



Federal Housing Finance Board

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MEMORANDUM

TO: Bruce A. Morrison
Chairman

THROUGH: Deborah F. Silberman *DS*
Acting General Counsel

FROM: Eric M. Raudenbush *ERM*
Attorney-Advisor

SUBJECT: Authority of the FHLBank of Chicago to Establish a Pilot Mortgage Partnership Finance" Program

ISSUE:

Is there a legal basis for the Federal Housing Finance Board (Finance Board) to permit the Federal Home Loan Bank (FHLBank) of Chicago to undertake a proposed pilot "Mortgage Partnership Finance" (MPF) program, under which the FHLBank would engage in residential mortgage lending through its member institutions acting as agents, as a permissible incidental activity under the Federal Home Loan Bank Act?

CONCLUSION:

Yes. Because the dominant statutory purpose of the FHLBanks is, at minimum, to serve member institutions by providing to them funds for residential mortgage lending, and because the MPF program is simply a method of channeling funds through member institutions into residential housing finance in a manner that is technically more sophisticated than, yet functionally similar to, that which occurs when a FHLBank makes an advance, it is reasonable for the Finance Board to approve as a permissible incidental activity the undertaking of the MPF program by the FHLBank of Chicago.

DISCUSSION

I. Background

On May 22, 1996 the Federal Home Loan Bank (FHLBank of Chicago transmitted to the Federal Housing Finance Board (Finance Board) a request for approval to establish a pilot program known as "Mortgage Partnership Finance" (MPF). and supplemental items supporting the request. In response to two separate inquiries from Finance Board staff, the FHLBank provided additional information on July 2, 1996 and September 20, 1996 and on November 6, 1996, amended its original request for-approval by proposing to finance the MPF directly with FHLBank assets.

II. Description of the MPF Program

Under the MPF program, as amended, the FHLBank of Chicago proposes to make residential mortgage loans through participating FHLBank of Chicago member institutions ("participating financial institutions" or "PFIs") acting as origination agents for the FHLBank. As origination agent for the FHLBank and subject to eligibility standards developed by the FHLBank, each PFI would originate a pool of one-to-four family residential mortgage loans with its retail customers. The proceeds of each loan would be paid from the assets of the FHLBank, which would be listed as the mortgagee on the mortgage note. However, the PFI would retain the mortgage documents and service the loans for the FHLBank (subject to the FHLBank's right of removal), passing the principal and interest payments and prepayment fees therefrom on to the FHLBank and any other FHLBank participants. The FHLBank proposes to hold such loans in its portfolio and to participate out interests in the loans to other FHLBanks. The other FHLBank participants would hold an undivided ownership interest in the master pool of mortgage loans, comprising the individual pools specific to each PFI. The FHLBank of Chicago and the other FHLBank participants would be entitled to income derived from any positive spread between the yield borne by the pools of mortgage loans, less fees, excess yield to cover defaults and the investors' funding and administrative costs.

As a buffer against loan losses, the FHLBank of Chicago would maintain a separate spread account (loss reserve), on behalf of itself and the other FHLBank participants, to be funded by excess yield on the mortgage loans. The loss reserve would equal or exceed expected losses on the combined loan pools, after taking into account servicing and credit enhancement fees. In addition, PFIs would provide second loss coverage through a credit enhancement approximately equal to the amount of subordination that would be required by ratings agencies to achieve a AA rating in the senior tranche for the particular pool of mortgage loans originated by that PFI. According to the FHLBank any losses not covered by the loss reserve-or the credit enhancements would be directly expensed to the FHLBank of Chicago and the other FHLBank participants in the current period.

FHLBank of Chicago management believes that its members would be attracted to the MPF program because it offers members a less costly alternative to holding these loans in portfolio, securitizing the loans themselves, or selling the loans to Fannie Mae or Freddie Mac.

which could make mortgage lending more profitable for the member and thus make more mortgage funding available to consumers. Specifically (1) members would receive origination, selling and credit enhancement fees; (2) because the loans would be owned by the FHLBank, members would not have to pay fees to the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), or an investment bank to securitize the mortgage loans; and (3) because the members would have originated the loans merely as agent for the FHLBank, they would not have to hold capital against these loans. The FHLBank currently proposes to limit the size of its pilot MPF program to \$750 million in assets and ten (10) PFIs -- levels it expects to achieve mid-way through the program's second year of operation.

Because the Federal Home Loan Bank Act (Bank Act) does not address explicitly the authority of FHLBanks to engage in mortgage lending to consumers through FHLBank member institutions acting as agents,¹ the Finance Board must determine whether it reasonably can authorize such activity as being pursuant to the FHLBanks' incidental authorities under the Bank Act. Accordingly, OGC here addresses the authority of the FHLBank of Chicago to make mortgage loans directly to retail consumers through member institutions acting as agents for the FHLBank.

III. Analysis

A. The Finance Board May Adopt Reasonable Interpretations of the Bank Act's Incidental Authority Provisions

Although the Bank Act does not expressly empower FHLBanks to make mortgage loans directly to retail customers, section 11(a) of the Bank Act provides that “[e]ach Federal Home Loan Bank shall have power, subject to rules and regulations prescribed by the [Finance] Board, . . . to do all things necessary for carrying out the provisions of this chapter and all things *incident there to.*”² Section 11 (e)(1) restates the incidental powers language of section 11 (a) in the negative by providing, in pertinent part, that “no [FHL]Bank shall transact any banking or other business not incidental to activities authorized by this chapter.” *Id.* § 1431(e)(1). Although this dual grant of incidental authority to the FHLBanks under sections 11(a) and 11(e)(1) appears broad, it is not clear from the plain language of either section whether the activities authorized

¹ See 12 U.S.C. §§ 1421-49 (1995). The Bank Act, as originally enacted in 1932, included a provision that stated, “Any home owner who comes within the limits of this Act and who is unable to obtain mortgage money from any other source may obtain same from any bank organized under this Act: *Provided*, That this subsection shall not be effective when the Federal Government has had its stock retired.” C. 522. § 4(d), 47 Stat. 726 (1932). However, this provision was repealed by the Home Owner's Loan Act in 1933. *See* C. 64. § 3. 48 Stat. 129 (1933).

² *Id.* § 1431 (a) (emphasis added). The incidental authorities analysis set forth in this memorandum incorporates and expands upon certain aspects of the analysis set forth in the June 27, 1996 memorandum from Brandon B. Straus, Attorney-Advisor, to Deborah F. Silberman, Deputy General Counsel, regarding the authority of FHLBanks to act as counterparties in derivative contracts.

thereunder would include those which the FHLBank of Chicago proposes to undertake as part of the MPF program.

As the agency charged with the administration the Bank Act. see 12 U.S.C. 1422b(a)(1), interpretations of the Act by the Finance Board would be given great deference by courts if these questions were to be litigated. See NationsBank v. Variable Annuity Life Insurance Co. 130 L. Ed. 2d 740, 747 (1995) (quoting Clarke v. Securities Indus. Ass'n, 479 U.S. 388, 403-04 (1987)). Courts will uphold an agency's "permissible interpretation" of a statute that the agency administers if, using traditional rules of statutory construction. the court determines that "Congress has not directly addressed the precise question at issue." Chevron. U.S.A.. Inc. v. Natural Resources Defense Council, 467 U.S. 837. 843 & n.9 (1984). Under Chevron, a "permissible interpretation" is one. which represents a "reasonable accommodation of conflicting policies that were committed to the agency's care by the statute." Id. at 845 (quoting United States V. Shimer, 367 U.S. 374, 382-83 (1961)). Even if the agency's interpretation or corresponding policy choice is one which the court would not have chosen itself, the court may not overturn the interpretation unless "it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned." Id. Accordingly, it is appropriate to look to the legislative history of the Bank Act for guidance regarding the scope of the FHLBanks incidental authorities. See 2A N. Singer. Sutherland Statutory Construction (Sutherland) §§ 46.01, 48.01 (Sands 5th ed. 1992).

B. Legislative History of Bank Act and Amendments Supports Reference to National Bank Act Cases to Interpret Provisions Governing Incidental Authorities of FHLBanks

1. Under Original Bank Act. Incidental Authority Provisions Were Restrictive

The prohibitive language of section 11(e)(1), quoted above. is derived from former section 11(g) of the Bank Act of 1932, which stated. "No Federal Home Loan Bank shall transact any banking or other business not expressly authorized by this Act." See Pub. L. No. 304, ch. 522, § 11(g), 47 Stat. 733 (1932). The Report of the House Committee on Banking and Currency, which accompanied the original Bank Act, addresses then-section 11(g), stating, "The banks are specifically restrained from doing any general banking or commercial banking business. Their functions are confined solely to *servicing member institutions*." H.R. Rep. No. 1418, 73d Cong., 1st Sess. 6 (1932) (emphasis added).

In the National Housing Act of 1934. Congress redesignated section 11(g) as section 11(e) and removed the word "expressly," so that the prohibition in new section 11(e) read. "No Federal Home Loan Bank shall transact any banking or other business not authorized by this Act." Pub. L. No. 479, ch. 847, § 503.48 Stat. 1246, 1262 (1934). By removing the requirement that activities be "expressly" authorized. Congress freed the FHLBanks to engage in activities for which they possess *implied* authority under the Bank Act. At the same time, Congress added the incidental powers language in section 11(a) to the Bank Act, granting the FHLBanks broad implied authority "to do all things necessary for carrying out the provisions of this chapter and all things incident thereto." Id Although neither of these amendments is addressed in the legislative

history of the National Housing Act, their simultaneous adoption indicates that Congress narrowed the scope of the prohibition in section 11(e) in order to take into account the grant of implied authority to the FHLBanks under the incidental powers provision in section 11(a).

2. ADAPSO Court Held FHLBanks' Incidental Powers To Be Narrower Than Those of National Banks

Two Federal court decisions. Association of Data Processing Serv. Orgs., Inc. v. Federal Home Loan Bank Board (hereafter ADAPSO), 568 F.2d 478 (6th Cir. 1977) and Central Bank, N.A. v. Federal Home Loan Bank of San Francisco. 430 F. Supp. 1080 N.D. Cal. 1977), addressed the incidental powers of the FHLBanks under the formulations of sections 11(a) and 11(e) that resulted from the National Housing Act amendments. In ADAPSO, the United States Court Appeals for the Sixth Circuit affirmed the holding of the district court that the FHLBanks lacked authority under the Bank Act to provide on-line data processing services to their member institutions.

Though it ultimately affirmed the decision of the district court, the Sixth Circuit in ADAPSO questioned the lower court's application of Arnold Tours v. Camp, 472 F.2d 427 (1st Cir. 1972). to its analysis of the incidental powers of the FHLBanks. See 568 F.2d at 486. In Arnold Tours, the First Circuit Court of Appeals held that a national bank's activity is authorized as an incidental power if it is "convenient or useful" in connection with one of the bank's express statutory powers. See 472 F.2d 427. The ADAPSO court noted the prohibitive language of section 11(e) (which then provided that no FHLBank "shall transact banking or other business not authorized by this chapter." see 12 U.S.C. § 1431(e)(1970)), as well as the "competitive advantage" stemming from the FHLBanks' tax-exempt status. and concluded that "if anything the activities of the [FHL]Banks are even more restricted than the activities of national banks in Arnold Tours," See 568 F.2d at 486. The court then held that the FHLBanks did not have incidental authority to provide on-line data processing services because such activity constituted impermissible "other business" that was not connected with the FHLBanks' dominant statutory purpose, which the court described as:

placing "long-term funds in the hands of local institutions" in order to alleviate the pressing need of home owners for "low-cost, long-term. installment mortgage money" and to "decrease costs of mortgage money" with a "resulting benefit to home-ownership in the form of lower costs and more liberal loans."

568 F 2d at 486 (quoting Laurens Federal Sav. & Loan Ass'ns v South Carolina Tax Comm'n, 365 U.S. 517, 521-22, 81 S. Ct. 719 (1961)).

The court made the foregoing statements in order to distinguish the facts of ADAPSO from those of its earlier decision-in Greene County Nat'l Farm Credit Adm'n v. Federal Land Bank of Louisville. 152 F.2d 215 (6th Cir. 1945). cert. denied. 325 U.S. 834 (1946). In Green County, the Sixth Circuit had held that a proposed reorganization of certain national farm associations by one of the Federal Land Banks was permissible under the Federal Farm Loan Act, although there was no express power in the Act to carry out such a plan and although the Act expressly provided

for an alternative to the reorganization plan- the liquidation of insolvent associations. See 12 U.S.C. §§ 656-1012 (1944). In analyzing the authority of the Federal Land Bank to carry out the reorganization, the court had relied heavily upon the plan's relation to the "dominant purpose" of the Farm Credit System, stating:

The entire [Farm Credit] system is an integrated cooperative organization for the purpose of assuring farmers opportunity to borrow money upon long-term mortgages, at minimum interest rates. under the direction. supervision and with the aid of the government. That is the dominant purpose of the Act creating the [Farm Loan] associations and the [Federal Land] bank. in the light of which the scope of the bank's authority must be determined. It would seem to be clear that the authority of the bank to effectuate the public purposes of the Act must be liberally viewed, and restrictions on power not lightly asserted without clear mandate of the statute therein expressed or clearly implied.

Greene County, 152 F.2d at 220. Citing the "many practical difficulties" with applying the expressly-permitted liquidation procedure. Id at 219, the efficiency of and lack of fraud involved in the proposed reorganization, id., the approval of the plan by the Farm Credit Administration (the regulator of the Federal Land Banks), id. at 220, and most importantly, its reluctance "to interfere with the functioning of a governmental agency engaged in implementing a clearly defined public policy" (as described above), the court had upheld the power of the Federal Land Bank to execute its district reorganization plan. Id at 220-21.

Although questioning the applicability of Arnold Tours, the Sixth Circuit in ADAPSO found no inconsistency between its decision in Greene County and that of the First Circuit in Arnold Tours, opining that "to approve the supplying of on-line data processing capability *simply on the basis that it is convenient and useful* [(the Arnold Tours standard)] to the successful operation of the member thrift institutions is impermissible" without considering the "dominant purpose" of the Bank Act. "in view of the limiting language of [then] § 11(e)." See id. (emphasis added). The ADAPSO court noted that. in Greene County, it had upheld the reorganization plan as "an expedient for carrying out the broad purposes" of the Federal Farm Loan Act and had found the plan to be "within the field of discretion conferred upon [the Federal Land Banks] by Congress." although the Act provided for "no express power to carry out such a plan." See 568 F.2d at 487 (quoting Greene County, 152 F.2d at 220-21). Accordingly, the ADAPSO court ultimately ruled that. because the district reorganization that the Federal Land Bank sought to undertake in Greene County "had a direct connection to the normal functions of the farm loan system" and to the system's "dominant purpose" as evidenced by the Federal Farm Loan Act, while the provision of data processing services had no such connection to the FHLBanks' normal functions. or the dominant purpose of the Bank Act (as quoted above), the Greene County holding could not be applied to the facts in ADAPSO.³

³ See id. In Central Bank, N.A. v. Federal Home Loan Bank of San Francisco, the only other federal court decision to address the FHLBanks' incidental powers. the court ruled similarly that because the FHLBank of San Francisco's processing of money orders was not incidental to "home financing purposes." the activity contravened the Bank Act. 430 F. Supp. 1080, 1085 (N.D. Cal. 1977) However. the court did not address directly the applicability of Arnold Tours.

3. FIRREA Amended the Bank Act to Make Clear That The Incidental Authorities of the FHLBanks Are as Broad as Those of National Banks

The prohibition in section 11(e) addressed by the ADAPSO court was moved to section 11(e)(1) by the Depository Institutions Deregulation and Monetary Control Act of 1980. See Pub. L. No. 96-221, § 311.94 Stat. 132 (1980). In 1939, section 11(e)(1) was amended by the Financial Institutions ‘Reform, Recovery, and Enforcement Act (FIRREA) to read, “no [FHL]Bank may transact any banking or other business not *incidental to activities* authorized by this chapter.” Pub. L. No. 101-73, § 709, 103 Stat. 418 (emphasis added to highlight amendment). With respect to amended section 11(e)(1), the Conference Report accompanying FIRREA states only that “the [FHL]Banks are permitted to engage in activities that are incidental to those expressly authorized by the Bank Act” H.R. Conf. Rep. No. 222, 101st Cong., 2d Sess. 426 (1989) (FIRREA Conference Report).

However, during the House floor debate on FIRREA Representative Robert Garcia directly addressed the amendment to section 11(e)(1), offering the following unchallenged statement regarding its purpose:

It is my understanding, as author of this provision [section 709], that the amendment is intended to permit the [FHL]Banks to engage in activities incidental to their express statutory powers, and that Congress contemplated this incidental power to be broadly read... The reason that the [FHL]Banks’ incidental power was intended to be viewed broadly is that it supports the primary purpose of the [FHL]Banks; namely, housing finance. It also permits the [FHL]Banks to help their members control operating costs and interest rate and credit risk. *Under the current statute, it is possible to consume the [FHL]Banks incidental activities more narrowly than those permitted for national banks.* Section 709 is intended to clarify this point. It is my understanding that the *incidental activities of national banks and [FHL]Banks should now be viewed as similarly broad.* Incidental activities do not need to be strictly necessary to the [FHL]Banks’ exercise of their express powers. . . . The amendment is intended to ensure that the [FHL]Banks may provide a variety of products and services.

108 Cong. Rec. H4994 (daily ed. Aug. 3, 1989) (statement of Rep. Garcia) (emphasis added).

Rep. Garcia’s statement regarding the possibility that the FHLBanks’ pre-FIRREA incidental powers could be interpreted more narrowly than those permitted for national banks appears to be a reference to the comments of the ADAPSO court that “if anything the activities of the [FHL]Banks are even more restricted than the activities of national banks in Arnold Tours.” See 568 F.2d at 486. As such, it appears that Rep. Garcia, as drafter of section 11(e)(1).

or other cases decided under the National Bank Act to the FHLBanks. (Congress subsequently overruled the specific holding in Central Bank by granting the FHLBanks express authority to engage in money order banking. See Pub. L. No. 96-221, § 311.94 Stat. 132 (1980). codified at 12 U.S.C. § 1431(e)(2))

understood the provision **to** require application of the principles set forth in the line of cases interpreting the incidental powers language of the National Bank Act in determining the scope of the FHLBanks' incidental powers under the Bank Act, as amended by FIRREA.

Although statements made in floor debates generally are not considered to be as reliable an indication of Congressional intent as committee reports often have looked to such statements as an aid in determining Congressional intent when the more formal legislative history was not useful. See International Telephone and Telegraph Corp. v. General Telephone & Electronics Corp., 518 F.2d 913,921 & n.37 (9th Cir. 1975) and cases cited therein; see also United States v. San Francisco. 310 U.S. 16, 20-26 (1940) (wherein the Supreme Court referred to a lengthy colloquy on the floor of the House of Representatives to aid in determining the Congressional intent behind the Raker Act). Accordingly, given the unilluminating explanation for section 11(e)(I) set forth in the FIRREA Conference Report, Rep. Garcia's status as drafter of the provision and member of the House Committee on Banking, Finance and Urban Affairs (from which the FIRREA bill was reported) and the lack of any competing indication of Congressional intent. it is reasonable for the Finance Board to regard Rep. Garcia's above-quoted statement as a manifestation of Congressional intent on the issue of FHLBanks' incidental powers. Therefore. it is equally reasonable for the Finance Board, in conformity with this manifested intent. to look to the line &cases interpreting the incidental powers language of the National Bank Act as a guide in interpreting the incidental powers language of the Bank Act. as amended by FIRREA.

C. Expansive Incidental Powers Interpretations in National Bank Act Cases Support Broad Reading of Bank Act's Incidental Powers Provisions

Section 24 (Seventh) of the National Bank Act provides that each national bank shall have the power:

To exercise by its board of directors or duly authorized officers or agents. subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; by obtaining, issuing and circulating notes according to the provisions of title 62 of the Revised Statutes.

12 U.S.C. § 24(Seventh) (emphasis added). This provision was most recently addressed by the Supreme Court in 1995 in NationsBank v. Variable Annuity Life Ins. CO., 130 L. Ed. 2d 740 (1995). wherein the Court based its holding on the same reasoning: that lower courts had been applying to interpretations of section 24(Seventh) since the early 1970s.

At the time of the passage of FIRREA in 1989 and until 1995, the most prominent generally accepted interpretation of section 24(Seventh) was that set forth in Arnold Tours, wherein the Court of Appeals for the First Circuit held generally that a national bank's activity is authorized as an incidental power under the National Bank Act if the activity is "convenient or

useful” in connection with the performance of one of the bank’s express powers.⁴ Since the Arnold Tours decision, the Courts of Appeals for the Second, Eighth, Ninth and District of Columbia Circuits have adopted similar interpretations of section 24 (Seventh) and have expanded upon the holding in Arnold Tours. See First Nat’l Bank of Eastern Arkansas v. Taylor, 907 F.2d 775, 778 (8th Cir. 1990) (holding that of debt cancellation contracts was within a national bank’s incidental powers because such activity was closely related” to the bank’s express power to lend money and “useful” in carrying out that power); Securities Industry Ass’n v. Clarke, 885 F.2d 1034, 1048-49 (2d Cir. 1989) (holding that national banks have incidental authority to sell mortgage pass-through certificates because such activity is “convenient and useful” in connection with the sale of mortgage notes); American Ins. Ass’n v. Clarke, 865 F.2d 278, 281-82 (D.C.Cir. 1988) (holding that the sale of municipal bond insurance by a national bank subsidiary falls within its incidental powers because such insurance is essentially a credit product); M & M Leasing Corp. v. Seattle First Nat’l Bank, 563 F.2d 1377, 1382-83 (9th Cir. 1977) cert. denied, 436 U.S. 956 (1978) (holding that automobile leasing is a permissible activity for a national bank because it is incidental to the bank’s express power to “loan money on personal property”).

Although, in its NationsBank decision, the Supreme Court neither set forth a bright line test for determining the scope of national banks’ incidental powers, nor expressly endorsed the Arnold Tours line of cases.’ the Court’s approach to the interpretation of section 24 (Seventh) is wholly consistent with that employed in Arnold Tours and its progeny. In NationsBank, the Supreme Court upheld as reasonable the determinations of the Comptroller of the Currency that: (1) the powers of national banks under section 24 (Seventh) are not limited to those specifically enumerated in the National Bank Act, or powers incidental thereto, but comprise “all such incidental powers . . . necessary to carry on the [traditional] business of banking”; (2) although not specifically enumerated thereunder, section 24 (Seventh) authorizes national banks to act as financial intermediaries (i.e., brokers of financial investment instruments) because such brokerage activities are part of, or incidental to, the traditional “business of banking”; and (3) the sale of annuities comes within the national banks’ incidental power to broker financial investment instruments because annuities, despite their similarity to insurance (which, with limited exceptions, national banks may not sell), function primarily as investments. See 130 L. Ed. 2d at 747-50. In accord with its holding in Chevron, the Supreme Court gave great deference to the Comptroller’s interpretation of the incidental powers provision, stating that “[a]s the administrator charged with supervision of the National Bank Act, the Comptroller bears primary responsibility for surveillance of the ‘business of banking’ authorized by section 24 (Seventh),” and that the Comptroller’s judgment is entitled to “controlling weight” if his interpretation of the statute “fills a

⁴ 472 F.2d at 431-32. Specifically, in Arnold Tours, the court held that the operation of a full-scale travel agency is not within the incidental powers of a national bank because such activity is not convenient or useful in connection with any express power. Id. at 433-34.

⁵ In a footnote, the Court held that the “business of banking” is not limited to the enumerated powers in section 24 (Seventh), but that the Comptroller must keep his discretion within “reasonable bounds” in authorizing activities beyond those specifically enumerated in NationsBank. 130 L. Ed. 2d at 749 n.2 The Court then cited “operating a general travel agency” --the activity that was held to be outside the “business of banking” in Arnold Tours--as an activity that the Comptroller could not, within reasonable bounds, authorize. See id

gap or defines a term in a way that is reasonable in light of the legislature's revealed design." See id at 747.

Importantly, in assessing the reasonableness of the Comptroller's determination that the sale of annuities comes within national banks' power to broker financial investments, the Supreme Court in Nat NationsBank focused upon the functional similarities between modern financial investments: stating that "an annuity is like putting money in a bank account, a debt instrument, or a mutual fund. id at 749 (emphasis added); upholding the Comptroller's conclusion that the regime created by the National Bank Act "is best served by classifying annuities according to their functional characteristics." id. at 751 (emphasis added); and finding reasonable the Comptroller's observation that "annuities serve an important investment purpose and are functionally similar to other investments that banks typically sell." id. at 752 (emphasis added). This emphasis on the functional aspects of the incidental activity in question is identical to the approach taken by the Court of Appeals for the Ninth Circuit in M & M Leasing, wherein the court held that the leasing of automobiles to bank customers, "when in the light of all relevant circumstances the transaction constitutes a loan of money secured by the leased property, is incidental to the 'loan of money on personal security,' an activity expressly authorized by the National Bank Act." 563 F.2d at 1382.

In so holding, the court in M & M Leasing recognized that "the National Bank Act did not freeze the practices of national banks in their nineteenth century forms," and concluded that "the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking." Id. While conceding (as did the Supreme Court in NationsBank with regard to the annuities there at issue) that "leases and secured loans are regarded as distinct in both rhetoric and regulation" and that third parties in other contexts may treat the two differently, the court stated that the "functional interchangeability" of the leases and the secured loans was the "touchstone" of its decision. Id. at 1383. The court cited advantages of this transaction structure over traditional lending on chattel security, both for the bank (e.g. depreciation-related tax benefits and increased demand for credit by eliminating the need for down payments from customers) and for the customer (e.g., lease obligations may be reflected more favorably on a balance sheet than indebtedness and leasing may permit avoidance of limitations on a lessee's ability to borrow) and noted that the bank's rate of return on its leases "compares favorably to that of lending" and that a "portfolio of prudently arranged leases imposes no greater risks than one of equally prudently-arranged loans." Id at 1381-82.

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In M & M Leasing, the national banks involved had arrangements with automobile dealers, under which customers would choose a car and fashion the major details of a lease therefor with the dealer, within the limitations of the dealers' agreement with the banks. 563 F.2d at 1380. The bank would, then purchase the vehicle and hold legal title thereto, while the customer, as registered owner and lessee, would make lease payments directly to the bank. Id.

D . Cases Applied to the MPF Program

1. The Power to Establish and Operate the MPF Program Is Incidental to the FHLBank's Express Power to Make Advances to Members

According to principals set forth in the foregoing National Bank Act cases, it is evident that the establishment and operation of the MPF program falls squarely within the incidental powers of the FHLBank of Chicago. In the same sense that the leasing of automobiles is incidental to the loan of money on personal security, see M & M Leasing, 563 F.2d at 1382, and the sale of annuities is incidental to the brokerage of financial investment instruments, see NationsBank, 130 L. Ed. 2d at 749-52, the MPF program reasonably may be regarded; incidental to the FHLBank's express power to make secured advances to its members for the purpose of providing funds for residential housing finance. See 12 U.S.C. § 1430(a).

By establishing and operating the MPF program, the FHLBank of Chicago essentially would be providing to its member institutions a credit product designed to channel funds into housing finance in a fashion that is functionally similar to and in more ways more efficient than, that which occurs through the extension of advances. Even more directly than standard advances, the MPF program would provide retail borrowers with access to another source of mortgage financing, thus increasing incentives for other mortgage lenders to price their mortgages reasonably.⁷ In doing so through member institutions acting as agents, the FHLBank also would be providing members with tangible and intangible benefits on a par with those to be had from lending advance proceeds, such as: profits earned from origination, servicing and credit enhancement fees; money saved by eliminating the need to pay another entity for securitization fees; no need to hold capital against the loans because they will not appear on the members' balance sheets; and customer goodwill garnered from the opportunity to offer another mortgage product. In addition, to the extent that one could consider the FHLBank to be in financial competition with commercial banks and other non-government-sponsored mortgage lenders, such competition would differ little from that which arises through the making of traditional advances, given that the MPF program will be carried out entirely through FHLBank member institutions.

Although, to third parties and in other contexts the structure of the MPF program might be viewed as distinct "in rhetoric and regulation" from the FHLBanks' traditional credit product, the two are "functional[ly] interchangeab[le]." See M & M Leasing, 563 F.2d at 1380. To permit the FHLBank of Chicago to undertake the MPF program, would be to recognize, as did the M & M Leasing court with respect to the National Bank Act, that the Bank Act did not freeze the practices of the FHLBanks in their Depression-era forms and that the powers of the FHLBanks must be construed so as to permit them to continue to implement viable methods of carrying out their housing finance missions in a rapidly changing financial world. See *id.* Thus, as the

Because of the difficulty in tracking the precise flow of advance proceeds, Finance Board regulations require that the principal amount of all long-term advances held by a member may not exceed the book value of all residential housing finance assets held by the member. See 12 C.F.R. § 935.12(a)(2). Because, under the MPF program, member institutions would channel mortgage loans to individual retail customers from the FHLBank, there would be no need for any such "proxy test" to ensure that the money is being used for residential mortgage lending.

Supreme Court in NationsBank recognized that “modern annuities, though more sophisticated than the standard savings bank deposits of old, answer essentially the same [investment] need.” 139 L. Ed. 2d at 749, the Finance Board reasonably may conclude that the MPF program, though more sophisticated than standard advances authorized under section 10(a) of the Bank Act, answers essentially the same housing finance and member service needs. Accordingly, it is reasonable for the Finance Board to conclude that the FHLBank of Chicago establishment and operation of the MPF program are activities incidental to those “necessary for carrying out the provisions” of the Bank Act. See 12 U.S.C. § 1431(a).

2. The Power to Establish and Operate the MPF Program Is Also Incidental to the FHLBank’s Overall Housing Finance and Member Service Missions

Although, as discussed above, it is reasonable to regard the FHLBank of Chicago’s undertaking of the MPF program as being incidental to its power to make advances to members. OGC has concluded that: (1) in accordance with the NationsBank decision, an activity need not be tied directly to an expressly enumerated power in order to be permissible pursuant to a FHLBank’s incidental authority, and (2) it is also reasonable for the Finance Board to conclude that the FHLBank’s establishment and operation of the MPF program may be permitted as an activity incidental to the FHLBank’s dominant purpose under the Bank Act.

As detailed above, the Supreme Court in NationsBank held that the Comptroller of the Currency may, in his discretion, authorize national banks to engage in activities incidental not only to the express powers that are specifically enumerated in the National Bank Act, but also to the traditional “business of banking” mentioned in section 24(Seventh). Although section 11(e)(1) of the Bank Act, by prohibiting the FHLBanks from transacting “any banking or other business not incidental to activities authorized” by the Bank Act, makes clear that Congress did not intend that the FHLBanks be permitted to compete with commercial banks in all aspects of the general “business of banking,” the provision, when read with its counterpart in section 11(a), necessarily implies that the FHLBanks may engage in “banking business” related to the purposes of the Bank Act. In addition, as mentioned above, Congress has indicated since the ADAPSO decision that activities “do not need to be strictly necessary to the [FHL]Bank’s exercise of their express powers” to be permissible pursuant to the FHLBanks’ incidental powers. See 108 Cong. Rec. H4994. From this, it is reasonable to conclude that the Finance Board may, in its discretion, authorize the FHLBanks to undertake activities which, though not necessarily incidental to an express statutory power, are incidental to the execution of the general functions that the FHLBanks were created to carry out.

The plain language of the Bank Act, the Act’s legislative history and cases interpreting the Act indicate that the “dominant purpose” of the FHLBanks—that is, the realm of the “banking business” that the FHLBanks exist to undertake as part of their “normal functioning”—is, at minimum, to provide to their member institutions credit and other products and services to facilitate housing finance. Section 2A of the Bank Act alludes to such a dominant purpose in providing that one of the duties of the Finance Board is “to ensure that the FHLBanks carry out *their housing finance mission.*” See 12 U.S.C. § 1422a(a)(3)(B)(ii) (emphasis added). Similarly, the legislative history of the FIRREA amendments states that the FHLBanks may provide “a

variety of products and services” to support “the primary purpose of the [FHL]Banks: namely, housing finance.” and to serve member institutions by helping them to “control operating costs and interest rate” risk. See 108 Cong. Rec. H4994 Even the Supreme Court (as quoted in ADAPSO) has opined that the FHLBanks were chartered for the purpose of “placing 'long-term funds in the hands of local institutions’ in order to alleviate the pressing need of home owners for ‘low-cost, long-term, installment mortgage money.’”⁸

Although OGC does not here opine as to the scope of the general purposes of the Bank Act, or to the range of activities that may be considered incidental thereto, it is clear that the activities in which the FHLBank of Chicago proposes to engage under the MPF program are in harmony with even the most conservative interpretation of the Bank Act’s general purposes. As discussed in detail above, under the MPF program, the FHLBank of Chicago would channel funds into housing finance through member institutions acting as agents, thereby providing retail borrowers with access to an additional source of long-term mortgage financing. By offering its member institutions an opportunity to market a competitive mortgage product, the FHLBank not only would be benefiting its members financially, but also would be increasing the incentive for other mortgage lenders to price their mortgages reasonably. In addition, the MPF program would assist member institutions with their financial management by allowing them to assume those risks that they are best equipped to incur (i.e., credit and operational risks), while allocating to the FHLBank, through its investment in the pools of mortgage loans, those risks that it is most able to manage (i.e., funding, optionality and duration risks). Thus, it is also reasonable for the Finance Board to approve the FHLBank of Chicago’s establishment and operation of the MPF program as an activity incidental to the FHLBank’s overall housing finance and member service missions.

3. Even Under ADAPSO Standard, the Finance Board May Permit the FHLBank of Chicago to Establish and Operate the MPF Program

Although it is evident that Congress intended that the incidental powers of the FHLBanks be determined based upon the standards applicable to national banks, the FHLBank of Chicago’s establishment of the MPF program is permissible even under the conservative pre-FIRREA incidental powers guidelines set forth in ADAPSO. The Sixth Circuit in ADAPSO, citing its decision regarding the Federal Land Bank in Greene County, indicated that the FHLBanks could be permitted to undertake activities not expressly authorized under the Bank Act if such activities advance the “general purposes” of the Bank Act or have “a direct connection to the normal functions” of the FHLBank System. See ADAPSO, 568 F.2d at 486-87. Unlike the provision of data processing services at issue in ADAPSO, and as addressed at length above, the activities that would be invoked in the MPF program bear a direct relation to the “general purpose” and “normal functioning” of the FHLBanks.

⁸. Laurens Federal Sav. & Loan Ass’n v. South Carolina Tax Comm’n, 365 U.S. 517, 521-22, S. Ct. 719 (1961). The regulations of the Finance Board state that the “primary credit mission of the [FHL]Banks shall be to enhance the availability of residential mortgages.” See 12 C.F.R. § 935.2(a).

⁹. The comments of Rep. Garcia regarding the FHLBanks’ incidental powers under FIRREA indicate that the FHLBanks may have more than one “dominant purpose.” See 108 Cong. Rec. H4994.

Accordingly, if a court were to apply the ADAPSO standard to an analysis of activities like those connected with the MPF program, its approach to the issue presumably would parallel the approach taken in Greene County to the Federal Land Bank's exercise of power not expressly authorized in its organic act. Thus, a court could reason, analogous to the reasoning of the Greene County court with respect to the Federal Land Bank's powers that:

The entire [FHLBank] system is an integrated cooperative organization for the purpose of assuring [home owners] the opportunity to borrow money upon long-term mortgages, at minimum interest rates, under the direction, supervision and with the aid of the government. That is the dominant purpose of the Act creating the [FHLBanks and the Finance Board], in the light of which the scope of the [FHLBanks'] authority must be determined. It would seem to be clear that the authority of the [FHLBank] to effectuate the public purposes of the [Bank Act] must be liberally viewed, and restrictions on power not lightly asserted without clear mandate of the statute therein expressed or clearly implied.

Cf. Greene County, 152 F.2d at 220. Then consistent with the Greene County decision, the Sixth Circuit impliedly would have held that, despite the existence of an express power that might accomplish similar goals (though in some ways less efficiently) and given the efficiency if and lack of fraud involved in the MPF program, the approval of the plan by the Finance Board, and a reluctance "to interfere with the functioning of a governmental agency engaged in implementing a clearly defined public policy," an FHLBank has the power to undertake activities like those involved in the MPF program. See *id.* at 220-21.

Although the ADAPSO decision has been mooted subsequently by Congressional action, the fact that the MPF program would pass muster even under the conservative standards set forth therein serves further to bolster the conclusion that the Finance Board reasonably may approve the FHLBank of Chicago's establishment and operation of the MPF program as an activity within the power of the FHLBank under the Bank Act.

E. The Finance Board Will Need to Address its Advances Regulation Simultaneously With Approval of the MPF Program

The Finance Board's Advances regulation, which defines the term "advance" to include "a loan from a [FHL]Bank that is: (1) Provided pursuant to a written agreement; (2) Supported by a note or other written evidence of the borrower's obligation; and (3) Fully secured by collateral in accordance with the Act and this part." 12 C.F.R. § 935.1, is probably broad enough to encompass the lending in which the FHLBank of Chicago would engage as part of the MPF program. Given the technical differences between the FHLBank's proposed lending under the MPF program and the making of advances, it would be impractical to apply the precise requirements of the Advances regulation to loans made under the MPF program. Accordingly, if the Finance Board decides to permit the FHLBank to undertake the pilot MPF program, it will need either to amend the regulatory definition of "advances" or except the FHLBank's MPF

ending from the Advances regulation, and to set forth, in regulation or policy, separate guidelines for MPF Loans.

CONCLUSION

The Bank Act does not expressly address the power of the FHLBanks to engage in mortgage lending to retail customers through member institutions acting as agents. See 12 U.S.C. §§ 1421-49. However, the Bank Act provides that although no FHLBank "transact any banking or other business not incidental to activities authorized" by the Bank Act. *id.* § 1431(e)(1), the FHLBanks may "do all things necessary for carrying out the provisions of [the Bank Act] and all things incident thereto." *Id.* § 1431(a). Because Congress has not addressed the full scope of powers permitted to the FHLBanks pursuant to these provisions, the Finance Board must determine whether the incidental powers of the FHLBanks are wide enough to encompass those activities in which the FHLBank of Chicago proposes to engage as part of the MPF program. As the agency charged with the administration of the Bank Act, the Finance Board's reasonable interpretation of the incidental powers or provisions would be given great deference by courts. See NationsBank, 130 L. Ed. 2d at 747.

The legislative history of FIRREA, which amended section 11(e)(1) of the Bank Act to contain its current text regarding the incidental powers of the FHLBanks, indicates that Congress intended that the FHLBanks' incidental powers under the Bank Act be interpreted as broadly as those of national banks under section 24(Seventh) of the National Bank Act. See 108 Cong. Rec. H4994. The Supreme Court and appellate courts have interpreted the incidental powers language of section 24(Seventh) broadly, holding generally that: (1) national banks' incidental powers need not be derived directly from an expressly enumerated power, as long as they are related to the "business of banking"; (2) national banks should be permitted to utilize new methods of carrying out their traditional roles within the business of banking; and (5) the functional characteristics, rather than the technical structure, of these new methods should be examined in determining whether such methods are incidental to the business of banking. See NationsBank, 130 L. Ed. 2d 740. Because the MPF program is simply a method of empowering member institutions to channel funds into residential housing finance in a manner that is technically more sophisticated than, yet functionally similar to that which occurs when a FHLBank makes an advance, it is reasonable for the Finance Board to approve the FHLBank of Chicago's establishment and operation of the MPF program as an activity incidental to the FHLBank's express power to make advances to members.

Aside from its functional similarity to the extension of advances, the undertaking of the MPF program is also permissible as an activity incidental to the dominant statutory purpose of the FHLBanks. Although it is clear that the Bank Act does not permit the FHLBanks to engage in all aspects of the "business of banking." It is equally clear that under the Bank Act, the FHLBanks may at least engage in banking business designed to facilitate housing finance and to serve member institutions. Applying the reasoning of the Supreme Court's decision in NationsBank to the FHLBanks, it is also reasonable for the Finance Board to conclude that: (1) FHLBanks' incidental powers need not be derived directly from an express power, as long as the incidental power is related to the FHLBanks' dominant statutory purpose, (2) the dominant statutory

purpose of the FHLBanks is, at minimum, to serve member institutions by providing to them funds for residential mortgage lending, and (3) because, under the MPF program, the FHLBank of Chicago would channel funds into housing finance through member institutions acting as agents, thereby providing retail borrowers with access to an additional source of long-term mortgage financing, its undertaking is incidental to the FHLBanks' dominant statutory purpose.

Finally, because the channeling of mortgage money through member institutions advances the "general purposes" of the Bank Act and has "a direct connection to the normal functions" of the FHLBank System, the establishment and operation of the MPF program is permissible even under the conservative standards set forth in the now-mooted ADAPSO decision. See 568 F.2d 478. If the Finance approves the FHLBank of Chicago's undertaking of the MPF program, it should also take steps to ensure that loans made under the program are not subject to the provisions of the Finance Board's Advances regulation. See 12 C.F.R. part 935.