



REGULATORY INTERPRETATION 2005-RI-01

March 30, 2005

Subject:

Application of 12 C.F.R. § 966.8(c), which prohibits consolidated obligations (COs) from being directly placed with a Federal Home Loan Bank (Bank).

Guidance:

Section 966.8(c) prohibits a Bank from purchasing a CO as part of the CO's initial issuance. This prohibition applies regardless of whether the Bank purchased the CO directly from the Office of Finance (OF) or indirectly from one of approximately 100 firms that form the OF's approved underwriter network (collectively, Underwriters).

Analysis and Discussion:

The Banks issue COs through their agent, the OF. Taking the form of domestic bonds, global bonds, and discount notes, COs are the joint and several obligations of the 12 Banks. The Bank that receives the proceeds from the sale of a CO has the primary responsibility for making principal and interest payments on that obligation.

The vast majority of initial OF CO issuances are sold to Underwriters who purchase the COs for resale to investors. The OF issues a small percentage of its discount note COs to investors in direct placements not involving Underwriters. The OF also occasionally issues limited quantities of domestic bonds through direct placements.¹

Section 966.8(c) states that "COs shall not be directly placed with any Federal Home Loan Bank." This prohibition is not limited to the direct placements referred to above. It applies to any transaction in which one Bank seeks to purchase, as part of an initial issuance, a CO for which another Bank is primary obligor.

Section 966.8(c) codified a prohibition that initially appeared in the Finance Board's Financial Management Policy (FMP), which provided that a Bank "shall not directly place consolidated obligations with another Bank."² The preamble to the Finance Board rulemaking proposing section 966.8(c) stated that the Finance Board would continue the existing prohibition on directly placing COs with a Bank because "such placements do not further the mission of the Bank System." That proposal was adopted without change or further comment in the final rule adopting section 966.8(c).³

The Finance Board regulations state that the mission of the Banks is to provide to their members and housing associates financial products and services, including advances that assist and enhance the members' and housing associates' financing of housing and community lending.⁴ The regulations go on to enumerate several "core mission activities," including making advances, purchasing acquired member assets, providing standby letters of credit and

intermediary derivative contracts, and making specific investments that are intended to benefit housing finance or community investment.⁵ Investing in COs is not a core mission activity. Given the Banks' authority to purchase other investment securities, the Banks have ample investment vehicles to achieve their liquidity, asset management, and capital investment objectives.⁶

The prohibition in section 966.8(c) may not be circumvented by using an Underwriter to facilitate the purchase of a CO. It is important to look to the substance of a transaction to determine whether it complies with Finance Board regulations. A transaction in which an Underwriter purchases a CO from the OF with the expectation of selling it to a Bank is a direct placement for purposes of section 966.8(c) and is, therefore, prohibited. A different conclusion would elevate form over substance and eviscerate the prohibition.

A Regulatory Interpretation is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 CFR part 907.

¹ In 2004, the OF sold CO bonds in the principal amount of \$96 million in direct placements to two investors. These direct placements comprised 0.0247% of the OF's 2004 long-term bond initial issuances of \$388 billion.

² See former FMP Section IV.C.4.

³ See Resolution No. 1999-61, *published at* 65 Fed. Reg. 324, at 328 (Jan. 4, 2000) (proposed rule); Resolution No. 2000-24, *published at* 65 Fed. Reg. 36290, at 36299 (June 7, 2000) (final rule).

⁴ See 12 C.F.R. § 940.2.

⁵ *Id.* at § 940.3(a)-(i).

⁶ See 12 C.F.R. part 956.