco FHLBank Memorandum"); Federal Home Loan Bank Board ("FHLBB") G.C. Op. (June 30, 1966).[3] Only one case addressing section 7(j), the Fidelity decision from the Ninth Circuit, was found. In Fidelity, the court stated that the FHLBanks have broad discretionary authority under the Bank Act to deny or condition advances, and 'section 7(j) simply requires that the [FHL]Bank's board of directors exercise its discretion prudently in making advances." 792 F.2d at 1436.

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3. The language of section 7(j) has not changed since the G.C. Op. was issued in 1966.

a. Nondiscrimination Requirement

Judicial decisions construing the meaning of discrimination in the context of other statutes are useful in interpreting the standard to be applied under section 7(j). A brief analysis of the case law[4] indicates that mere classification of individuals or organizations by itself is not discriminatory, if it is associated with a rational, justified and noninvidious purpose. See, e.g. Washington v. Davis, 426 U.S. 23 (1976).

For example, discrimination for purposes of certain antitrust statutes has been defined as "the act of unfairly, injuriously and prejudicially distinguishing between persons or objects, where economically speaking a sound and fair distinction does not exist." Morton Salt Co. v. Federal Trade Commission, 162 F.2d 949 (7th Cir. 1947), rev'd on other grounds, 334 U.S. 37 (1948). In defining discrimination in the civil rights context, another court stated:

> Discrimination is a term well understood in the law. It is in general a failure to treat all persons equally where no reasonable distinction can be found between those favored and those not favored.

Baker v. California Land Title Company, 349 F. Supp. 235, 238 (C.D. Cal. 1972), aff'd, 507 F.2d 895 (9th Cir. 1974), cert. denied, 422 U.S. 1046 (1975).

Thus, the nondiscrimination standard of section 7(j) does not require that members be treated in identical fashion, as long as any disparate treatment is based upon rational and legitimate purposes. This rational basis standard was recognized by the FHLBB's Office of the General Counsel ("OGC') in various opinion letters. The opinions state that section 7(j) requires the FHLBanks to administer their advances programs "in accordance with standards of eligibility that do not impose an arbitrary or capricious classification or lack rational justification." See, e.g. FHLBB G.C. Op. (Oct. 25, 1982).

This standard comports with the standard of judicial review used by courts in reviewing agency regulations. The courts generally are deferential to an agency's interpretation of a statute if the subject matter is within the agency's specialization. See Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984); K. Davis, Administrative Law Treatise (2d ed. 1979) ("Treatise") § 7:22. Thus, it is reasonable to assume that the courts would defer to the Finance Board's interpretation of section 10(g) and other provisions of the Bank Act as authorizing it to establish community support

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4. An exhaustive analysis of the case law interpreting the discriminatory impact of classifications of individuals or organizations is beyond the scope of this memorandum.

incentive programs. The promotion of the FHLBanks' housing finance mission clearly is within the Finance Board's scope of responsibilities and expertise.

An agency's regulations may be set aside by a court only if they are found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." See 5 U.S.C. § 706. The essence of the "arbitrary and capricious" scope of review is the requirement that the rules be reasonable or rational. See Chevron, 467 U.S. 837; Treatise at § 6:6.

b. Fair and Impartial Treatment Requirement

The requirement under section 7(j) that the FHLBanks' boards administer the affairs of the FHLBanks "fairly and impartially" suggests that not only must classifications be reasonable and nondiscriminatory, but board members' motives in taking the actions must be proper. See FHLBB G.C. Op. (June 30, 1966). Thus, an action of a FHLBank's board might be invalidated, even though apparently reasonable, if improperly motivated. Id. An example of such a case might be where a FHLBank's board takes action against a group of members which, though not wholly unreasonable, was unnecessary and intended to enable their competitors to obtain some competitive advantage. Id.

2. Incentive Programs Are Reasonable and Properly Motivated

The determination whether nondiscriminatory or fair and impartial treatment occurs in connection with a particular advance program depends upon the facts and circumstances involved. See FHLBB G.C. Op. (March 31, 1976). The issue arises in the context of the proposed incentive programs because different borrowers may pay varying interest rates for the same type of advance depending on their community support records.

The establishment of community support incentive programs is a reasonable and rational method for encouraging members to meet their community support obligations, as required by section 10(g) of the Bank Act. Under the draft regulations, the proposed incentive programs would be available to all members of the FHLBank System. In order to participate in the programs, members would have to achieve outstanding records of community support lending. The decision whether or not to participate in the programs would be within the discretion of each member. Those members that seek to take advantage of the special programs will have to maintain outstanding community support records. Those institutions that do not make such efforts will not be eligible for the special long-term advances. It is simply a matter of choice on the part of each member whether to undertake voluntarily the community support actions necessary to participate in the programs.

In short, the proposed incentive programs are reasonable and rational programs furthering the section 10(g) purpose of promoting community support lending. In addition, the FHLBanks would be properly motivated in establishing such programs as they are designed to encourage the legitimate purpose of community support lending by members pursuant to the requirements of section 10(g) and the community support regulations. Accordingly, the proposed incentive programs would not discriminate in favor of or against any member borrower, and would treat members fairly and impartially, in compliance with the requirements of section 7(j). It is unlikely, therefore, that a court would overturn the incentive provisions of the proposed regulations under the arbitrary and capricious standard of review,

3. FHLBB General Counsel Opinions Interpreting FHLBank Special Advances Programs

A number of FHLBB General Counsel Opinions interpreting the applicability of section 7(j) to FHLBank special advances programs have determined that legitimate economic and business purposes justify the FHLBanks' distinctions among member borrowers. For example, in a 1982 Opinion, the OGC examined a proposal for creation of a category of long-term advances used only for Federal Savings and Loan Insurance Corporation ("FSLIC")-negotiated transactions, with repayment fully guaranteed by the FSLIC. FHLBB G.C. Op. (Oct. 25, 1982). The purpose of the proposal was to provide advances to members that acquired FSLIC cases with more favorable terms and less stringent collateral requirements than those afforded other FHLBank members. The Opinion concluded that the special advances program would not on its face violate the nondiscrimination provision of section 7(j), even though all members might not be eligible to participate. Id.

A 1966 Opinion determined that section 7(j) would not be violated by a FHLBB variable interest rate policy, to be enforced by the FHLBanks, under which higher rates would be charged on expansion advances than on withdrawal advances. FHLBB G.C. Op. (June 30, 1966). The Opinion reasoned that since the FHLBank System was established to provide a source of liquidity for eligible institutions, and there was a short supply of money at the time, charging higher interest rates for expansion advances than withdrawal advances would not impose a "patently arbitrary classification, utterly lacking in rational justification." Id.; see also FHLBB G.C. Op. (March 31, 1976) (program of auctioning of FHLBank advances not discriminatory under section 7(j) if purpose of program was the legitimate goal of allocating limited funds; program was discriminatory if purpose was to "squeeze-out" less sophisticated investors and smaller institutions); San Francisco FHLBank Memorandum (proposed credit risk adjusted pricing program, under which FHLBank members posing smaller credit risks would receive more favorable terms on advances, not discriminatory under section 7(j)).

Thus, the analyses in the FHLBB G.C. Opinions support the position that the proposed incentive programs in the community support regulations would not violate the nondiscrimination provision of section 7(j).

4. Standards Applicable to the Finance Board

The question also arises whether the Finance Board, in requiring the FHLBanks to adopt incentive programs subject to Finance Board approval, could be opening itself up to charges of discrimination under section 7(j). However, section 7(j) by its terms applies only to the boards of the FHLBanks, and not to members of the Finance Board. See FHLBB G.C. Op. (June 30, 1966).[5] Even if section 7(j) were applicable to the Finance Board, the same arguments and rationales discussed above with regard to the FHLBanks' incentive programs would apply equally to the Finance Board in authorizing such programs.

The Finance Board, however, would be subject to the due process clause of the fifth amendment, which embraces the requirements of equal protection. Where economic regulation is involved, the courts scrutinize economic classifications only with the greatest deference by analyzing whether the classification is so "patently arbitrary" and "utterly lacking in rational basis" that the court cannot conceive of any possible legitimate basis for its adoption. See U.S. Railroad Retirement Board v. Fritz, 449 U.S. 166, 177 (1980); Fidelity Financial Corp. v. Federal Home Loan Bank of San Francisco, 589 F. Supp. 885 (N.D. Cal. 1983), aff'd, 792 F.2d 1432 (9th Cir. 1986), cert. denied, 479 U.S. 1064 (1987).

An exhaustive analysis of the equal protection standard of the fifth amendment is beyond the scope of this memorandum. However, application of the above-mentioned standard to the proposed incentive programs suggests that the Finance Board would not be violating the equal protection clause by requiring the FHLBanks to establish such programs. As discussed earlier, the

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5. But see FHLBB G.C. Op. (Oct. 25, 1982) at n.6 (stating that although section 7(j) does not mention the FHLBB, the FHLBB's supervisory role over the FHLBanks arguably makes section 7(j) applicable to any advances program established by the FHLBB or by the FHLBanks with the FHLBB's express knowledge).

incentive programs are a reasonable and legitimate method for encouraging members to engage in community support lending.[6]

II. Proposed Section 936.8(h) -- Finance Board Review of Member Compliance With Action Plans

Section 936.8(h) of the draft community support regulations provides that:

> The decision to permit a member subject to an action plan unlimited access to long-term advances shall be a joint decision of the [FHL]Bank and the Finance Board based on a review of the member's record of community support, including loan products and originations.

The question arises whether this provision would involve the Finance Board in individual member credit decisions beyond the scope of the Finance Board's general supervisory authority over the FHLBanks under the Bank Act. See 12 U.S.C.A. §§ 1422a(a)(3); 1422b(a)(l).

The Finance Board's review of members' community support lending records is a reasonable and rational means for ensuring members' compliance with their action plans. The review would take place after the fact (i.e., after the member already has made loans). This is similar to the role of bank and thrift examiners in reviewing the lending records of institutions they examine to determine compliance with agency lending requirements and policies. Thus, the Finance Board would not be involved in directing the individual credit decisions of the members.

The argument could be made that by determining that a member has not complied with its action plan, the Finance Board is directing how the member should lend in the future in order to satisfy the plan -- thereby becoming involved in the member's individual credit decisions. However, the Finance Board would not prescribe the specific terms or conditions of such loans, or the identities of the borrowers. The Finance Board merely would be approving the general parameters set forth in the plan for the types of lending that will satisfy the community support requirement.

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6. In addition, the Ninth Circuit held in Fidelity that a member did not have a fifth amendment due process right against the San Francisco FHLBank for denial by the FHLBank of a regular credit advance to the member because, even assuming such action by the FHLBank was government action, the member did not have a protectable property interest in receiving regular credit advances from the FHLBank. 792 F.2d at 1435-36. Thus, a Finance Board requirement that the FHLBanks establish incentive programs that may deny advances to members most likely also would not be a violation by the Finance Board of the fifth amendment due process clause.

In short, the proposed Finance Board review of members' community support lending records is a reasonable and rational means for ensuring member compliance with action plans, and would not involve the Finance Board in individual member credit decisions beyond the scope of the Finance Board's authority under the Bank Act. Accordingly, it is unlikely that a court would overturn the review provisions of the proposed regulations under the arbitrary and capricious standard of review.

CONCLUSION:

The provision for FHLBank incentive programs in the draft community support regulations would not violate the fair and impartial treatment or nondiscrimination requirements of section 7(j) of the Bank Act, 12 U.S.C.A. § 1427(j). In addition, the proposal for Finance Board review of members' compliance with action plans would not involve the Finance Board in individual member credit decisions beyond the scope of the Finance Board's authority under the Bank Act.

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