Federal Housing Finance Board

December 24, 1992

MEMORANDUM

TO: Philip J. Conover
Deputy Executive Director

FROM: Beth L. Climo
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Office of Legal and External Affairs

SUBJECT: Effect of In-substance Defeasance on Calculation of the Federal Home Loan Banks' ("FHLBanks'") Compliance with the Leverage Ratio and Negative Pledge Requirements

We have been asked to address the following issues concerning in-substance defeasance of FHLBank bonds.

ISSUES:

I. Whether the in-substance defeasance of FHLBank consolidated bonds through the creation of an irrevocable trust would exclude those defeased bonds issued prior to the 1992 amendment to § 910.1 of the regulations of the Federal Housing Finance Board ("Finance Board") from the calculation in former § 910.1 that prohibits the issuance of consolidated bonds in excess of twelve times the total paid-in capital and reserves of the FHLBanks ("leverage ratio requirement").

II. Whether the in-substance defeasance of FHLBank consolidated bonds through the creation of an irrevocable trust would exclude those defeased bonds issued prior to the 1992 amendment to § 910.1 of the regulations of the Finance Board from the calculation in former § 910.1 that requires the FHLBanks to maintain certain specified low-risk assets, free from liens or pledges, in an amount at least equal to total outstanding consolidated bonds ("negative pledge requirement").

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1. 12 C.F.R. § 910.1 (1992).

CONCLUSIONS:

I. FHLBank consolidated bonds issued prior to the 1992 amendment to § 910.1 that are subject to in-substance defeasance through the use of an irrevocable trust containing cash or securities backed by the U.S. Government may be excluded in calculating compliance with the leverage ratio requirement of former § 910.1.

II. FHLBank consolidated bonds issued prior to the 1992 amendment to § 910.1 that are subject to in-substance defeasance through the use of an irrevocable trust also may be excluded in calculating compliance with the negative pledge requirement, to the extent the trust contain6 assets that are eligible to fulfill the negative pledge requirement of former § 910.1.

DISCUSSION:

I. EXCLUSION OF DEFEASED FHLBANK CONSOLIDATED BONDS ISSUED PRIOR TO THE 1992 AMENDMENT TO § 910.1 FROM CALCULATION OF COMPLIANCE WITH THE LEVERAGE RATIO REQUIREMENT UNDER FORMER § 910.1

In-substance defeasance of a debt involves the placement of cash or securities into a fund, which may take the form of an irrevocable trust, with adequate legal restrictions such that the proceeds of the fund can only be applied to the repayment of the debt to be defeased. The Finance Board recently approved amendments to § 910 which exclude defeased FHLBank consolidated bonds from the leverage ratio requirement. See Amendment 3 of Regulation 910, Fed. Reg. (1992) (to be codified at 12 C.F.R. § 910(6)). However, FHLBank bonds issued prior to these amendments are governed by the terms of former § 910.1. This opinion addresses whether FHLBank bonds issued prior to the amendment of § 910.1 may be defeased such that they can be excluded from the leverage ratio requirement of former § 910.1.

A. Neither the Federal Home Loan Bank Act ("Bank Act")2 Nor Its Implementing Regulations Indicates whether Defeased Bonds Issued Prior To The 1992 Amendment to § 910.1 Are Subject To The Leverage Ratio Requirement

The leverage ratio requirement contained in the penultimate sentence of former § 910.1. of the Finance Board's regulations states that the Finance Board "shall not issue consolidated bonds in excess of 12 times the total paid-in capital stock and reserves . . . of all the Federal Home Loan Banks." 12 C.F.R. § 910.1 (1992). Section 910.1 was promulgated under the general authority given to the Finance Board in subsection 11(c) of the Bank Act to issue consolidated FHLBank bonds, "upon such terms and conditions as the (Finance] Board may prescribe," that are the joint and several obligations of the FHLBanks. 12 U.S.C. § 1431(c) (Supp. II 1990). Subsection 11(c) contains no limitation on the amount of bonds for which the FHLBanks may be liable at any one time. Id.

Neither former § 910.1 nor any other Finance Board regulation provides guidance as to whether a FHLBank consolidated bond that is subject to in-substance defeasance and was issued prior to the 1992 amendment to § 910.1 must be included for purposes of calculating the leverage ratio requirement under former § 910.1. We did not find any case law interpreting former § 910.1. We also did not find anything in the regulatory history of former § 910.1 that provides us with guidance on this issue.3 A search of the General Counsel opinions of the former Bank Board has yielded no opinions on point.

B. Whether Defeased Bonds Are Subject To The Leverage Ratio Requirement Should Be Determined In Accordance with General Corporate Law

In the absence of regulatory or statutory guidance, the issue of what bonds must be taken into account for purposes of calculating compliance with the leverage ratio requirement under former § 910.1 should be decided in accordance with the legal precedents governing the customary and usual powers of

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2. Pub. L. No. 304, ch. 522, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. § 1421 et seq. (Supp. II 1990)).

3. Section 910.1 originally was promulgated by the former Federal Home Loan Bank Board ("Bank Board") in 1958, see 23 Fed. Reg. 9878 (1958), as 12 C.F.R. § 506.1. The regulation was redesignated as a Finance Board regulation in 1989. See 54 Fed. Reg. 36757 (1989). Prior to the 1992 amendments — approved by the Finance Board, the only amendment to the regulation was made in 1990, when the reference in the first sentence to the former Bank Board was changed to the Finance Board. See 55 Fed. Reg. 2229 (1990).

corporation6 generally. Under subsection 12(a) of the Bank Act, the FHLBanks are created as corporate bodies, each having "all such incidental powers, not inconsistent with the provisions of this chapter, as are customary and usual in corporations generally." 12 U.S.C. § 1432(a) (Supp. II 1990). The power to take on indebtedness through the issuance of debt obligations is a customary and usual corporate power. See 188 Am. Jur. 2d Corporations § 2113 (1985). Incident to this power is the power to defease debt obligations. Since neither the Bank Act nor it6 implementing regulations addresses whether defeased bond6 issued prior to the 1992 amendment to § 910.1 are subject to the leverage ratio requirement, pursuant to Bank Act subsection 12(a), the issue should be resolved in accordance with general corporate law precedents.

C. Under General Corporate Law Precedents, Defeased Bond6 Generally Are Excluded From The Calculation Of A Corporation's Limit On Indebtedness

The case law supports the view that when a corporation creates a trust fund, the proceeds of which are to be applied solely to the repayment of previously issued bonds, those bonds are excluded from the calculation of the corporation's outstanding indebtedness for the purpose of determining compliance with statutory debt limits.

1. Municipal Corporations and Political Subdivisions

The bulk of the relevant case law addresses the issue of in-substance defeasance of bonds issued by municipal corporations and political subdivisions where the proceeds of newly issued bonds were placed in a trust, and funds from the trust could be used only to repay the previously issued bonds. For example, in Banta v. Clarke County, 260 N.W. 329 (Iowa 1935), the Iowa Supreme Court held that for the purpose of determining compliance with the Iowa constitutional debt limit provision, the total indebtedness of the issuer "should be determined by deducting the cash on hand, segregated to meet the payment of certain designated bonds . ..." Id. at 332. In Beaumont v. Faubus, 394 S.W.2d 478 (Ark. 1965), the Supreme Court of Arkansas held that when the proceeds of a state bond issuance are placed in trust and designated for the repayment of bonds already outstanding, "the indebtedness evinced by the outstanding bonds is discharged insofar as the issuing authority is concerned and is no longer outstanding (for the purposes of the constitutional debt limit]." Id. at 484. Accord Rodin v. State, 417 P.2d 180 (Wyo. 1966); Taxpayers and Citizens of Shelby County v. Shelby County, 20 So. 2d 36 (Ala. 1944); Albuquerque v. Gott, 389 P.2d 207 (N.M. 1964); Revnolds v. Stark, 217 P. 166 (Okla. 1923).

The holdings of the state court cases cited above are contrary to an 1892 decision of the United States Supreme Court, which held that when a municipal corporation sold bonds in order to raise funds to repay previously issued bonds, the total

indebtedness of the corporation was increased for the purpose of calculating compliance with the Iowa constitution's debt limit on municipal corporations. See District Township of Doon v. Cummins, 142 U.S. 366 (1892). However, the Court's decision in Doon was based on facts particular to that case which were not present in the state cases nor in the defeasance procedure proposed by the Office of Finance ("OF"). The opinion of the court in each of the state cases (including an opinion on the Iowa constitutional provision that was the subject of the Doon case) rejected the Doon holding.

In Doon, proper application of the bond proceeds depended "solely upon the discretion or the honesty of [the corporation's) officers," Id. at 372. The Court's overriding concern in Doon was that there was no safeguard to ensure that once a corporation issued new bonds in excess of its debt limit in order to refund outstanding bonds, the proceeds from the new bonds would be properly applied to repayment of the outstanding bonds. See id. However, in the state cases and in the case of the OF defeasance, the obligor transfers the bond proceeds to a trustee for the sole benefit of the outstanding bondholders. Therefore, the Doon case's rationale of protecting the corporation from liability for its officers' misappropriation of funds is not applicable where an irrevocable trust is created to ensure proper application of the bond proceeds.

2. Private Corporations

There are few cases addressing the effect of in-substance defeasance on the calculation of a private corporation's compliance with pre-set limitations on corporate debt. However, the cases that have been decided are in accord with those decided in the municipal corporation context. In Citrus Growers' Dev. Ass'n v. Salt River V.W. Users' Ass'n, 268 P. 773 (Ariz. 1928), the Supreme Court of Arizona held that:

> where bonds are issued by a corporation for the purpose of refunding other outstanding indebtedness, and where the proceeds of such refunding bonds are placed in a trust fund for the sole and express purpose of paying off the original indebtedness, the latter bonds, so far as the amount which is placed in the trust fund is concerned, are not to be considered as an increase in the indebtedness of the corporation within charter and statutory provisions limiting it.

Id. at 781. See also Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 506 (S.D.N.Y. 1935).

Based on the state court precedents cited above, if corporate bonds are defeased through the creation of a trust fund, the sole purpose of which is to provide funds to repay

those bonds, then those bonds may be deducted from the corporation's total indebtedness in order to calculate compliance with statutory or charter debt limits.

3. Debt Defeasance Under FASB

The approach to debt defeasance taken by the accounting profession is consistent with the approach set forth in the state court cases discussed above. Under Financial Accounting Standard NO. 76 ("FAS 76"),4 debt is considered extinguished for financial reporting purposes if "[t]he debtor irrevocably places cash or other assets in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote." FAS 76 ¶ 3. The assets used for this purpose must be "monetary assets that are essentially risk-free as to amount, timing, and collection of interest and principal." Id. ¶ 4 (emphasis original). For debt denominated in U.S. dollars, essentially risk-free monetary assets are limited to obligations backed by the full faith and credit of the U.S. Government or collateralized by such obligations under an arrangement by which the interest and principal payments on the collateral flow through to the holder of the obligation. Id. Therefore, under FAS 76, if a corporation were to create an irrevocable trust containing these types of qualifying assets with the condition that the proceeds of the trust be used solely to satisfy payment of certain specified outstanding bonds, the corporation could treat those bonds as extinguished for financial accounting purposes, including the calculation of outstanding indebtedness.

The OF would like to defease outstanding FHLBank bonds issued prior to the 1992 amendment to § 910.1 using the proceeds from an irrevocable trust containing U.S. Government securities and securities issued by the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC"). Under FAS 76, an irrevocable trust must contain "essentially risk-free" assets in order to extinguish the debt to be paid from the proceeds of the trust. Id. FNMA and FHLMC securities are not "essentially risk-free" assets under FAS 76 because they are not backed by the full faith and credit of the United States. See FAS 76 ¶ 4. Further, we have found no cases addressing the validity of an in-substance defeasance of bonds where the trust created to defease the bonds held assets other than cash or U.S. Government securities. Therefore, the case law and FAS 76 suggest that to be legally valid, an in-substance defeasance must be done through the creation of a trust in which the assets are limited to cash and securities backed by the U.S. Government. The 1992 amendment to § 910.6 of

4. Codification of Accounting Standards and Procedures, Statement of Financial Accounting Standards No. 76 (Fin. Accounting Standards Bd. 1983).

the Finance Board regulations is consistent with this view. It provides for the defeasance of outstanding bonds using "direct obligations of the United States of America or obligations fully guaranteed by the United States of America." See Amendment 4 of Regulation 910, ___ Fed. Reg. ___ (1992) (to be codified at 12 C.F.R. § 910.6(b)(1)).

II. EXCLUSION OF DEFEASED FHLBANK CONSOLIDATED BONDS ISSUED PRIOR TO THE 1992 AMENDMENT TO § 910.1 FROM CALCULATION OF COMPLIANCE WITH THE NEGATIVE PLEDGE REQUIREMENT UNDER FORMER § 910.1

The negative pledge requirement contained in the final sentence of the former § 910.1 states that:

> The Federal Home Loan Banks shall at all times maintain assets of the following types, free from any lien or pledge, in a total amount at least equal to the amount of consolidated bonds outstanding:
> (a) Cash;
> (b) obligations of or fully guaranteed by the United States;
> (c) secured advances; and
> (d) mortgages as to which one or more Federal Home Loan Banks have any guarantee or insurance, or commitment therefore, by the United States or any agency thereof.

12 C.F.R. § 910.1 (1992) (emphasis added).[5] Until all the bond[6] issued prior to the 1992 amendment to § 910.1 are retired, former § 910.1 requires that the FHLBanks determine the amount of "consolidated bonds outstanding" so that the FHLBanks can match that amount with an equal or greater amount of certain unencumbered assets. Id. Whether defeased FHLBank bonds must be included in the negative pledge calculation depends on whether such bonds should be considered "outstanding" within the meaning of former § 910.1.

There is no statutory, regulatory, or administrative guidance as to whether defeased FHLBank bonds issued prior to the amendment to § 910.1 must be taken into account in determining the total amount of bonds "outstanding" within the meaning of former § 910.1. See supra § I(A). However, the foregoing analysis of the status of defeased bonds for purposes of the leverage ratio requirement also supports the reasoned conclusion that defeased FHLBank bonds should not be considered outstanding for purposes of determining compliance with the negative pledge requirement. The general corporate precedents regarding the exclusion of defeased

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5. The 1992 amendment to § 910.1 added two further categories of assets eligible to fulfill the negative pledge requirement. See Amendment 3 of Regulation 910, ___ Fed. Reg. ___ (1992) (to be codified at 12 U.S.C. § 910.1(c)).

debt from corporate debt limits are based on the principle that when the issuer of bonds makes an irrevocable commitment to repay outstanding bonds from a specific source of funds, "the indebtedness evinced by the outstanding bonds is discharged insofar as the issuing authority is concerned and is no longer outstanding." Beaumont, 394 S.W.2d at 484.

It is reasonable to apply this principle in interpreting the negative pledge requirement because the purpose of the negative pledged is to fulfill the requirement in subsection 11(c) of the Bank Act that joint and several obligations of the FHLBanks be secured. See 12 U.S.C. § 1431(c) (Supp. II 1990). When assets are placed in an irrevocable trust for the sole purpose of funding the repayment of specific FHLBank bonds, those bonds become secured by the assets in the trust. If the trust assets are eligible to fulfill the negative pledge requirement, then it is reasonable to conclude that the bonds to be repaid from the proceeds of the trust assets need not be considered "outstanding" bonds against which the FHLBanks must pledge unencumbered assets in order to secure repayment. However, if all or some of the trust assets are not eligible to fulfill the negative pledge requirement, then the bonds to be repaid from the proceeds of such ineligible assets would continue to be "outstanding" bonds against which the FHLBanks must pledge eligible assets in order to secure repayment.

CONCLUSION:

Based on the foregoing, it is the opinion of the General Counsel that FHLBank consolidated bonds issued prior to the 1992 amendment to § 910.1 that are subject to in-substance defeasance through the use of an irrevocable trust containing cash or U.S. Government securities may be excluded in calculating compliance with the leverage ratio requirement of former § 910.1. In addition, such bonds may be excluded in calculating the negative pledge requirement of former § 910.1, to the extent the trust contains assets eligible to fulfill the negative pledge requirement.

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