Regulatory Interpretation 2021-RI-01

***Subject*:** Eligibility of Mortgage Loan Participations as Collateral for Federal Home Loan Bank (Bank) Advances

***Issue*:** May a Bank accept as collateral to secure advances mortgage loan participations that cannot be readily liquidated in the form in which they are to be pledged?

***Conclusion*:** No. Mortgage loan participations must meet the requirements of 12 CFR 1266.7(a)(4), including the requirement that the collateral can be "liquidated in due course," in order to be eligible to secure Bank advances. Participations for which there would be a known impediment to liquidation—due to their not being in salable form, lack of a viable secondary market, or other reasons—do not meet that requirement and, therefore, are not eligible collateral for advances. Prior guidance from Bank System regulators to the effect that mortgage loan participations may be eligible as collateral under regulatory provisions other than section 1266.7(a)(4) are rescinded.

***Background*:**

A Bank accepted as collateral for advances to a member 100 percent participation interests in single family residential mortgages pledged by the member's subsidiaries (as permitted under 12 CFR 1266.7(g)). The participations are in mortgage loans that were originally made or purchased by the member, which retains possession of the mortgage notes, continues to be the legal owner of the loans, and continues to service the loans, for which it receives fees from the subsidiary. In addition to the pledge of the participations by the subsidiary, the member has pledged any and all retained interests in the underlying mortgage notes and the member or subsidiary, as applicable, have pledged: all related servicing and custodial agreements, records, rights, and fees; all related insurance policies; and all related collection and escrow accounts and letters of credit. The Bank has perfected its security interest in all of the pledged assets through a series of UCC-1 filings.

The loan participations are not represented by certificates, but are transferred to the subsidiary through one or more participation agreements, under which interests in specific loans may flow in and out of the pool of participations covered by the respective agreements. The Bank entered into tripartite "loan participation affirmation agreements" with the member and the subsidiary, which are intended to identify (via attached schedules) the exact loans that have been participated out to the subsidiary, to provide representation and warranty language to the effect that those specific participation interests in fact have been legally passed to the pledging subsidiary, and to make clear that the Bank will rely on those representations and warranties as a basis for accepting the participations as collateral.

Because (as conceded by the Bank) there exists no viable secondary market for non-arm's length single family mortgage loan participations of the type described, the participations would need to be put into salable form by "collapsing" them back into the underlying mortgage notes held by the member should the member default and liquidation of the collateral become necessary. Realizing this, the Bank revised its advances/collateral agreements with both the member and the pledging subsidiary to add to each a "remedy provision" that, in the event the Bank has declared an "event of default" under the Bank-member agreement, requires the member and subsidiary to collapse the participations back into the mortgage notes held by the member to reconstitute whole mortgage loans. By its terms, the remedy provision is to be invoked only to the extent that proceeds from the liquidation of other collateral pledged by or on behalf of the member is insufficient to repay the advances in default. The remedy provision also grants the Bank power of attorney to execute the documents necessary to facilitate the collapse in the event the member and subsidiary fail to do so on their own. Despite the existence of these agreements, such a collapse would, by the member's own estimate, take between 15 and 60 business days, even assuming that all parties could and would fulfill the terms of the relevant agreements, which, of course, would come into play only when the member was sufficiently stressed that it was not repaying its advances.

***Analysis*:**

Each Bank, at the time of origination or renewal of an advance, must obtain from the borrowing member, or from an affiliate of the borrowing member, and thereafter maintain, a security interest in collateral that is eligible under one or more of the five categories enumerated in 12 CFR 1266.7(a): (1) whole first mortgage loans or privately issued mortgage backed securities (MBS) (excluding certain types of high-risk MBS); (2) securities issued, insured, or guaranteed by the United States Government or any agency thereof; (3) cash or deposits in a Bank; (4) other real estate-related (ORER) collateral meeting certain requirements; and (5) securities representing equity interests in assets that are eligible as collateral under any of the four preceding categories.[1] For clarity, this Regulatory Interpretation (RI) will refer to the provisions addressing those five categories of collateral as paragraphs (a)(1) through (a)(5), due to the fact that they appeared in different CFR sections (first, in 12 CFR 935.9 and, later, in 12 CFR 950.9) at the time the prior legal opinions and RIs discussed below were issued.

[1] 12 CFR 1266.7(a). That provision implements the statutory collateral requirements set forth at 12 U.S.C. § 1430(a)(3).

I. The Participations At Issue Are Not Eligible as ORER Collateral Under Paragraph (a)(4)

Paragraph (a)(4) explicitly mentions mortgage loan participations as one among several examples of the types of assets that may potentially qualify as eligible ORER collateral.[2] A real estate-related asset is actually eligible to secure advances under that provision, however, only if the Bank can perfect a security interest in the collateral and it "has a readily ascertainable value, can be reliably discounted to account for liquidation and other risks, and can be liquidated in due course."[3] The latter two stipulations were added to the regulation by the former Federal Housing Finance Board (Finance Board) in 2000 as part of the implementation of a statutory amendment that removed a clause limiting the amount of outstanding advances secured by ORER collateral to 30 percent of a member's capital.[4] The preamble to the final rule revising the ORER collateral requirements explained that the phrase "'can be liquidated in due course' is intended to mean that there are no known impediments to liquidation at the time the collateral is accepted by the Bank."[5]

Because, as conceded by the Bank, the loan participations at issue would take a minimum of 15 business days to collapse back into salable whole loan form—assuming that all parties promptly fulfilled their contractual obligations—there is unquestionably a "known impediment[] to liquidation" not only at the time the collateral is accepted by the Bank, but on a continuing basis. Accordingly, the mortgage loan participations at issue in this RI cannot be "liquidated in due course" as required under paragraph (a)(4) and are therefore not eligible as ORER collateral under that provision.

II. Earlier Agency Statements That Loan Participations Are Eligible Under Regulatory Provisions Other Than Paragraph (a)(4) Are Rescinded

Notwithstanding that the described loan participations do not qualify as eligible ORER collateral under paragraph (a)(4), there are a number of RIs and legal opinions issued by the Finance Board's Office of General Counsel (OGC) in the late 1990s and early 2000s to the effect that mortgage loan participations may in some circumstances qualify as eligible collateral under paragraph (a)(1) or paragraph (a)(5). Those statements were issued in response to requests for approval of specific transactions by individual Banks and were intended primarily (and perhaps solely) as a means of allowing Bank members to pledge mortgage loan participations as collateral in excess of the 30-percent-of-capital limitation on ORER collateral that was then in effect, where doing so was consistent with the safe and sound operation of the lending Bank. Because that statutory limitation was long ago removed, the motivation for those statements no

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[2] *See* 12 CFR 1266.7(a)(4)(ii)(D).

[3] 12 CFR 1266.7(a)(4)(i).

[4] *See* Pub. L. No. 106-102, § 604, 113 Stat. 1338, 1451 (1999).

[5] *See* 65 FR 44414, 44420 (July 18, 2000).

longer exists, and FHFA now disaffirms their reasoning. As discussed below, by means of this RI, FHFA is expressly rescinding those earlier legal opinions and RIs.

A. *Legal Opinion and RIs Stating that Participations Are Eligible Whole Loans Under Paragraph (a)(1)*

A 1998 legal opinion (1998-GC-04) by the Finance Board's OGC concluded that a Bank could be considered to have a security interest in whole mortgage loan collateral eligible under paragraph (a)(1), where its borrowing member's second-tier subsidiary had pledged certificates representing 100 percent undivided participation interests in pools of whole residential mortgage loans expressly eligible under that provision, and the Bank also had security interests in: (1) the member's remaining legal interest in the underlying mortgage loans; (2) 100 percent of the voting stock of the member's second-tier subsidiary that owned the participation certificates; and (3) 100 percent of the voting stock of the member's first-tier holding company subsidiary.[6] The conclusion was based on the Finance Board's view that, pursuant to such an arrangement, the Bank would have a complete security interest in the whole first mortgage loans underlying the participation interests and would have all of the rights that would exist in connection with a direct pledge of unified whole mortgage loans by its member. Subsequently, the Finance Board issued two RIs (1998-RI-01 and 1999-RI-08) holding similar arrangements to constitute pledges of eligible collateral under the Bank Act and regulations, not subject to the 30-percent-of-capital limitation.[7]

As exemplified by the loan participations at issue in this RI, however, separate pledges of participations and of the legal interests in the underlying mortgage notes are not, in fact, the functional equivalent of a pledge of whole mortgage loans. While unified whole loans can be readily liquidated—even if at a discount—through an established secondary market under normal circumstances, that may not be the case for all types of loan participations, particularly those that were not created as part of an arm's length transaction. Where a viable secondary market does not exist for a particular type of loan participation, the foreclosure and liquidation procedures will be more complex and uncertain and the risks materially higher than is the case for unified whole mortgage loans. In such cases, there is no sound basis upon which to accept such participations as whole loan collateral under paragraph (a)(1).

Where a loan participation can be reliably valued and discounted and readily liquidated in its existing form, it will qualify as eligible collateral under paragraph (a)(4). Given that the 30-percent-of-capital limitation on ORER collateral was long ago eliminated, the only possible motivation to view loan participations as being eligible under paragraph (a)(1) would be to circumvent the requirements of paragraph (a)(4) and allow a Bank to accept as collateral participations that are not of a similar liquidity to the other types of collateral that are eligible to

[6] *See* 1998-GC-04 (Mar. 16, 1998).

[7] *See* 1998-RI-01 (Dec. 2, 1998); 1999-RI-08 (Mar. 16, 1999). These RIs did not actually identify the specific regulatory provisions pursuant to which the collateral was deemed to be eligible.

secure advances. FHFA rejects such a reading of the collateral requirements as contrary to its duty to ensure the safety and soundness of the Banks and as not aligned with the language of the regulation, given that mortgage loan participations are expressly mentioned in paragraph (a)(4) as an example of assets that may qualify as eligible ORER collateral. Accordingly, 1998-GC-04, 1998-RI-01, and 1999-RI-08 and any other statements that may have been issued by the Finance Board or FHFA to the effect that loan participations may be eligible as whole loan collateral pursuant to paragraph (a)(1) are hereby rescinded.

B. *RI Stating that Participations Are Eligible Securities Under Paragraph (a)(5)*

Separately, an RI issued by the Finance Board OGC in 2000 (2000-RI-05) found certificates representing 100 percent participation interests in mortgage loans that would be eligible as whole loan collateral under paragraph (a)(1) to be themselves eligible collateral that a Bank could accept, without regard to the 30-percent-of-capital limit on ORER collateral, pursuant to paragraph (a)(5).[8] Under that provision, a Bank may accept "[a]ny security the ownership of which represents an undivided equity interest in underlying assets, all of which qualify either as: (i) Eligible collateral under paragraphs (a)(1), (2), (3) or (4) of this section; or (ii) Cash equivalents."[9] The RI concluded that by owning a 100 percent participation interest in the underlying mortgages, the member would "possess all benefits of ownership of the mortgages (*i.e.*, the right to the principal and interest payments)" and that, therefore, "the certificates issued by the member's affiliate to represent the transfer of the participation interests constitute a type of security contemplated under [paragraph (a)(5)]."[10]

Other than the foregoing summary conclusion, 2000-RI-05 did not further justify the characterization of the participation certificates as "securities." In support of its conclusion, the RI described the purpose of paragraph (a)(5) as being "to authorize the [Banks] to permit their members to pledge otherwise-eligible collateral in which the member holds all beneficial interests, yet to which the member does not have legal title." But, in fact, the preamble to the final rule adopting paragraph (a)(5) indicated that there was a more specific intent—that is, "to permit [the Banks] to accept as collateral <u>shares of mutual funds and similar equity investments</u> where the underlying assets of the fund comprise only eligible collateral."[11] This statement implies that the word "security," as used in paragraph (a)(5), was actually intended to refer to an instrument that is actively traded in the securities markets or easily redeemable at its market value.[12]

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[8] *See* 2000-RI-05 (June 7, 2000) available at: https://www.fhfa.gov/SupervisionRegulation/LegalDocuments/Documents/Regulatory-Interpretations/2000/2000-RI-05.pdf.

[9] *See* 12 CFR 1266.7(a)(5). At the time the RI was issued, this provision was located at 12 CFR 950.9(a)(5).

[10] The RI did not mention whether the legal interests in the underlying loans were to be pledged in addition to the participation interests; in any case, the conclusion did not depend on that factor.

[11] *See* 64 FR 16618, 16619 (Apr. 6, 1999) (emphasis added).

[12] The RI does not mention whether the participation certificates addressed in the RI were marketable.

Under the law, whether a particular instrument or transaction constitutes a "security" is generally dependent on the context. Most relevant with respect to collateral is the distinction between securities and loan participations under the Uniform Commercial Code (UCC), which, as codified by the respective states, governs secured transactions. Under the UCC, loan participations are categorized not as securities, but as "payment intangibles."[13] As such, they are, among other things, subject to different rules with respect to the perfection of security interests than are securities. In the securities law context, there are a number of cases holding that loan participations are not "securities" under both federal and state law (and FHFA has found none to the contrary).[14] In each of those cases, one of the factors the court relied upon in concluding that the participations at issue were not "securities" was the lack of "common trading [in the participation] for speculation or investment"—in other words, the lack of an active secondary market.

For these reasons, FHFA interprets the word "securities," as used in paragraph (a)(5), not to include loan participations. Accordingly, 2000-RI-05 and any other statements that may have been issued by the Finance Board or FHFA to the effect that loan participations may be eligible as securities collateral pursuant to paragraph (a)(5) are hereby rescinded.

III. The Mortgage Loan Participations at Issue Are Not Eligible Collateral Under the Advances Regulation

The types of collateral explicitly addressed in paragraphs (a)(1), (a)(2), and (a)(3)—whole first mortgage loans and high-quality private MBS, U.S. government and agency securities, and cash and deposits—can all be readily liquidated in their inherent forms at a more-or-less predictable value under normal circumstances, as can "securities" eligible under paragraph (a)(5), as that provision has been interpreted here. That may not be the case for the myriad assets that are potentially eligible as ORER collateral under paragraph (a)(4). It is precisely to ensure that ORER collateral is of a quality similar to that of the expressly enumerated collateral types that a Bank's ability to accept such collateral is made contingent upon the requirement that the asset can be liquidated in due course, as well as to the other caveats, under paragraph (a)(4). The fact

[13] The UCC defines "payment intangible" to mean "a general intangible under which the account debtor's principal obligation is a monetary obligation." *See* U.C.C. § 9-102(61). It defines "general intangible" to mean "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction." *See* U.C.C. § 9-102(42). Although the text of the UCC does not expressly state that loan participations are payment intangibles, they are considered to fall within that catch-all category by virtue of the fact that they do not meet the definition of any other type of right or asset under the code. This is confirmed in the Official Comments, which refer to "bank loan participation transactions" as "fall[ing] in a residual category of collateral, 'payment intangibles'." *See* UCC § 9-101, Official Comment, note 5.d.

[14] *See Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992) (holding short-term loan participations not to be "securities" under the Securities Act of 1933); *Kirschner v. JP Morgan Chase Bank, N.A.,* 2020 U.S. Dist. LEXIS 90797; 2020 WL 2614765 (SDNY 2020) (holding syndicated bank loan not to be security, and the loan syndication not to be a "securities distribution" under the blue sky laws of California, Colorado, Illinois, and Massachusetts); *BRS Assocs., L.P. v. Dansker*, 246 B.R. 755 (SDNY 2000) (holding commercial mortgage loan participations not to be "securities" under the Securities Act of 1933).

that "mortgage loan participations" are explicitly mentioned in paragraph (a)(4) as a type of ORER collateral strongly indicates an intent that all such assets must meet the requirements of that provision in order to be deemed eligible as advances collateral and, by means of this RI, FHFA expressly adopts that interpretation going forward.

Because, as discussed above, the mortgage loan participations at issue in this RI do not qualify as eligible ORER collateral under paragraph (a)(4), they are ineligible to secure Bank advances. Accordingly, the Bank should follow the instructions of the Division of Bank Regulation in releasing its security interests in those loan participations, and in any other participations that do not qualify as eligible ORER collateral, and in requiring any borrowing members whose advances are secured by such collateral to pay down those advances to the extent that the remaining eligible collateral, or any eligible collateral that may be substituted for the loan participations, is insufficient to fully secure its outstanding advances.

Congressional Review Act:

In accordance with the Congressional Review Act (5 U.S.C. 801 et seq.), FHFA has determined that this RI constitutes a major rule and has verified this determination with the Office of Information and Regulatory Affairs of the Office of Management and Budget.

Effective Date:

This RI shall become effective on December 13, 2021.

By: CLINTON JONES Digitally signed by CLINTON JONES
Date: 2021.10.04 09:37:24 -04'00'

Clinton Jones
General Counsel

This Regulatory Interpretation is issued pursuant to 12 CFR 1211.5 and is subject to modification or rescission by the Director of the Federal Housing Finance Agency.