[redacted]

Federal Housing Finance Board

February 19, 1998

MEMORANDUM

TO: Richard Tucker
Deputy Director
Compliance Assistance Division
Office of Policy

THROUGH: Deborah F. Silberman
Acting General Counsel

FROM: Brandon B. Straus
Senior Attorney-Advisor

SUBJECT: Use Of Community Investment Program (CIP) Advances By Members To Finance CIP-eligible Loans By Third Parties

I BACKGROUND

This is in response to an issue raised by the Federal Home Loan Bank of [redacted] (Bank) in a letter of January 14, 1998, in which the Bank requested a review of its proposal to make CIP advances to members to fund loans to third parties, such as community development corporations or mortgage bankers, which would in turn use the proceeds of the members' loans exclusively to originate loans financing CIP-eligible activities. [1] Included with [redacted] Letter is a. legal memorandum in support of the Bank's proposal.[2] As further discussed below, the general outline of the transaction proposed by the Bank is not legally objectionable. However, some aspects of the proposed structure of the transaction may raise legal and policy issues.

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[1] See Letter from [redacted] President, Federal Home Loan Bank of to William W. Ginsberg, Managing Director, Finance Board (Jan. 14, 1998) ([redacted] Letter). CIP-eligible activities are those activities described in sections 10(i)(2)(A) through (D) of the Federal Home Loan Bank Act (Bank Act), which are discussed further below. See 12 U.S.C. § 1430(i)(2).

[2] See Attachment, [redacted] Letter, Memorandum from [redacted] Vice President and Deputy General Counsel, to [redacted], Vice President, Community Investment Services (Jan. 13, 1998) ([redacted] memo).

II. ANALYSIS

The statutory requirements governing the CIP are set forth in section 10(i) of the Bank Act, which provides, in part:

> Each Bank shall establish a program to provide funding for members to undertake community-oriented mortgage lending . . .

12 U.S.C. § 143O(i)(1). Section 10(i)(2) of the Bank Act provides:

> For purposes of this subsection, the term "community-oriented mortgage lending" means providing loans: .
>
> (A) to finance home purchases by families whose income does not exceed 115 percent of the median income for the area,
>
> (B) to finance purchase or rehabilitation of housing for occupancy by families whose income does not exceed 115 percent of the median income for the area,
>
> (C) to finance commercial and economic development activities that benefit low- and moderate-income families or activities that are located in low- and moderate-income neighborhoods,
>
> (D) to finance projects that further a combination of the purposes described in subparagraphs (A) through (C).

Id § 1430(i)(2).[3] Thus, in order to obtain a CIP advance, a member must "provid[e] loans to finance" one of the activities described above. At issue with regard to the Bank's proposal is whether a member that lends funds to a third party to originate loans financing UP-eligible activities may be considered to be "providing loans to finance" CIP-eligible activities. See id

The phrase "providing loans to finance" does not expressly preclude the concept of financing CIP-eligible activities through an intermediary. Indeed, the Office of General Counsel (OGC) previously has opined that neither the statutory language of section 10(i)(2) nor the legislative history of the Bank Act limits the meaning of the phrase "providing loans" to direct

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[3] The Federal Housing Finance Board (Finance Board) has not issued regulations implementing the statutory provisions quoted above. The only formal guidance issued by the Finance Board to date interpreting these statutory provisions is a policy statement approved by the Board of Directors on July 17, 1992, encouraging the Banks to promote the CIP. See CIP Policy Statement, Bd. Res. 92-533.1 (July 17, 1992).

lending by members.[4] Specifically, OGC has concluded that "providing loans" may be read to include the purchase of bonds or mortgage-backed securities (MBS) representing interests in pools of loans previously originated by third parties that financed CIP-eligible activities (secondary market scenario). See id.

Under both the secondary market scenario and the [redacted] Bank's proposal, the member, in effect, is financing CIP-eligible activities through one or more intermediaries. In the secondary market scenario, the member may be considered to be "providing loans to finance" CIP-eligible activities because the member is proving liquidity to the secondary market for loans that finance (CIP-eligible activities. See OGC memorandum at 3. This, in turn, increases the credit available for origination of such loans by other parties. See id. Arguably, the nexus between the member's extension of credit and the origination of loans financing CIP-eligible activities is less attenuated under the [redacted] Bank's proposal than under the secondary market scenario, because the Bank's proposal involves only one intermediary. In addition, under the Bank's proposal, the extension of credit by the member and the origination of the loan financing CIP-eligible activities are closer in time.

In sum, in order for a member to be eligible to receive a CIP advance from a Bank, the member must be deemed to be "providing loans to finance" one or more of the CIP-eligible activities set forth in section 10(i)(2) of the Bank Act. See 12 U.S.C. § 1430(i)(2). Neither the language of the statute nor the legislative history requires the phrase "providing loans to finance" to be interpreted to refer solely to the origination of loans by the member that directly finance CIP-eligible activities. See id. Assuming that the Bank and its member can demonstrate that the loans made by the third-party intermediary are in fact being used to finance CIP-eligible activities, we believe there is a sufficient nexus between the member's loan to the intermediary and the loan financing the CIP-eligible activity that the member may be deemed to have provided a loan to finance a CIP-eligible activity under section 10(i)(2) of the Bank Act. See id. Consequently, a member may apply for and obtain a CIP advance to fund its loan to a third party, subject to the customary requirements associated with obtaining a CIP advance, and subject to confirmation that the ultimate loans are made for CIP-eligible activities.

III. ADDITIONAL CONSIDERATIONS

Although we believe the concept of such financing to be legally unobjectionable, there may be some operational deficiencies in the proposal in its current form. For example, the Bank does not give a clear picture of how funds are to flow between the Bank, the member, and the third party. Consequently, it is not clear whether the Bank's proposed documentation requirements are sufficient to demonstrate a nexus between the member's loan to the third party and that party's origination of a loan financing CIP-eligible activity. According to the proposal, upon receiving documentation from the member demonstrating that the third party has made loans financing CIP-eligible activities, the Bank either would transfer the CIP advance proceeds to the

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[4] See Memorandum from Brandon B. Straus, Attorney-Advisor, through Deborah F. Silberman, Acting General Counsel, to Gary B. Townsend, Deputy Director, Office of Supervision (Aug. 21, 1996) (OGC memorandum).

member as a reimbursement for the member's loan to the third party, or transfer the advance proceeds directly to the third party. See [redacted] memo at 2. It is not clear why the third party would receive the advance proceeds if the third party's loan already had been funded by the member.

We also question the practice of a Bank transferring advance proceeds directly to a party other than the member that borrowed the advance. Only members may obtain CIP advances. See 12 U.S.C. § 1430(i). Transferring advance proceeds directly to a non-member creates the appearance of direct lending to non-members, and may violate the Bank Act, depending on how the transfer is done. Similarly, by permitting members to act essentially as conduits of advances to third parties, without any apparent limitation, the Bank's proposal may raise policy issues regarding the perceived receipt of benefits of Bank System membership by non-members, such as mortgage bankers, who compete directly with members.

In sum, the concept of the [redacted] Bank's proposal appears legally unobjectionable if certain conditions discussed above are observed, but it is not clear from the materials received that, as proposed, the concept would be implemented an unobjectionable manner. We defer to the Office of Policy on operational and policy issues.

cc: James L. Bothwell
Janet M. Fronckowiak
Neil R. Crowley