



## REGULATORY INTERPRETATION 2003-RI-02

**Date:** March 28, 2003

**Subject:** The qualification of securities issued or guaranteed by state or municipal governments or their political subdivisions (Municipal Securities) as “other real estate-related collateral.”

**Request Summary:**

A Federal Home Loan Bank (Bank) has asked whether Municipal Securities may qualify as “other real estate-related collateral” under section 10(a)(3)(D) of the Federal Home Loan Bank Act (Bank Act).

**Conclusion:**

A Bank may accept as “other real estate-related collateral” a Municipal Security to the extent that the proceeds of the Municipal Security have been or will be used to finance the acquisition, development or improvement of real estate (Real Estate Improvements).

**Background:**

Section 10(a)(3)(D) of the Bank Act authorizes “other real estate-related collateral acceptable to the Bank” as one of several classes of collateral eligible to secure advances, provided such collateral has a readily ascertainable value and the Bank can perfect its interest in the collateral. *See* 12 U.S.C. § 1430(a)(3)(D). The Bank Act does not define “other real estate-related collateral” and there is no legislative history offering guidance on congressional intent.

The Finance Board regulations also do not define “other real estate-related collateral,” but they do provide four examples of “other real estate-related collateral,” including commercial real estate loans. Each example is, directly or indirectly, secured or backed by mortgages on real estate. *See* 12 C.F.R. § 950.7(a)(4). The preamble accompanying the original version of section 950.7(a)(4) states that “other real estate-related collateral” could include limited amounts of “mortgage-related” collateral. Both the regulation and the accompanying preamble language make clear, however, that the four examples of “other real estate-related collateral” were illustrative, not exhaustive.

**Analysis and Discussion:**

Municipal Securities are a widely used source of funding for public infrastructure and other forms of community development projects. For these and other reasons, Municipal Securities benefit from certain exemptions from income tax and federal securities laws. From an economic and a practical perspective, if all of the proceeds of a Municipal Security have been or will be

used, directly or indirectly, for Real Estate Improvements, there is a direct relationship between the Municipal Security and the underlying real estate. This direct relationship provides a legally supportable basis to conclude that the outstanding principal balance of a Municipal Security whose proceeds have been or will be used, directly or indirectly, to finance Real Estate Improvements qualifies as “other real estate-related collateral” under section 10(a)(3)(D) of the Bank Act.<sup>1</sup>

A mixed-use Municipal Security, *i.e.*, one for which a portion of the proceeds have been or will be used for purposes other than Real Estate Improvements, may qualify as “other real estate-related collateral,” to the extent that the mixed-use Municipal Security’s proceeds, directly or indirectly, finance Real Estate Improvements. For example, if 80% of the proceeds of a Municipal Security are used for Real Estate Improvements, then up to 80% of the outstanding principal balance of the Municipal Security could qualify as “other real estate-related collateral.” The remaining 20% of the outstanding balance of the Municipal Security, *i.e.*, the portion corresponding to uses unrelated to Real Estate Improvements, could not qualify as “other real estate-related collateral.”

A Bank seeking to accept the outstanding principal balance of a Municipal Security as collateral to secure an advance must determine:

- i. whether the proceeds of the Municipal Security have been or will be used directly or indirectly to finance Real Estate Improvements; and
- ii. in the case of a mixed-use Municipal Security, what percentage of the proceeds has been or will be used to finance Real Estate Improvements.

The Office of General Counsel (OGC) believes that a Bank generally may make these determinations based on information contained in the official statement prepared in connection with a Municipal Security. Where part of the proceeds of a Municipal Security have been or will be devoted to indirect “soft costs” such as architectural, development and legal fees related to Real Estate Improvements, the OGC believes that the portion of the outstanding principal balance of the Municipal Security which is attributable to these indirect “soft costs” would qualify as “other real estate related collateral” if the indirect “soft costs” are capitalized on the same basis as real estate under accounting principles generally accepted in the United States.

During the course of their examination of a Bank, Finance Board examiners may conduct selective reviews of official statements prepared for Municipal Securities that have been

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<sup>1</sup> In an opinion letter of Paul J. Drolet, former Finance Board General Counsel, to Jonathan R. West, General Counsel, Federal Home Loan Bank of Indianapolis, dated February 8, 1996 (Drolet Opinion), the Office of General Counsel (OGC) analyzed whether mortgage revenue bonds could qualify as “other real estate-related collateral” under section 10(a)(3)(D). Mortgage revenue bonds are Municipal Securities that state and local governments issue through housing finance agencies to help finance below-market-interest-rate mortgages for first-time qualifying homebuyers. Citing the OGC’s past practice and policy as interpreting “other real estate-related collateral” to mean mortgage-related assets, the Drolet Opinion stated that mortgage revenue bonds qualified as “other real estate-related collateral” because, as mortgage-backed securities, they had a direct connection to mortgage loans. The OGC has reconsidered this interpretation of “other real estate collateral” since the Drolet Opinion and now has determined that the strict proceeds-based analysis for considering whether or not Municipal Securities may qualify as “other real estate related collateral” discussed in this Regulatory Interpretation is more consistent with the Bank Act than the “mortgage-related assets” analysis relied on in the Drolet Opinion. Accordingly, this Regulatory Interpretation supersedes the Drolet Opinion. However, any Municipal Securities that have been accepted by a Bank as collateral for an advance in reliance on the Drolet Opinion may remain eligible collateral until they mature or the advance that they secure is repaid.

accepted as “other real estate related collateral.” Finance Board examiners also may contact the trustee of Municipal Securities to verify the percentage of the proceeds of the Municipal Securities that were used, directly or indirectly, to finance Real Estate Improvements.

If a Bank wishes to secure an advance with Municipal Security collateral, the Bank must apply the appropriate discount required by its collateral policy to the amount of the outstanding principal balance of the Municipal Security that qualifies as “other real estate-related collateral.”

This Regulatory Interpretation only applies to Municipal Securities and not to any other type of security whose proceeds are used to finance Real Estate Improvements.

<p>A Regulatory Interpretation applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 CFR part 907.</p>
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