Federal Housing Finance Board

August 24, 1992

MEMORANDUM

TO: Philip L. Conover
Deputy Executive Director

FROM: Beth L. Climo
General Counsel

SUBJECT: Federal Funds as Deposits in Banks or Trust Companies

ISSUE: Whether a Federal Home Loan Bank's ("FHLBank's") sale of Federal funds is equivalent to placing "deposits in banks or trust companies" for purposes of section 11(g) of the Federal Home Loan Bank Act ("Bank Act"). 12 U.S.C. § 1431(g) (Supp. I 1989).

CONCLUSION: The Federal Housing Finance Board ("Finance Board") has the authority to interpret a FHLBank's sale of Federal funds as a deposit in a bank or trust company for purposes of the reserve requirements in section 11(g) of the Bank Act.

DISCUSSION:

1) INTRODUCTION

Section 11(e)(1) of the Bank Act authorizes the FHLBanks to accept deposits from their members "upon such terms and conditions as the (Finance] Board may prescribe." 12 U.S.C. § 1431(e)(1) (Supp. I 1989). These deposits are subject to the investment limitations in section 11(g) of the Bank Act, which require each FHLBank to have at all times an amount equal to the current deposits of its members invested in, among other things, deposits in banks or trust companies. 12 U.S.C. § 1431(g) (Supp. I 1989).

You have asked whether a FHLBank may satisfy its reserve requirements under section 11(g) of the Bank Act by including Federal funds that it has sold to banks and trust companies. 12 U.S.C. § 1431(g) (Supp. I 1989). For the reasons discussed herein, we conclude that the sale of Federal funds by a FHLBank to

a bank or trust company is equivalent to placing "deposits in banks or trust companies" for purposes of the reserve requirements in section 11(g) of the Bank Act.

Although couched in terms of sale and purchase, a Federal funds transaction involves a borrowing (purchase) and lending (sale) [1] of excess reserve balances by depository institutions in order for the borrowing institution to meet its legal reserve requirements.[2] There are two methods of conducting unsecured Federal funds transactions.[3]

Conventional Federal funds transactions. The first is referred to as a "conventional Federal funds transaction," since it involves the traditional method of transferring reserve balances at a Federal Reserve Bank from one depository institution with excess reserves to another depository institution in need of

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1. The Federal Reserve Board treats a transaction in Federal funds as involving a loan on the part of the "selling" bank and a borrowing on the part of the "purchasing" bank. See 12 C.F.R. § 260.160 (1992). In contrast, the Office of the Comptroller of the Currency ('OCC") characterizes the sale of overnight Federal funds as a purchase and sale of such funds rather than a loan or an extension of credit. See 12 U.S.C. § 84 (1989); see also 12 C.F.R. § 32.102(b) (1992). However, a term Federal Funds transaction (maturity of over one business day) would be included in the calculation of a national bank's legal lending limit. Id.

2. Section 19(b)(2)(A) of the Federal Reserve Act requires depository institutions to maintain reserves against transaction accounts at their district Federal Reserve Bank as prescribed by the Board of Governors of the Federal Reserve System ("Federal Reserve Board") for the purpose of implementing monetary policy. 12 U.S.C. § 461(b)(2)(A) (1989). Depository institutions meet these legal reserve requirements by either maintaining accounts with their District Federal Reserve Bank or by holding cash in vaults. These reserves are commonly referred to as "Federal funds." A depository institution with excess reserves may sell the excess to another depository institution in need of additional funds to meet its legal reserve requirements.

3. By contrast, a secured Federal funds transaction involves the sale of government securities with the agreement to repurchase such securities or their equivalent at a later date. Although the FHLBanks engage in repurchase agreements, the scope of this opinion is limited to unsecured Federal funds transactions.

additional funds to meet its reserve requirements.[4] Conventional Federal funds transaction are usually overnight borrowings (herein an "overnight Federal funds transaction"). However, their maturity may exceed one business day (herein a "term Federal funds transaction").[5]

Although the FHLBanks are not subject to Regulation D's reserve requirements, they maintain accounts with their district Federal Reserve Banks.[6] Occasionally, a FHLBank has excess funds in its district Federal Reserve Bank account and may sell such excess funds to depository institutions in need of additional funds to meet their legal reserve requirements. These transactions may be structured as either overnight or term Federal funds transactions. However, the FHLBank may not engage in a term Federal funds transaction with a maturity that exceeds six months. See Federal Housing Finance Board -- Financial Management Policy For The Federal Home Loan Bank System, § II(B)(1) at page 2.

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4. To execute a conventional Federal funds transaction, the lending institution (in our case a FHLBank) authorizes its district Federal Reserve Bank to debit its account and to credit the account of the borrowing institution. The transaction appears on the balance sheet of the lending institution as an asset account ("Federal funds sold") and a liability account ("Federal funds purchased") on the balance sheet of the borrowing institution.

5. In recent years, the Federal Reserve has allowed the parties to Federal funds transactions to extend the maturity of the transaction past one day. These transactions are similar to overnight Federal funds in all aspects other than maturity and are referred to as "term Federal funds." Term Federal funds generally command a higher interest rate and have not been extensively traded. Wayne J. Smith, Repurchase Agreements and Federal Funds, 64 Fed. Res. Bull. 353 (May 1978).

6. For example, the FHLBanks maintain clearing balances with their district Federal Reserve Banks, which provide check clearing and payment services for the FHLBanks. The FHLBanks also serve as pass-through agents for their members that do not maintain accounts with a Federal Reserve Bank for purposes of reserve requirements under the Federal Reserve Board's Regulation D. See 12 C.F.R. § 204.2(1) (1992). A FHLBank accepts deposits from its members and then places such deposits in an aggregate pass-through account with its district Federal Reserve Bank. This aggregate account is used by the FHLBanks' members in meeting their reserve requirements under Regulation D.

Correspondent-respondent Federal funds transactions. The second form of unsecured Federal funds transaction is referred to as a "correspondent-respondent Federal funds transaction," since it involves correspondent banking relationships. For example, the FHLBanks accept overnight deposits and demand deposits from their members, which, because of their short-term maturities, must be matched with short-term investments.' The Federal funds market provides the FHLBanks with a facility for investing these short-term funds. Specifically, a FHLBank sells (lends) these short-term funds in the Federal funds market by depositing them directly into a correspondent bank. The correspondent bank subsequently reclassifies these deposits on its books as "Federal funds purchased" so that the borrowed funds may be used to meet its reserve requirements. This transforms the FHLBank's non-interest earning demand account with the correspondent bank into an interest earning loan. Unlike the conventional Federal funds transaction discussed above, the entire transaction takes place on the books of the correspondent bank and does not involve transfers of funds through a Federal Reserve Bank account.[8] The FHLBank is denied access to its deposited money as long as the money is classified as Federal funds on the books of the correspondent bank. Id. Upon maturity of the loan, the FHLBank's

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7. The Finance Board has the authority under section 11(e)(l) of the Bank Act to prescribe the kinds of deposit accounts the FHLBanks may offer their members and the rates payable on such accounts. 12 U.S.C. § 1431(e)(1) (Supp. I 1989). In particular, the Finance Board has authorized the FHLBanks to accept demand deposits and overnight deposits from their members .

8. In 1964, the Federal Reserve Board authorized a respondent bank, whether a member or not, to request a correspondent member bank to simply reclassify the respondent bank's deposit account with the correspondent bank as "Federal funds borrowed," instead of having to transfer Federal funds through a Federal Reserve Bank account. See 50 Fed. Res. Bull. 1000, 1001 (Aug. 1964). The Federal Reserve Board concluded that legal effect of this transaction was indistinguishable from a conventional Federal funds transaction. Its reasoning was that the respondent bank could readily have the funds transferred temporarily to its account in a third bank and then have the same amount transferred back to the borrowing correspondent bank by entries on the books of the Federal Reserve Bank. Thus, correspondent-respondent Federal funds transaction eliminate the second step, which is basically a conventional Federal funds transaction. The major effect of this ruling was to open the Federal funds market to smaller respondent banks that did not maintain accounts with a Federal Reserve Bank.

demand deposit account is credited for the total value of the loan, plus interest. [9] Id.

11) THE SALE OF' FEDERAL FUNDS IS EQUIVALENT TO PLACING "DEPOSITS IN BANKS OR TRUST COMPANIES"

A) The Bank Act and its Legislative History Provide Little Guidance

The phrase "deposits in banks or trust companies" is not defined anywhere in the Bank Act. The legislative history of section 11(g) provides little guidance on what was meant by the phrase "deposits in banks or trust companies," other than indicating that the reserve requirements were intended as a method of ensuring that the FHLBank maintain liquid investments. Creation of a System of Federal Home Loan Banks, 1932: Hearing on s. 2959 Before the Subcomm. of the Committee on Banking and Currency, 72nd Cong., 1st Sess. 36 (1932) (statement of John O'Brien, Assistant Legislative Counsel, United States Senate).

Although the Bank Act's legislative history provides little guidance, analyzing it together with interpretations of the former Federal Home Loan Bank Board ("Bank Board") support the conclusion that the FHLBanks' sale of Federal funds may be treated as placing "deposits in banks or trust companies."

B) The Bank Board Considered the Legal Relationship of the Parties in Both Transactions Identical

In an opinion dated December 27, 1974, the Office of General Counsel ("OGC") of the former Bank Board addressed the issue of whether the FHLBanks' sale of Federal funds qualifies as "cash" as that term is used for purposes of the eligible investments under the negative pledge requirement in section 506.1 of the former Bank Board's regulations. See Opin. Gen. Couns. Bank Board (Dec. 27, 1974); see also 12 C.F.R. § 506.1 (1989). [10] Since section

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9. When the funds sold are overnight deposits, the transaction is usually structured as an overnight Federal funds transaction. However , if the funds sold are demand deposits, the transaction may be structured as a term Federal funds transaction with a maturity not exceeding six months.

10. Section 506.1 sets forth the conditions under which the Bank Board could issue FHLBank consolidated bonds. Specifically, section 506.1 contained a negative pledge requirement, which required the FHLBanks to hold eligible assets, free and clear of any liens or pledges, in an amount greater than or equal to the amount of consolidated bonds. After the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), which created the Finance Board, section 506.1 of the former Bank Board regulation was redesignated as section 910.1 of the Finance Board's regulations. See Pub.

506.1 of the Bank Board's regulations did not define the term "cash," the Bank Board's OGC relied on a former Bank Board legal opinion interpreting the term "cash" for purposes of liquidity requirements for savings associations under former section 523.10 of the Bank Board's regulations. [11] Section 523.10 defined the term "cash" as "[c]ash on hand and unpledged demand accounts in a [FHL]Bank, an insured bank, an insured institution, or the Bank for Savings and Loan Associations." 12 C.F.R. § 523.10 (1974).

Based on this definition, the Bank Board's OGC concluded that a FHLBanks' sale (lending) of overnight Federal funds in either a conventional or correspondent-respondent Federal funds transaction was equivalent to placing funds in a demand account of a depository institution and, thus, qualified as cash for purposes of the negative pledge requirement in section 506.1 of the former Bank Board regulations. In reaching this decision, the Bank Board's OGC reasoned:

> Although couched in the language of purchase and sale, previous opinions of this Office define an overnight Federal Funds transaction as an unsecured loan. By the same token, cash represented by a demand bank deposit creates the relationship of debtor and creditor between the bank and depositor, and is also an unsecured loan. It is . . . a fundamental rule of banking law that . . . the bank and the depositor assume the legal relation of debtor and creditor. The legal effect of the transaction is that of a loan to the bank upon the promise and obligation, usually implied by law, to pay or repay the amount deposited, usually upon demand . . . .

Opin. Gen. Couns. Bank Board (Dec. 27, 1974).

(Footnote 10 continued from previous page)
L. No. 101-73, Title VII, § 702(a), 103 Stat. 413 (Aug. 9, 1989); See also 12 C.F.R. § 910.1 (1992).

11. Prior to FIRREA, section 5a of the Bank Act placed liquidity requirements on all FHLBank members (primarily savings associations), which required such institutions to invest a certain percentage of their total assets in liquid assets as prescribed by the former Bank Board. 12 U.S.C.A. § 1425a (West 1989). Section 5a included “cash” as one of the eligible liquid assets. Section 301 of FIRREA redesignated section 5a as section 5 of the Home Owners' Loan Act ("HOLA"). See Pub. L. No. 101-73, Title III, § 301, 103 Stat. 313 (Aug. 9, 1989); See also 12 U.S.C. § 1465 (Supp. I 1989). Further, section 301 revised former section 5(a) by making all savings associations subject to these liquidity requirements and made the Office of Thrift Supervision (“0TS”) the agency in charge of implementing these requirements.

The Bank Board also considered the sale of term Federal funds as equivalent to placing "deposits in banks or trust companies." For example, the liquidity requirements for FHLBank members under section 523.10 of the former Bank Board's regulations characterized Federal funds sold by members to be equivalent to deposits. Specifically, section 523.10(g)(4) defined liquid assets inter alia as "[s]avings accounts of an insured bank or insured institution, including loans of unsecured day(s) funds to an insured bank or insured institution (i.e., Federal funds or similar unsecured loans), if . . . (ii) Loans of unsecured day(s) funds will mature in 6 months or less . . . ." 12 C.F.R. § 523.10(g)(4) (1989) recodified as section 566.1(g)(4) of the OTS's regulations (12 C.F.R. § 566.1(g)(4) (1992) (emphasis added). -Accordingly, term Federal funds transactions engaged in by the FHLBanks meet the former Bank Board's definition of a deposit that is eligible as a liquid asset, since their maturies do not exceed six months in duration.

C) The Differences Between Federal Funds and Deposits are Insignificant

There are some practical differences between a depository institution's sale of Federal funds and its placement of deposits in another depository institution (herein an "inter-bank deposit"). However, these differences are insignificant for purposes of the reserve requirements in section 11(g) of the Bank Act.

1) Deposit Insurance

Deposits on account with an insured depository institution, unlike Federal funds sold to a depository institution, are insured up to $100,000.[12] However, the Bank Board did not consider this distinction significant, since the dollar amounts in Federal funds transactions are usually well above the $100,000 insurance coverage. See Opin. Gen. Couns., Bank Board (Dec. 27, 1974).

The legislative history of the Bank Act supports the Bank Board's conclusion that deposit insurance is an immaterial distinction for purposes of the reserve requirements under section 11(g) of the Bank Act. Specifically, the safety net provided by deposit insurance was not the legislative purpose for requiring the FHLBanks to invest in deposits of banks or trust companies, since deposit insurance was established in 1933, one year after

12. "Federal funds purchased" appear on the Federal Deposit Insurance Corporation's call report as a separate nondeposit liability. These funds are segregated for reporting reasons in order to separate them from insured deposits. Further, they are segregated to reflect the fact that as long as the funds are classified as "Federal funds purchased" on the correspondent's books, the respondent-lender may not draw upon them.

the creation of the FHLBanks. Rather, the legislative history of section 11(g) indicates that the reserve requirements were designed to ensure that the FHLBanks have sufficient liquidity to meet the advances demand of members and to serve as a cushion against FHLBank deposit withdrawals by members. [13] Overnight Federal funds transactions are liquid investments and, thus, satisfy this legislative purpose. Further, by restricting the maturity of term Federal funds transactions to six months, the Finance Board's policy ensures that such transactions remain liquid investments.

2) Regulation D and Regulation Q

The Federal Reserve Board, the agency that regulates and monitors the Federal funds market, views a transaction involving the sale and purchase of Federal funds as a lender/borrower relationship. See 12 C.F.R. § 260.160 (1992); see also footnote 1 supra. It classifies a sale and purchase of overnight Federal funds as an inter-bank deposit transaction that is exempt from the definition of "deposit" for purposes of the legal reserve requirements in Regulation D [14] and the prohibition on paying

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13. In a hearing held on January 14, 1932 before the Senate Subcommittee of the Committee on Banking and Currency, the assistant legislative counsel, Mr. John O'Brien, made the following statement regarding section 11(g)(2):

> The theory under which that is written - and that is to be taken in connection with the deposits in (g) on page 20 - is this: In addition to this bank being a bank which will provide credit for home loan lenders, that is, these institutions, the bank is to have on hand a lot of liquid assets, which can be readily capable of being lent to these members. Part of the funds which they are to invest in liquid assets are these deposits which are made under (g). Not only are the capital stock subscriptions to be invested in these liquid assets, but also the deposits.

Creation of a System of Federal Home Loan Banks, 1932: Hearings on S. 2959 Before a Subcomm. of the Comm. on Banking and Currency, 72d Cong., 1st Sess. 36 (1932) (statement of John O'Brien, Assistant Legislative Counsel, U.S. Senate); "The Federal Home Loan Bank System," Office of Finance, Federal Home Loan Banks (1980) at 40-41.

14. Section 204.2(a)(1)(vii)(A) of Federal Reserve Board's Regulation D exempts from the definition of 'deposit" any obligation of a depository institution that is 'issued or undertaken and held for the account of . . . [a]n office located in the United States of another depository institution, foreign bank, Edge or Agreement Corporation, or

interest on demand deposits in Regulation Q. [15]

The Federal Reserve Board's exclusion of the sale and purchase of Federal funds for purposes of Regulation D does not preclude the Finance Board from considering the transaction as equivalent to placing a deposit in a bank or trust company. Federal funds transactions are exempted by the Federal Reserve Board from reserve requirements because such funds are excess reserves shifted from one member's reserve account to another member's reserve account. The reserve requirements have been met by the seller bank that accepted funds as a deposit which latter became the funds sold. Thus, including Federal funds purchased for purposes of reserve requirements would result in holding reserves against reserves (i.e., deposits at a Federal Reserve Bank).

In fact, when the seller of Federal funds is a non-depository institution that is not subject to reserve requirements, the Federal Reserve Board requires the purchasing depository institution to include the Federal funds purchased in the calculation of its legal reserve requirements. This is because the selling institution has not already held reserves against the funds sold. For example, the Federal Reserve Board considers a non-depository institution's participation in the Federal funds market through interdepository institution loan participations as outside the exemption in section 204.2(a)(vii)(A) of Federal funds for purposes of Regulation D. [16] See 12 C.F.R. § 204.127 (1992). An interdepository institution loan participation transaction is one through which an institution that has sold Federal funds to a depository institution, subsequently "sells" or participates out the obligation to a nondepository third party without notifying

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(Footnote 14 continued from previous page)
New York Investment (Article XII) Company." 12 C.F.R. § 2042(a)(1)(vii)(A) (1992). Federal funds purchased by a depository institution are obligations of that depository institution that are "issued or undertaken and held for the account . . . of another depository institution." Thus, they are deposits exempt from reserve requirements under Regulation D. Id.

15. Section 217.2(b) of the Federal Reserve Board's Regulation Q states that the term "deposit" as used for purposes of Regulation Q has the same meaning as under section 204.2(a) of Regulation D. 12 C.F.R. § 217.2(b) (1992). Since Federal funds are generally exempted from the definition of deposit under Regulation D, they are also exempted under Regulation Q.

16. Although the FHLBanks are "depository institutions" as that term is defined in section 204.2(m) of Regulation D, Federal funds purchased by a depository institution from a FHLBank are not subject to reserve requirements. See 12 C.F.R. § 204.2(a)(1)(vii)(A)(2) (1992).

the obligated institution. Id. Such transactions are treated as deposits subject to reserve requirements whether the non-depository institution third party is a party to the initial transaction or thereafter becomes a participant in the transaction through purchase of all or part of the obligation held by the "selling" depository institution. Id.

In short, the legal relationship between the parties in a Federal funds transaction is virtually identical to the legal relationship between the parties in an interbank deposit transaction. Furthermore, there are no significant differences between such transactions. Accordingly, the Finance Board has the authority to interpret a FHLBank's sale of Federal funds as a deposit in a bank or trust company for purposes of the reserve requirements in section 11(g) of the Bank Act.

D) The Finance Board's Regulation Defining the Phrase "Deposit in a Bank or Trust Company would Have to be Amended

If the Finance Board in its discretion decides to interpret the phrase "deposits in banks or trust companies" in section 11(g) to include Federal funds transactions, it must amend the definition of that phrase in section 931.5 of its regulations. Section 931.5 of the Finance Board's regulations defines the phrase "deposits in banks or trust companies" as:

> [A] deposit in another Bank, a demand account of a Bank with a Federal Reserve Bank, or a deposit in such other depository as the Bank's board of directors may designate which, unless otherwise authorized, is a member of the Federal Reserve System or the Federal Deposit Insurance Corporation.

12 C.F.R. § 931.5 (1992) (emphasis added).

As discussed above, a conventional Federal funds transaction involves a transfer of funds from a FHLBank's Federal Reserve Bank account to the purchasing institution's Federal Reserve Bank account. In a correspondent-respondent Federal funds transaction, a FHLBank sells Federal funds by depositing them directly into a correspondent bank, which subsequently reclassifies them as "Federal funds purchased."

Although the definition in section 931.5 includes a FHLBank's account with a Federal Reserve Bank and a FHLBank's deposit in a depository institution, it currently does not include a FHLBank's sale of unsecured days funds to a depository institution. Thus, the definition needs to be amended to include a FHLBank's sale of unsecured day(s) funds with a maturity of six months or less (i.e., Federal funds).

III) CONCLUSION

There are several reasons for treating a FHLBank's sale of overnight or term Federal funds to a bank or trust company as equivalent to placing deposits in such depository institutions. Most significantly, a Federal funds transaction involves a debtor-creditor relationship similar to a deposit transaction between depository institutions.

Although there are some differences between the sale and purchase of Federal funds and an inter-bank deposit transaction, they do not appear to be significant enough to distinguish the two when considering the intent and purpose behind section 11(g) of the Bank Act. First, the fact that Federal funds transactions are not protected by deposit insurance is immaterial, since the safety net provided by deposit insurance was not the purposes behind the reserve requirements in section 11(g). Rather, these reserve requirements were designed to ensure that the FHLBanks have sufficient liquidity to meet advances demand or unexpected withdrawals of deposits. Federal funds transactions serve as liquid investments for the FHLBanks and, thus, satisfy the intents and purposes of section 11(g) of the Bank Act. Furthermore, the dollar amounts of such transactions are well above $100,000.

Second, the exemption of Federal funds transactions from the definition of deposit for purposes of Regulation D is insignificant, since the Federal Reserve Board exempts such transactions simply because the reserve requirements have already been met by the seller bank on the funds it received as deposits and later sold. In fact, when the seller of Federal funds is a non-depository institution that is not subject to reserve requirements, the Federal Reserve Board requires the purchasing bank to treat the Federal funds as deposits for purposes of Regulation D's reserve requirements.

Based on the foregoing, it is our opinion that the Finance Board has the authority to interpret the sale of Federal Funds by a FHLBank to a bank or trust company as equivalent to placing a deposit in a bank and trust company for purposes of the reserve requirements under section 11(g) of the Bank Act. However, as mentioned above, the definition of the phrase "deposits in banks or trust companies" in section 931.5 of the Finance Board's regulations would have to be amended in order to include conventional and correspondent-respondent Federal funds transactions.

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