Federal Housing Finance Board

Memorandum

August 27, 1991

TO: Philip L. Conover
Director, District Banks Directorate

FROM : Beth L. Climo
General Counsel

SUBJECT: Treatment of Participation Transactions Proposed Under the Master Participation Agreement

ISSUE:

Whether participation of advances among the Federal Home Loan Banks (FHLBanks) proposed under the Master Participation Agreement (MPA) may be treated as sales transactions, divesting the transferor FHLBank of ownership in the advance; or whether such participations must be treated as financing transactions, which do not divest the transferor FHLBank's ownership interest.

CONCLUSION:

While the proposed MPA contains many features of a sales transaction, the absence of a ratable share of loss may not be deemed sufficient to effect a sale, rather than a financing. If the proposed MPA is revised to provide for a pro rata loss sharing, the MPA clearly would effect a sale. Accordingly, it is for the Federal Housing Finance Board (Finance Board) to determine as a matter of policy whether transactions under the proposed MPA transfer ownership.

DISCUSSION:

I. BACKGROUND

The Office of the General Counsel received a letter dated May 29, 1991, from Dana A. Yealy, General Counsel of the FHLBank-Pittsburgh, requesting our opinion on whether the Finance Board will treat transactions between FHLBanks pursuant to the

proposed Master Participation Agreement[1] as sales, rather than financings.

As discussed below, this opinion concludes that: (1) Participation transactions under the MPA may not be sufficient to divest the transferor FHLBank of ownership in an advance because the MPA does not transfer a ratable share of the risk of loss associated with the advance; (2) If the MPA were to provide in all cases for the transfer of a ratable share of the risk of loss associated with an advance, the MPA transactions clearly would effect a transfer of ownership in the advance; and (3) The Finance Board may decide as a matter of policy whether MPA transactions that do not shift a pro rata share of the risk effect a transfer of ownership in the advance.

II. THE FHLBANKS ARE AUTHORIZED TO TRANSFER OWNERSHIP OF THEIR ADVANCES TO OTHER FHLBANKS UNDER SUBSECTION 10(d) OF THE BANK ACT

A. A FHLBank Can Transfer Ownership of Its Advances to Another FHLBank by Sale or Participation

Subsection 10(d) of the Federal Home Loan Bank Act (Bank Act) authorizes any FHLBank to transfer its advances to any other FHLBank, subject to the Finance Board's approval. See 12 U.S.C.A. § 1430(d) (West Supp. 1990). Under subsection 10(d), the transfer of an advance between FHLBanks can take the form of a sale, with or without recourse, or the transferring FHLBank can "allow [the transferee FHLBank) a participation [in the advance.)" Id.; see also Spec. Couns. Mem. of Dec. 11, 1981, Dot. No. 2498 (Westlaw Private Library) at 8 n.1 (stating that since subsection 10(d) authorizes FHLBanks to participate in advances, it is clear that a FHLBank is not prohibited from holding an interest in advances that are outstanding to members of other FHLBanks). In connection with a participation in another FHLBank's advance, the FHLBank that accepts the participation must receive "an appropriate assignment of security therefor." 12 U.S.C.A. § 1430(d) (West supp. 1990).

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1. The MPA is a model contract dated May 22, 1991 whose terms govern individual loan transfer transactions (MPA transactions) between the FHLBanks that are parties to the MPA. In an MPA transaction, a FHLBank that makes an advance to a member borrower transfers part of its interest in the advance to one or more other FHLBanks. See MPA §§ 2.02, 2.06. Under the MPA, the transferor FHLBank is required to retain at least a 20 percent interest in the advance at all times and is responsible for servicing the advance. See id. §§ 3.01, 2.03. Payments of principal and interest by-the-borrower are applied first to the transferee FHLBanks on a pro rata basis and then to the transferor FHLBank. See id. § 2.06. Similarly, upon default by the borrower, the transferor FHLBank's right to repayment is subordinate to that of the transferee FHLBanks. See id. § 5.03.

B. The MPA Transactions Appear to Come Within the Definition of "Participation" Under Subsection 10(d) of the Bank Act

The MPA transactions appear to come within subsection 10(d), which states that a FHLBank can allow another FHLBank a participation in its advance. See id. The plain meaning of the term "participation" as it appears in subsection 10(d) is not clear. We have found nothing in the legislative history of subsection 10(d) that explains what type of transaction Congress intended to describe by using the term "participation."[2] Further, we have found no case law or opinions of the former Federal Home Loan Bank Board's General Counsel interpreting the term "participation" in subsection 10(d) of the Bank Act.

When a technical term appears in a statute, it is presumed to have its technical meaning, absent legislative intent to the contrary. See 2A N. Singer, Sutherland, Principles of Statutory Construction § 47.29, at 234 (Sands 4th ed. 1984). According to its technical meaning, "participation" is a financial term that refers to a transaction in which a lender makes a loan to a borrower and portions or shares of the loan are allotted to one or more other lenders. See G. Munn, F. Garcia 6 C. Woefel, Encyclopedia of Banking & Finance 796 (1991). The party that makes the underlying loan to the borrower is the "lead" lender and the parties that receive shares in the underlying loan are "participating" lenders. See id. The parties to a participation agreement can structure the allotment of the shares of the underlying loan as either a sale or a financing. See 2 R. Nimmer Commercial Asset-Based Financing § 9:10 (1988).

The MPA transactions appear to come within the technical meaning of "participation" as that term is used in subsection 10(d) because the MPA refers to loan transfer transactions between the FHLBanks that are parties to the MPA as "Participation Transactions." See MPA § 2.10. Each "Participation Transaction" involves the transfer from a lead FHLBank to one or more participating FHLBanks of a portion of the lead FHLBank's interest in an advance as well as an interest in the underlying borrower's collateral. See id. § 2.16. Thus, each MPA transaction falls within the general technical definition of participation as it is used in subsection 10(d) of the Bank Act.

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2. The current subsection 10(d) was part of the original Bank Act and has not been amended to date. See Federal Home Loan Bank Act, ch. 522, § 10(d), 47 Stat. 725, 732. (1932).

III. THE MPA TRANSACTIONS MAY NOT TRANSFER OWNERSHIP OF THE LEAD FHLBANK'S ADVANCES TO THE PARTICIPATING FHLBANKS

A. In Order for a FHLBank to Transfer Ownership of its Advances to Other FHLBanks, the Lead FHLBank Must Sell An Interest in the Advance to the Other FHLBanks

In order to transfer ownership of part of an advance pursuant to a participation transaction, the lead lender must sell an ownership interest in the advance to the participating lender. 2 R. Nimmer, supra § %9:10. When, instead, a participation transaction constitutes a loan or financing, it does not effect a transfer of an ownership interest in the advance. See id.

B. The MPA Transactions Have Some Characteristics of Sales Transactions

1. The MPA Contains Language of Sale

The MPA describes each "participation transaction" in terms of a sale transaction. A sale transaction usually involves the transfer of an ownership interest in return for consideration. See, e.g.) U.C.C. § 2-206(l) (1977) (stating, 'a 'sale' consists in the passing of title from the seller to the buyer for a price ..."). Section 2.02 of the MPA states that "the Lead Bank shall sell and the Participating Bank shall purchase . . . a Participating Interest in the Advance." A "Participating Interest" is 'an undivided pro rata ownership interest in [an advance]." MPA § 2.06. Thus, the MPA's definition of a "participation transaction" comports with the concept of a sales transaction because it provides for the transfer without recourse of an "ownership interest" from the seller to the purchaser in return for a "Purchase Amount." [3]

2. The Procedure for Servicing the Underlying Advance is Structured as if the MPA Transactions Effected a Sale of an Ownership Interest

When a participation transaction constitutes a sale of an interest in the underlying obligation, the participant's return on investment comes from the proceeds of the underlying obligation. See 2 R. Nimmer, supra § 9:l0. Under the MPA transactions, the borrower's repayments of the advance are received on a pro rata basis by the respective holders of each "Participating Interest," rather than only by the lead FHLBank. Although the lead FHLBank

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3. "Purchase Amount" is defined in section 1.01(u) of the MPA as "the amount paid by the Participating Bank for the Participating Interest as stated in the Confirmation."

collects all payments of principal and interest, it acts as a trustee of those funds that correspond to the participating FHLBanks' shares of the advance. The lead FHLBank is a fiduciary to the participating FHLBanks. See MPA § 3.01. It holds the repayments in trust and distributes them to the participating FHLBanks. See id. § 3.03. In contrast, in a financing transaction the lead bank has an ownership interest in all repayments of the advance, and the participating banks look only to the lead bank, not to the borrower, for repayment.

3. The Participating FHLBanks Do Not Have a Right of Recourse Against the Lead FHLBank

The MPA transactions are unlike loan transactions because the participating FHLBanks enter into the transactions without an express right of recourse against the lead FHLBank. According to regulations promulgated by the Office of Thrift Supervision (OTS), "with recourse means, in connection with a . . . participation interest in a loan, an agreement . . . under which the purchaser is to be entitled to receive from the seller a sum of money . . . upon default in payment of any loan involved . . . ." 12 C.F.R. § 561.55 (1991). The MPA has no provision under which the lead FHLBank, or "seller," must pay a participating FHLBank, or "purchaser," any sum in the event the borrower defaults. See MPA § 2.06. In contrast to the MPA transactions, in a loan transaction the participating lender ordinarily retains the right to collect against the lead lender should the borrower default on the underlying obligation. See 2 R. Nimmer, supra § 9:lO.

c. A Ratable Sharing of Risk May be Required to Effect a Sales Transaction

1. Authorities Differ on Whether a Sales Transaction Requires that Risk of Loss Transfer on a Pro Rata Basis

The determinant of whether a participation transaction is a sale of an ownership interest in an advance -- as opposed to a loan from the participating lender -- is whether the transaction shifts actual credit risk of the underlying obligation to the participant. See 2 R. Nimmer, supra § 9:10; In re S.O.A.W. Enter., 32 Bankr. 279 (Bankr. W.D. Tex. 1983) (holding that when a participation transaction is a sale, the participant normally assumes the same risk as that of the person selling the participation). If the participating lender does not acquire present ownership rights of all attributes of the underlying obligation, including the risk of loss on the underlying obligation, then the transaction is more a loan than a sale. See 2 R. Nimmer, supra § 9:10; P. Weil, Asset-Backed Lending, An Introductory Guide to Secured-Financing 397 (1989).

In light of the legal requirements for a participation, most financial institution regulators have determined that a participation may be a sale only if it is without recourse and if the risk of loss transfers on a pro rata basis. The banking regulators have taken the position that a participation transaction constitutes a sale of an interest in a loan only if the participating lender bears a portion of the risk of loss associated with the entire loan in direct proportion (pro rata) to its percentage interest in the entire loan.[4] However, the OTS does not require such a ratable sharing of risk and deems loans sold with recourse to be participations.[5] This divergence of views between the banking regulators and the OTS highlights the fact that a pro rata sharing of the risks is not essential to create a sale of a participation. Thus, whether or not to require a pro rata shifting of the risk of loss for FHLBank participations is a policy judgment to be made by the Finance Board.

2. The MPA Transactions Do Not Transfer the Risk of Loss Associated With the Underlying Advance on a Pro Rata Basis

In Article V, entitled "Procedures Upon Default," the MPA provides that upon default by the borrower and disposition of collateral, the lead FHLBank's rights to repayment of principal and interest are subordinated to the rights to repayment of

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4. See Office of the Comptroller of the Currency (OCC) Interp. Letter No. 256, April 4, 1983, Banking L. Rep. (CCH) ¶ 85,420 (1983-84 Tr. Binder) (stating that a loan participation is a "true" participation only if there is a pro rata sharing of market and credit risks between the seller and the participant); see also 12 C.F.R. § 32.107 (1991) (OCC regulation stating that in order to remove a loan from a bank's lending limit, a participation must result in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders); Consolidated Report of Condition and Income (Call Report Instructions) promulgated by the Federal Financial Institutions Examination Council (FFIEC) pursuant to 12 U.S.C. § 3301 (1988).

5. See 12 C.F.R. § 563c.14 (OTS regulation permitting thrift institutions to report loans sold with recourse as a participation); see also Reporting by Transferors of Receivables with Recourse, Statements of Financial Accounting Standards No. 77, § 5 (Fin. Accounting Standards Bd. 1989).

principal and interest of the participating FHLBanks. [6] The effect of section 5.03 is to place a disproportionate amount of the risk of loss on the lead FHLBank. The Office of the Comptroller of the Currency specifically addressed a participation agreement with similar terms in OCC Interp. Letter No. 256, April 4, 1983. See Banking L. Rep. (CCH) ¶ 85,420 (1983-84 Tr. Binder). The OCC stated that the inclusion of a provision in a participation agreement that, in the case of default, no payments shall be made to the lead bank until the participating bank has been fully repaid negates the sharing of credit risk, which must be present in a true participation.'

Because the MPA is structured so that in some cases the lead FHLBank's share of losses upon default is greater than its proportional interest in the underlying advance, the lead FHLBank bears a greater proportional risk of loss than the participating FHLBanks.

Since there are differences among the authorities on whether a sales transaction requires that risk of loss transfer on a pro rata basis, it is for the Finance Board to decide, as a matter of policy, whether pro rata risk of loss must transfer for the participation of a FHLBank advance pursuant to the MPA to be a sales transaction. However, if the MPA is revised to provide for transfer of a ratable share of the risk of loss associated with an advance, such MPA transactions clearly would effect a transfer of ownership in, and thus a sale of, the advance.

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6. Section 5.03 of the MPA provides that upon default by the underlying borrower, after the lead FHLBank is reimbursed for any administrative costs, see MPA § 5.03(a), the proceeds of the liquidation of the borrower's collateral are distributed in the following order: First, each participating FHLBank receives any accrued and unpaid interest that it is due from the borrower, in proportion to that participating FHLBank's share of the total accrued and unpaid interest owed to all the FHLBanks. See id. § 5.03(b). Second, each participating FHLBank receives payment of its outstanding principal balance on the advance, in proportion to that participating FHLBank's share of the total outstanding principal balance owed to all the FHLBanks. See id. § 5.03(c). Third, the lead FHLBank receives any accrued and unpaid interest that it is due from the borrower. See id. § 5.03(d). Fourth, the lead FHLBank receives its share of the outstanding principal balance on the advance. See id. § 5.03(e).

7. Although Interpretive Letter No. 256 is based in part on 12 C.F.R. § 7.1135, which was removed in 1983, the principle that "true" participations involve pro rata risk sharing is currently embodied in 12 C.F.R. § 32.107 (1991).

3. Provision for Amendment of the MPA

Even if section 5.03 of the MPA were changed to eliminate the subordination of the lead FHLBank's right to repayment upon default, there is a possibility that the FHLBanks might structure individual MPA transactions so that a disproportionate amount of the risk of loss remained with the lead FHLBank. Section 2.02 states that in individual transactions made pursuant to the MPA, the parties to the MPA may modify, amend, or waive any of its provisions as long as the change is executed by the party against whom it is asserted and pertains only to the individual transaction. See MPA § 6.02. If the FHLBanks were to amend the MPA in individual MPA transactions to include a duty of the lead FHLBank to repurchase the advance upon request of a participating FHLBank or a right of recourse against the lead FHLBank in the event of default, the risk of loss associated with each advance would remain with the lead FHLBank. Whether or not a transaction under the provision for amendment of the MPA would constitute a sale will depend on the amendment and on policy determinations made by the Finance Board.

IV. CONCLUSION:

The proposed participation transactions do not transfer a ratable share of the risk of loss associated with the advance from the lead FHLBank to the participant. If the MPA is revised to provide for transfer of a ratable share of the risk of loss associated with an advance, such MPA transactions clearly would effect a transfer of ownership in the advance. Whether such a change is required depends on whether the Finance Board adopts the approach taken by the banking regulators and FFIEC or the approach taken by the OTS and the Financial Accounting Standards Board.

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