

Section	Remove	Add
986.1 (def. of <i>Office of Finance</i> )	Part 941	Part 985.
986.2(a)	Part 912	Part 986.
986.2(b)	§ 912.4(c)(1)	§ 986.4(c)(1).
986.2(b)	§ 912.3	§ 986.3.
986.3(a)(introductory text)	Part 912	Part 986.
986.4(c)(2)	§ 912.2(b) or § 912.3	§ 986.2(b) or § 986.3.
986.5(a)	§ 912.4(c)(1)	§ 986.4(c)(1).
986.5(a)	Part 912	Part 986.
986.6(b)	Part 912	Part 986.
986.8(a)	Part 912	Part 986.
986.8(b)	Part 912	Part 986.
986.9(a)	Part 912	Part 986.
986.9(b)	Part 912	Part 986.

**PART 987—FINANCIAL STATEMENTS OF THE BANKS**

112. The authority citation for newly designated part 987 continues to read as follows:

**Authority:** 12 U.S.C. 1422a, 1422b, 1431 and 1440.

113. Amend newly designated part 987 by removing and reserving newly designated § 987.1.

**PART 995—FINANCING CORPORATION OPERATIONS**

114. The authority citation for newly designated part 995 continues to read as follows:

**Authority:** 12 U.S.C. 1441(b)(8), (c) and (j).

115. Amend newly designated § 995.1 by:

- a. Removing paragraph designations (a) through (p);
- b. Removing the definitions of the terms “Act”, “Bank or Banks” and “Finance Board”.

116. Amend newly designated § 995.4(b) by:

- a. Removing the words “Federal Home Loan Bank securities” wherever they appear and adding, in their place, the words “consolidated obligations”.
- b. Removing the terms “Federal Home Loan Bank” and “Federal Home Loan Banks”, wherever they appear, and

adding, in their place, the words “Bank” and “Banks”, respectively.

117. Amend newly designated § 995.8(b) by removing the words “Board of Directors of the FDIC” and adding, in their place, the words “board of directors of the FDIC”.

118. In the table below, for each newly designated section indicated in the left column, remove the cross-reference indicated in the middle column and, in its place, add the cross-reference indicated in the right column:

Section	Remove	Add
995.1 (def. of <i>Office of Finance</i> )	Part 941	Part 985.
995.4(b)	Part 912	Part 986.
995.7(a)	§ 950.6	§ 995.6.
995.8(b)(1)	§ 950.6	§ 995.6.
995.8(c)(1)	§ 950.6	§ 995.6.
995.8(c)(2)	§ 950.6	§ 995.6.

**PART 996—AUTHORITY FOR BANK ASSISTANCE OF THE RESOLUTION FUNDING CORPORATION**

119. The authority citation for newly designated part 996 is revised to read as follows:

**Authority:** 12 U.S.C. 1422a, 1422b.

120. Amend newly designated § 996.1 by removing the words “Federal home loan banks” and adding, in their place, the word “Banks”.

121. Amend newly designated § 996.2 by removing the word “bank” and adding, in its place, the word “Bank”.

Dated: July 28, 1999.

By the Board of Directors of the Federal Housing Finance Board.

**Bruce A. Morrison,**  
*Chairman.*

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**FEDERAL HOUSING FINANCE BOARD**

**12 CFR Parts 917, 925, 930, 940, 954, 955, 958, 965, 966 and 980**

[No. 99-45]

RIN 3069-AA84

**Federal Home Loan Bank Financial Management and Mission Achievement**

**AGENCY:** Federal Housing Finance Board.

**ACTION:** Proposed rule.

**SUMMARY:** The Federal Housing Finance Board (Finance Board) is proposing to adopt new financial management and mission achievement regulations, and amend certain existing regulations, for the Federal Home Loan Banks (Banks). The proposal would modernize policies governing the business activities of the Banks and, for the first time, would establish regulatory standards for

mission achievement by the Banks and a definition of mission assets. The proposal includes a risk-based capital requirement, pursuant to which the amount of capital required to be maintained by a Bank would be based on the credit, market, and operations risks to which it is exposed. The risk-based capital regime builds upon the regulatory framework used by other financial institution and government-sponsored enterprise (GSE) regulators. The mission achievement requirement in the proposal would: codify the authority of the Banks to hold mortgage assets, including mortgage-backed securities; allow mortgage assets meeting certain regulatory requirements to be counted as mission assets; and eliminate the use of the Banks’ GSE advantages in issuing debt to fund arbitrage investments. The proposal also sets forth in the regulation the responsibilities of the boards of

directors and senior management of the Banks, as a means of ensuring that they fulfill their duties in operating the Banks in a safe and sound manner and in furtherance of their mission. The proposal will enable the Banks to help their members be more effective competitors in the housing finance and community lending marketplace, which in turn will assure that benefits accrue to consumers. In a separate rulemaking, the Finance Board is proposing to reorganize its regulations in a more logical arrangement and to reflect the revisions to be made by this proposal.

**DATES:** Comments on this proposed rule must be received in writing on or before December 27, 1999.

**ADDRESSES:** Comments should be mailed to: Elaine L. Baker, Secretary to the Board, Federal Housing Finance Board, 1777 F Street, NW, Washington, DC 20006. Comments will be available for public inspection at this address.

**FOR FURTHER INFORMATION CONTACT:** James L. Bothwell, Director and Chief Economist, (202) 408-2821; Scott L. Smith, Deputy Director, (202) 408-2991; Julie Paller, Senior Financial Analyst, (202) 408-2842; Ellen E. Hancock, Senior Financial Analyst, (202) 408-2906; Austin Kelly, Senior Financial Economist, (202) 408-2541; or Syed Ahmad, Senior Financial Economist, (202) 408-2870; Office of Policy, Research and Analysis, Federal Housing Finance Board, 1777 F Street, NW, Washington, DC 20006.

**SUPPLEMENTARY INFORMATION:**

**I. Overview of Proposal**

The proposed rule would establish new financial management and mission achievement requirements for the Banks, including: (1) a capital provision that would incorporate both minimum total capital and risk-based capital elements; (2) provisions linking the GSE debt funding advantage to activities that further the mission of the Banks (as set forth in the new regulatory definition), thus eliminating GSE debt-funded arbitrage investments and authorizing the Banks to hold "member mortgage assets"; and (3) provisions defining the responsibilities—and thus the accountability—of the boards of directors and senior management of the Banks. The proposal would give the Banks greater flexibility to manage their business so as to better serve their members and fulfill their public purpose, while operating within a risk-based capital framework that ensures the safety and soundness of the Bank System.

**A. Capital Requirements**

Under current law, the amount of capital a Bank must hold is determined not by the risks inherent in its portfolio or business practices, but by the asset size of, or the dollar amount of advances outstanding to, its members. Specifically, a member must maintain a minimum investment in the capital stock of its Bank in an amount equal to the greater of: (1) 1 percent of the member's mortgage assets; (2) 0.3 percent of the member's total assets; or (3) 5 percent of total advances outstanding to the member (with a somewhat higher percentage for any member that is not a "qualified thrift lender"). See 12 U.S.C. 1426(b)(1), (b)(2), (b)(4); 1430(c), (e)(1), (e)(3); 12 CFR 933.20(a).

The Banks currently operate in accordance with the Finance Board's Financial Management Policy (FMP), under which risk management is accomplished principally through a list of specific restrictions and limitations on the Banks' investment practices and a leverage limit which prohibits Banks from incurring liabilities in the form of consolidated obligations (COs) or unsecured senior liabilities in an amount greater than twenty times their capital stock. See 62 FR 13146 (Mar. 19, 1997); Finance Board Res. No. 96-45 (July 3, 1996), *as amended by* Finance Board Res. No. 96-90 (Dec. 6, 1996), Finance Board Res. No. 97-05 (Jan. 14, 1997), and Finance Board Res. No. 97-86 (Dec. 17, 1997). Though this approach has served the purpose of ensuring the safety and soundness of the Bank System, it lacks the flexibility that would enable the Banks to fulfill their mission to the maximum extent.

To ensure that the risks taken by a Bank are adequately supported by its capital, the proposal would implement, for the first time, a risk-based capital requirement for the Banks, which builds upon the risk-based capital regimes of other federal financial institution regulators. Under the proposed rules, the amount of capital to be held by each Bank would depend, in part, on the risks—credit risk, market risk, and operations risk—to which the Bank is exposed. The credit risk capital requirement would be set according to credit ratings and the associated historical default and recovery data made available by nationally-recognized statistical rating organizations (NRSROs). This approach would improve on the broad credit risk weighting categories set forth in the Basle Accord in 1988<sup>1</sup> by determining

<sup>1</sup> The risk-based capital standards of the other federal bank regulatory agencies are based on the

the credit risk capital component based on the risk of an instrument rather than the type of instrument.

A Bank's market risk capital requirement would be equal to the market value of the Bank's portfolio at risk from changes in interest rates, foreign exchange rates, and commodity and equity prices during periods of extreme market stress, as determined in accordance with internal market risk models to be developed by each Bank. A Bank would be required to assess its market values at risk regularly through stringent stress testing of its entire portfolio, including both on-balance sheet assets and liabilities and off-balance sheet items, as well as related options. By comparison, large commercial banks are required to conduct such assessments only for their trading account and for certain other assets, leaving out much bank business from the value at risk calculation.

The operations risk capital requirement proposed would be equal to 30 percent of the combined amount of capital required for credit and market risks. This is consistent with the statutory requirement for operations risk capital imposed on the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). See 12 U.S.C. 4611(c)(2).

In addition to the risk-based capital requirement, the proposal would establish a minimum total capital requirement that would require each Bank to maintain total capital of not less than 3.0 percent of its total assets, regardless of its risk profile, although

document entitled "International Convergence of Capital Measurement and Capital Standards" (July 1988) (the Basle Accord). The Basle Accord was agreed to by the Basle Committee on Banking Supervision (BCBS) which comprises representatives of the central banks and supervisory authorities of the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States and Luxembourg). The BCBS meets at the Bank for International Settlements, Basle, Switzerland. The Basle Accord defines bank capital and sets credit risk-based capital standards for on- and off-balance sheet instruments. The Basle Accord has been amended many times with the most significant amendment entitled "Amendment to the Capital Accord to Incorporate Market Risks" (Jan. 1996) (the Amendment). The Amendment sets specific risk-based capital standards for instruments held in trading portfolios of commercial banks. For debt instruments, the specific risk is defined by the Amendment as credit and event risk. In addition, the Amendment incorporates a measure of the market risk due to interest rates, foreign exchange rates, equity prices and commodity prices for all instruments held in trading portfolio (trading book); and foreign exchange and commodity risks for instruments held in non-trading portfolio (banking book). The BCBS issued a consultative paper entitled "A New Capital Adequacy Framework" (June 1999) (the Framework) that introduces a new framework to replace the Basle Accord.

the Finance Board could require a greater amount in individual cases.<sup>2</sup>

### B. Mission Achievement

The principal source of funding for the Banks is the COs that are issued in the global capital markets and for which the twelve Banks are jointly and severally liable. Because of the Banks' GSE status, the costs to the Banks of obtaining such funding are substantially less than the borrowing costs for comparable debt issued by other entities. The Banks pass the benefit of this funding advantage to their members through wholesale loans (called advances) priced lower than the members could otherwise obtain to provide support for housing finance, including community lending, in fulfillment of the Banks' mission.

The FMP does not expressly require the Banks to use any particular percentage of the funds obtained through the issuance of COs to provide advances to their members. In large part due to the financial burdens imposed on the Banks as a result of the savings and loan crisis, the Banks began in 1991 to use a portion of the proceeds from COs to finance investments which the Finance Board does not consider to be adequately related to their statutory mission. The level of such non-mission-related investments rose substantially in the early 1990s, but has begun to decline appreciably, as a percent of assets, in recent years, as the membership base of the Bank System and the level of advances outstanding to members have increased.

To better link the GSE advantages in the capital markets to the mission performance of the Bank System, the proposed rule would require, by January 1, 2005, that an amount equal to 100 percent of each Bank's outstanding COs be held by the Bank in core mission activities. "Core mission activities" would be defined as those activities that assist and enhance members' and eligible nonmember borrowers' financing of housing and community lending. Included in this definition are advances and also a newly authorized class of investments to be called "member mortgage assets." The transition period is intended to allow the Banks sufficient time to restructure their balance sheets as necessary to

bring the level of core mission activities in line with the amount of outstanding COs.

The proposed core mission activity requirement would be subordinate to the safe and sound financial operation of the Banks, as mandated by the Federal Home Loan Bank Act (Act). See 12 U.S.C. 1422a(a)(3)(A). During any specified period in which a Bank's board of directors determines that the core mission activities requirement would be inconsistent with the safe and sound operation of the Bank, the Bank would be permitted to be out of compliance with the core mission activities requirement.

By establishing the core mission activities requirement at 100 percent of COs outstanding, the proposed rule will both permit and encourage the Banks to develop new products and business activities (such as member mortgage assets, discussed below) that: further the statutory mission of the Banks; build upon the cooperative nature of the Bank's relationship with its members; meet the core mission activities definition in the proposed rule; and are supported by appropriate levels of capital.

### C. Responsibilities of Bank Boards of Directors and Senior Management

Because it allows the Banks substantially greater authority to acquire new assets and manage their risks, and to raise member capital accordingly, the proposed rule also would articulate certain minimum responsibilities of the Banks' boards of directors and senior management with regard to operating the Banks in a safe and sound manner and ensuring that the Banks achieve their statutory mission. These responsibilities include matters such as the adoption and annual review of risk management policies, periodic risk assessments, the maintenance of effective internal controls, independent audit committees, and adoption and review of and compliance with mission achievement policies.

### D. Reorganization of Finance Board Regulations

Because of the comprehensive nature of the amendments that would be made by the proposal, the Finance Board separately is proposing to reorganize its regulations in order that the revised regulations will remain internally consistent and will reflect the proposed changes in a logical manner. Cross-references appearing in the text of the proposed rule are made to the new section and part numbers that would be in effect once the reorganization regulation is finalized. Where such

references are to provisions that currently exist under different section or part numbers, the existing citation has been noted in this preamble. For ease of reference, this proposed reorganization regulation is also being published in this edition of the **Federal Register**.

### E. Public Hearing

The Finance Board will hold a public hearing on this proposal. Persons interested in participating in the public discussion of the proposed rule should contact Karen H. Crosby, Director, Office of Strategic Planning, in writing at the Federal Housing Finance Board, 1777 F St. NW, Washington, DC, 20006, by the close of business October 15, 1999.

## II. Statutory and Regulatory Background

### A. The Bank System

The twelve Banks are instrumentalities of the United States organized under the authority of the Act. See 12 U.S.C. 1423, 1432(a). The Banks are cooperatives; only members of a Bank may own the capital stock of a Bank and only members or certain eligible nonmember borrowers (such as state housing finance agencies) may obtain access to the products provided by a Bank. See 12 U.S.C. 1426, 1430(a), 1430b. Each Bank is managed by its own board of directors and serves the public by enhancing the availability of residential mortgage and community lending credit through its members and eligible nonmembers. See 12 U.S.C. 1427. Any eligible institution (typically, an insured depository institution) may become a member of a Bank by satisfying certain criteria and by purchasing a specified amount of the Bank's capital stock. See 12 U.S.C. 1424, 1426, 1430(e)(3); 12 CFR part 933. As GSEs, the Banks are granted certain privileges that enable them to borrow funds in the capital markets on terms more favorable than could be obtained by other entities. Typically, the Bank System can borrow funds at a modest spread over the rates on U.S. Treasury securities of comparable maturity. The Banks pass along their GSE funding advantage to their members—and ultimately to consumers—by providing advances (secured loans) and other financial services at rates that would not otherwise be available to their members.

Together with the Office of Finance, the twelve Banks comprise the Bank System, which operates under the supervision of the Finance Board, an independent agency in the executive branch of the U.S. government. The primary duty of the Finance Board is to

<sup>2</sup> By comparison, the statutory minimum total capital requirement for the other housing GSEs—Fannie Mae and Freddie Mac—is 2.5 percent of on-balance sheet assets plus, generally, 0.45 percent of off-balance sheet items. See 12 U.S.C. 4612(a).

<sup>3</sup> Section 10b of the Federal Home Loan Bank Act, 12 U.S.C. 1430b, provides that certain nonmember mortgagees making targeted housing loans may apply for access to Bank advances.

ensure that the Banks operate in a financially safe and sound manner; consistent with that duty the Finance Board is required to supervise the Banks, ensure that they carry out their housing finance mission, and ensure that they remain adequately capitalized and able to raise funds in the capital markets. 12 U.S.C. 1422a(a)(3)(A), (B).

#### *B. The Banks' Housing Finance and Community Lending Mission*

Under section 10 of the Act and part 935 of the Finance Board's regulations, the Banks have broad authority to make advances in support of housing finance, which includes community lending. See 12 U.S.C. 1430(a), (i), (j); 12 CFR part 935. The Banks also are required to offer two programs—the Affordable Housing Program (AHP) and the Community Investment Program (CIP)—to provide subsidized or at-cost advances, respectively, in support of unmet housing finance or targeted economic development credit needs. See 12 U.S.C. 1430(i), (j); 12 CFR parts 960, 970. In addition, section 10(j)(10) of the Act, as implemented by a recently issued Finance Board regulation, authorizes the Banks to establish Community Investment Cash Advance (CICA) Programs for community lending, defined as providing financing for economic development projects for targeted beneficiaries. See 12 U.S.C. 1430(j)(10); 12 CFR part 970; 63 FR 65536 (Nov. 27, 1998).

#### *C. Investment Authority and Oversight*

The Banks' investment authority is set forth primarily in sections 11(h) and 16(a) of the Act, which govern the investment of the Banks' surplus and reserve funds, respectively. See 12 U.S.C. 1431(h), 1436(a). Under both of these sections, the Banks are authorized to invest in: obligations of the United States; certain obligations of Fannie Mae, the Government National Mortgage Association (Ginnie Mae), or Freddie Mac; and in such securities in which fiduciary and trust funds may be invested under the law of the state in which the Bank is located. Section 11(h) also authorizes investments in the securities of certain small business investment companies (SBIC).

In addition to those permissive investments, the Banks are required to have liquidity reserves in an amount equal to deposits from their members invested in obligations of the United States, deposits in banks or trust companies, and certain specified short-term advances to their members. See 12 U.S.C. 1431(g).

Currently, the Finance Board regulates the Banks' investment

practices through its regulations, as well as through the FMP. Section 934.1 of the regulations provides that the Banks may acquire or dispose of investments only with the prior approval of the Finance Board, or in conformity with authorizations of the Finance Board or "stated [Finance] Board policy." 12 CFR 934.1. By resolution, the Finance Board adopted the FMP, in part, as its "stated policy" regarding permissible Bank investments. The FMP generally provides a framework within which the Banks may implement their financial management strategies in a prudent and responsible manner. Specifically, the FMP identifies the types of investments that the Banks may purchase pursuant to their statutory investment authority and, therefore, by implication, prohibits any investments not specifically identified by the FMP. The FMP also includes a series of guidelines relating to the funding and hedging practices of the Banks, as well as to the management of their credit, interest rate and liquidity risks, and establishes liquidity requirements in addition to those required by statute, as noted above. See FMP sections III–VII.

The FMP evolved from a series of policies and guidelines initially adopted by the Finance Board's predecessor agency, the Federal Home Loan Bank Board (FHLBB), which had adopted guidelines comparable to the FMP in the 1970s and revised them a number of times thereafter. The Finance Board adopted the FMP in 1991, consolidating into one document the previously separate policies on funds management, hedging and interest rate swaps, and adding new guidelines on management of unsecured credit and interest rate risks. As discussed in considerably more detail below, this proposed rule would supersede the FMP as the Finance Board's means of overseeing the investment practices and mission achievement of the Banks.

### **III. Analysis of Proposed Rule**

#### *A. Part 917—Responsibilities of Bank Boards of Directors and Senior Management*

##### **1. Overview**

Each state generally has laws of incorporation that require, among other things, a corporation to be managed by a board of directors. Consistent with this general corporate concept, the Act provides for the management of each Bank to be vested in the Bank's board of directors. See 12 U.S.C. 1427(a). The Act states that each Bank is a corporate body. See *id.* at 1432(a). In addition to authorizing certain enumerated corporate and banking powers, *see id.* at

1431, 1432, the Act grants each Bank all such incidental powers as are consistent with the provisions of the Act and customary and usual in corporations generally. See *id.* The Finance Board believes that, attendant to the exercise of customary and usual corporate powers, the Banks' boards of directors are subject to the same general fiduciary duties of care and loyalty to which the board of a state-chartered business or banking corporation would be subject, although this previously has not been set forth in regulation.

The duties, responsibilities and privileges of a director of a Bank derive from a source different from that of a director of a state-chartered business or banking corporation. Each Bank is created in accordance with Federal law to further public policy, and its statutory powers and purposes are not subject to change except by the Congress. A Bank's board of directors has neither the right nor the duty to alter the purpose of the Bank, whereas an ordinary corporate board of directors may approve mergers, consolidations and changes in the corporate charter that could drastically alter the objectives and nature of the business of the corporation. The directors of a Bank are responsible for managing that Bank to achieve the statutorily-mandated objectives of promoting housing finance and community lending and meeting the Bank's statutory obligations (*e.g.*, paying a portion of the interest on obligations of the Resolution Funding Corporation (REFCORP), *see id.* at 1441b, and making contributions to the AHP, *see id.* at 1430(j)), all in a financially safe and sound manner.

All Banks are subject to the supervision of the Finance Board. Although the directors manage and control their Banks, they may act only within the parameters established by the Finance Board. The bulk of the Banks' corporate powers, duties and responsibilities are described in sections 10, 11, 12 and 16 of the Act. *Id.* at 1430, 1431, 1432 and 1436. Section 10 of the Act authorizes each Bank to make secured advances to its members upon collateral sufficient, in its judgment, to fully secure the advance, and to certain eligible nonmember borrowers upon statutorily specified collateral. See *id.* 1430(a), 1430b. The Banks may conduct correspondent services, establish reserves, make investments and pay dividends, all subject to statutory limitations. See *id.* at 1431, 1436. Under section 12(a) of the Act, a Bank, and hence any director of that Bank, has the power to sue and be sued. See *id.* at 1432(a). In addition, each Bank has adopted bylaws that address such

matters as: the conduct of meetings of the board of directors; existence, composition, conduct and administration of committees of the board of directors; and indemnification.

Proposed part 917 for the first time would set forth in one place and in regulation the duties and responsibilities of a Bank's board of directors and of senior management of the Bank. It will make clear the Finance Board's belief that oversight of management by a strong and proactive board of directors is critical to the safe and successful operation of a Bank. Under proposed part 917, the board of directors of each Bank shall be responsible for: approving and periodically reviewing the significant policies of the Bank; understanding the major risks taken by the Bank, setting acceptable tolerance levels for these risks and ensuring that senior management takes the steps necessary to identify, measure, monitor and control these risks; monitoring that the Bank is in compliance with applicable statutes, regulation and policy (both of the Finance Board and the Bank); ensuring that the Bank carries out its housing finance and community lending mission; approving the organizational structure and delegations of authority; and ensuring that an adequate and effective system of internal controls is established and maintained and that senior management is monitoring the effectiveness of the internal control system.

Proposed part 917 provides that senior management of each Bank shall be responsible for implementing strategies and policies approved by the Bank's board; developing processes that identify, measure, monitor and control risks incurred by the Bank; maintaining an organizational structure that clearly assigns responsibility, authority and reporting relationships; ensuring that delegated responsibilities are effectively carried out; setting appropriate internal control policies; and monitoring the adequacy and effectiveness of the internal control system.

The proposed requirements for the Banks' boards of directors and senior management generally are based on widely accepted best corporate practices. They are intended to augment the responsibilities, independence and expertise of the boards of directors by requiring them to oversee both risk management for safety and soundness and achievement of the public purpose of supporting housing and targeted economic development. Oversight by both the boards of directors and senior management is integral to the overall business operation of the Bank. The first

line of defense in ensuring safety and soundness has to be an effective corporate governance structure within the Banks themselves. Having an active, informed and engaged board of directors is the cornerstone of a well-run entity.

In addition, recognition of the importance of mission achievement must originate with the board of directors and fulfillment of mission at all levels of the Bank must be promoted and encouraged by the board. The requirements contained in the proposed rule are intended to ensure that the boards of directors of the Banks give serious consideration to these important responsibilities.

## 2. General Duties of Bank Boards of Directors—§ 917.2

Proposed § 917.2 provides that each Bank's board of directors shall have the general duty to direct the operations of the Bank in conformity with the requirements of the Finance Board's regulations. Proposed § 917.2 further provides that each board director shall carry out his or her duties as director in good faith, in a manner such director believes to be in the best interests of the Bank, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

## 3. Risk Management—§ 917.3

Section 917.3 of the proposed rule sets forth the risk management responsibilities of Bank boards of directors and senior management. Proposed § 917.3(a)(1) would require that, within 180 calendar days of the adoption of the rule in final form, each Bank's board of directors shall adopt a risk management policy addressing the Bank's exposure to credit risk, market risk, liquidity risk, business risk and operations risk in a manner consistent with the substantive risk management requirements set forth in part 930 of the proposed rule. The risk limits set forth in the policy shall be consistent with the Bank's capital position and its ability to measure and manage risk. Under proposed § 917.3(a)(1), a Bank will be required to submit its initial risk management policy to the Finance Board for approval; subsequent versions of the policy or amendments would not be required to be submitted to, or approved by, the Finance Board. However, Bank risk management policies will be reviewed by the Finance Board as part of the ongoing examination process.

Proposed § 917.3(a)(2)(i) would require that the Bank's board of directors review the Bank's risk management policy on at least an

annual basis. Proposed § 917.3(a)(2)(iii) provides that the board of directors also would be required to re-adopt the risk management policy, including interim amendments, not less often than every three years, as appropriate based on the board's reviews of the policy. In addition to providing consistency, this requirement is intended to ensure that, despite the turnover in board personnel that will occur over a number of years, all or most current members of a Bank's board of directors will be thoroughly familiar with the Bank's risk management policy, will have given meaningful consideration to its provisions and will have expressed an opinion regarding the adequacy of the policy through the voting process. Proposed § 917.3(a)(2)(iv) also would make clear that each Bank's board of directors has the ultimate responsibility to ensure that the Bank is in compliance at all times with the risk management policy.

Section 917.3(b) of the proposed rule sets forth several specific requirements for each Bank's risk management policy. Proposed § 917.3(b)(1) would require that each Bank's risk management policy describe how the Bank will comply with the risk-based capital standards set forth in proposed part 930. Proposed § 917.3(b)(2) would require each Bank's risk management policy to set forth tolerance levels for the market and credit risk components.

Proposed § 917.3(b)(3) requires each Bank's risk management policy to set forth standards for the Bank's management of credit, market, liquidity, business and operations risks. Credit risk is defined in proposed § 930.1 as the risk that an obligation will not be paid in full and loss will result. The Banks must assess the creditworthiness of issuers, obligors, or other counterparties prior to acquiring investments and, under proposed § 917.3(b)(3)(i), the Bank's risk management policy would be required to include the standards and criteria for such an assessment. In addition, the credit risk portion of each Bank's risk management policy also should identify the criteria for selecting brokers, dealers and other securities firms with which the Bank may execute transactions.

Market risk is defined in proposed § 930.1 as the risk of loss in value of the Bank's portfolio resulting from movements in market prices. Under proposed § 930.6, each Bank would be required to have in place a comprehensive market risk management model that allows the Bank to estimate in a timely manner the value of the portfolio at risk from changes in market prices under various stress scenarios.

Proposed § 917.3(b)(3)(ii) would require that each Bank's risk management policy establish standards for the methods and models used to measure and monitor market risk, including maximum exposure thresholds and scenarios for measuring risk exposure.

Liquidity risk is defined in proposed § 917.1 as the risk that a Bank would be unable to meet its obligations as they come due or meet the credit needs of its members and eligible nonmember borrowers in a timely and cost-efficient manner. Operational liquidity addresses day-to-day or ongoing liquidity needs under normal circumstances.

Operational liquidity needs may be either anticipated or unanticipated. Contingency liquidity addresses the same liquidity needs, but under abnormal or unusual circumstances in which a Bank's access to the capital markets is impeded. This impediment may result from a market disruption, operational failure, or real or perceived credit problems. Proposed § 917.3(b)(3)(iii) would require that each Bank's risk management policy indicate the Bank's sources of liquidity, including specific types of investments to be held for liquidity purposes, and the methodology to be used for determining the Bank's operational and contingency liquidity needs. The proposed new liquidity requirements are addressed in more detail below in the discussion of proposed § 930.10.

Operations risk is defined in proposed § 930.1 as the risk of an unexpected loss to a Bank resulting from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems. Proposed § 917.3(b)(3)(iv) would require each Bank's risk management policy to address operations risk by setting forth standards for an effective internal control system (as described in more detail below), including periodic testing and reporting.

Business risk is defined in proposed § 930.1 as the risk of an adverse impact on a Bank's profitability resulting from external factors as may occur in both the short and long run. Such factors include: continued financial services industry consolidation; declining membership base; concentration of borrowing among members; and increased inter-Bank competition. Proposed § 917.3(b)(3)(v) would require that each Bank's risk management policy identify these risks and include strategies for mitigating such risks, including contingency plans where appropriate.

In order for each Bank to create and maintain a meaningful risk management policy, it is important that the boards of

directors be cognizant of the strategic risks facing the Bank. Therefore, proposed § 917.3(c) would require that senior management of each Bank perform, at least annually, a written risk assessment that identifies and evaluates all material risks, including both quantitative and qualitative aspects, that could adversely affect the achievement of the Bank's performance objectives and compliance requirements. Proposed § 917.3(c) also requires that the risk assessment be in written form and be reviewed by the Bank's board of directors promptly upon its completion.

#### 4. Internal Control System—§ 917.4

While the existing FMP requires that management of each Bank establish internal control systems, there is no guidance provided on how to ascertain the sufficiency of the systems. There have been several instances where internal control weaknesses have been uncovered through the Finance Board's examination process. As a result, the Finance Board believes it prudent to provide more specific requirements for the internal control process that should be in place at each Bank.

In developing requirements for internal control processes for the Banks, the Finance Board reviewed the available literature on the appropriate internal control systems for financial institutions. Included in this review was the BCBS's Framework for Internal Control Systems published in September 1998 (hereinafter Basle Committee Report) and the Committee of Sponsoring Organizations of the Treadway Commission's Internal Control—Integrated Framework Report published in September 1992 (hereinafter Treadway Commission). The recommendations contained in these Reports are considered to be state of the art for defining, implementing, monitoring, and evaluating internal control systems.

According to the Basle Committee Report, a system of effective internal controls is a critical component of bank management and a foundation for safe and sound operation of a banking organization. A strong system of internal controls can help a bank meet its goals and objectives, achieve long-term profitability targets, and maintain reliable financial and managerial reporting. An internal control system also can help to: (1) Ensure the bank is in compliance with laws, regulations and the bank's internal policies and procedures; (2) safeguard assets; and (3) decrease the risk of damage to the bank's reputation.

The Treadway Commission Report defines internal controls as a process,

effected by the board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the: (1) Effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with applicable laws and regulations.

Both Reports discuss basic components or principles for establishing and assessing internal control—management oversight and the control environment, risk recognition and assessment, control activities and segregation of duties, information and communication, and monitoring activities and correcting deficiencies.

The provisions of § 917.4 of the proposed rule were adapted from the basic components and principles in the Basle Committee and Treadway Commission Reports. The Finance Board believes that appropriate internal controls will be critical to successful implementation of this regulation. The proposed rule would provide the framework for an effective internal control system, and establish senior management and board of directors' responsibilities regarding internal controls.

Proposed § 917.4 addresses the requirements for a Bank's internal control systems. Proposed § 917.4(a)(1) would require each Bank to establish and maintain an effective internal control system adequate to ensure: the efficiency and effectiveness of Bank activities; the safeguarding of assets; the reliability, completeness and timely reporting of financial and management information and transparency of such information to the Bank's board of directors and to the Finance Board; and compliance with applicable laws, regulations, policies, supervisory determinations and directives of the Bank's board of directors and senior management.

Proposed § 917.4(a)(2) enumerates certain minimum ongoing internal control activities that the Finance Board considers to be necessary in order for the internal control objectives described in proposed § 917.4(a)(1) to be achieved. These activities include: top level reviews by the Bank's board of directors and senior management; activity controls, including review of standard performance and exception reports; physical controls adequate to ensure the safeguarding of assets; monitoring for compliance with the risk tolerance limits set forth in the risk management policy that would be required under proposed § 917.3(a); any required approvals and authorizations for specific activities; and any required

verifications and reconciliations for specific activities.

Section 917.4(b) of the proposed rule would charge each Bank's board of directors with the responsibility of directing the establishment and maintenance of the internal control system by senior management, and overseeing senior management's implementation of the system on a continuing basis. Under proposed § 917.4(b), specific board actions necessary to fulfill these responsibilities would include: conducting periodic discussions with senior management regarding the effectiveness of the internal control system; ensuring that an effective and comprehensive internal audit of the internal control system is performed annually; ensuring that the Bank's board of directors receives reports on internal control deficiencies in a timely manner and that such deficiencies are addressed promptly; conducting a timely review of evaluations of the effectiveness of the internal control system made by auditors and Finance Board examiners; ensuring that senior management promptly and effectively addresses recommendations and concerns expressed by auditors and Finance Board examiners regarding weaknesses in the internal control system; reporting internal control deficiencies, and the corrective action taken, to the Finance Board in a timely manner; establishing, documenting and communicating an clear and effective organizational structure for the Bank; ensuring that all delegations of board authority state the extent of the authority and responsibilities delegated; and establishing reporting requirements.

Section 917.4(c) of the proposed rule would charge each Bank's senior management with the responsibility to establish, implement and maintain the internal control system under the direction of the Bank's board of directors. Under proposed § 917.4(c), specific actions on the part of senior management that would be necessary to fulfill these responsibilities include: establishing, implementing and effectively communicating to Bank personnel policies and procedures that are adequate to ensure that internal control activities necessary to maintain an effective internal control system are an integral part of the daily functions of all Bank personnel; ensuring that all Bank personnel fully understand and comply with all policies and procedures; ensuring that there is appropriate segregation of duties among Bank personnel and that personnel are not assigned conflicting responsibilities; establishing effective paths of

communication throughout the organization in order to ensure that Bank personnel receive necessary and appropriate information; developing and implementing procedures that translate the major business strategies and policies established by the board of directors into operating standards; ensuring adherence to the lines of authority and responsibility established by the Bank's board of directors; overseeing the implementation and maintenance of management information and other systems; establishing and implementing an effective system to track internal control weaknesses and the actions taken to correct them; and monitoring and reporting to the Bank's board of directors the effectiveness of the internal control system on an ongoing basis.

#### 5. Audit Committees—§ 917.5

Section 917.5 of the proposed rule addresses requirements for the establishment of an audit committee by each Bank's board of directors. Current Finance Board requirements for audit committees are contained in Finance Board Res. No. 92-568.1 (July 22, 1992) and Finance Board Advisory Bulletin 96-1 (Feb. 29, 1996).

Resolution No. 92-568.1 contains guidelines intended to be the minimum standards that should be adopted by the Banks for revisions of the respective audit charters. The guidelines require that: audit committee charters include a statement of the audit committee's responsibilities, including a statement of its purpose to assist the full board of directors in fulfillment of its fiduciary responsibilities; the audit committee shall consist of at least three board members and shall include appointed directors and elected directors; that in determining the membership of the audit committee, the board of directors should provide for continuity of service; the audit committee shall meet at least twice annually with the audit director and the audit committee shall meet in executive session with both the audit director and the external auditors at least annually; the audit committee shall oversee the selection, compensation, and performance evaluation of the audit director; written minutes shall be prepared for each meeting and a copy of such minutes forwarded to the Finance Board; and the charters of the audit director and audit committee shall be reviewed and approved at least annually by the audit committee and the board of directors, respectively.

Advisory Bulletin 96-1 communicated examination findings

regarding certain Bank practices that may tend to reduce the independence of the internal audit function, specifically the processes by which Bank audit director compensation is determined and performance is evaluated. The Bulletin indicated that examiners would review measures taken by the audit committee to assure the independence from management of the internal audit function, and to fulfill its responsibility to select, set the compensation of, and evaluate the performance of the audit director, and specified that all Bank audit committees should review their current practices and revise these as appropriate.

Proposed § 917.5 codifies into regulation the Finance Board's existing policy on requiring the Banks to have audit committees and adds requirements addressing their independence and their responsibilities for oversight of Bank operations. The proposed requirements for audit committees are based on standard corporate requirements and best practices. In developing the appropriate requirements for Bank audit committees, the Finance Board reviewed the audit committee regulations of other financial institution regulatory agencies and the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999) (hereinafter Blue Ribbon Committee Report). The Securities and Exchange Commission encouraged the New York Stock Exchange and the National Association of Securities Dealers to form a private sector body to investigate perceived problems in financial reporting. Accordingly, the Blue Ribbon Committee was formed in October 1998 to take an objective look at U.S. corporate financial reporting, specifically assessing the current mechanisms for oversight and accountability among corporate audit committees, independent auditors, and financial and senior management.

Proposed § 917.5(a) would require that each Bank's board of directors establish an audit committee. Proposed § 917.5(b) would require that each Bank's audit committee consist of five or more board directors, each of whom meets the independence criteria discussed below, and include a balance of representatives of large and small members and of appointed and elected directors of the Bank. The requirement in proposed § 917.5(b) that the audit committee comprise five or more persons differs from the recommendation of the Blue Ribbon Committee Report that the audit



committee comprise a minimum of three directors. The Finance Board believes it is important that the audit committee include representatives of large and small members and appointed and elected directors of the Bank in order to prevent dominance by one particular individual or group of individuals. A minimum of five members is necessary to ensure that the audit committee will have such diverse representation.

The terms of audit committee members must be appropriately staggered to provide for continuity of service, and to avoid a complete, or substantial, turnover of the membership of the audit committee in any one year. All members of the audit committee would be required to have a working familiarity with basic finance and accounting principles, with at least one member having extensive accounting or financial management expertise. This requirement is intended to ensure that audit committee members have the ability to read and understand the Bank's balance sheet and income statement and to ask substantive questions of internal and external auditors. The Finance Board recognizes that, in some cases, a Bank's board of directors may not include enough members with expertise sufficient for the demands of service on the audit committee, considering the representation requirements. Thus, proposed § 917.5(b)(4) would require that, if such familiarity or expertise is lacking among current board directors, the board of directors shall, in the case of appointed directors, notify the Finance Board or, in the case of elected directors, include in the notice of election required under § 915.6(a) (existing § 932.6(a)), a statement describing the skills or expertise needed.

In addition, proposed § 917.5(c) would require that any board director serving on the audit committee be sufficiently independent of the Bank and its management so as to maintain the ability to make the type of objective judgments that are required of audit committee members. The proposed independence criteria were adapted from the Blue Ribbon Committee Report, which states that "common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The Finance Board agrees that the independence of the directors serving on the audit committee is of great importance. Proposed

§ 917.5(c) describes several examples, which are not intended to include all possible examples, of relationships that would call into question the independence of an audit committee member and that, therefore, would disqualify any director having such a relationship with the Bank or its management from serving on the audit committee. The list is not intended to be exhaustive, because it is impossible to foresee all potential individual circumstances that might compromise the independence of a particular director. Thus, the Finance Board expects that the board of directors will consider all potential relationships when qualifying a director for service on the audit committee.

Proposed § 917.5(d) would require that each Bank's audit committee adopt a formal written charter setting forth the scope of the audit committee's powers and responsibilities and establishing its structure, processes and membership requirements. Both the audit committee itself and the Bank's full board of directors would be required to review the provisions of the audit committee charter annually and to adopt the charter, including amendments, not less often than every three years, as appropriate based on the board's and audit committee's reviews of the policy. Proposed § 917.5(d)(3) would require that the audit committee charter contain the following specific provisions: that the Bank's internal auditor may be removed only with the approval of the audit committee; that the internal auditor shall report directly to the audit committee on substantive matters and to the Bank President on administrative matters; that the audit committee shall be empowered to employ such outside experts as it deems necessary to carry out its functions; and that the internal and external auditors be allowed unrestricted access to the audit committee without any requirement of management knowledge or approval. The proposed requirements pertaining to the audit committee charters were adapted from the recommendations contained in the Blue Ribbon Committee Report and the current Finance Board requirements on audit committees.

Proposed § 917.5(e) sets forth the duties of each Bank's audit committee under the new regulatory structure, including the duties to: ensure that senior management maintains the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the Bank; review the basis for the Bank's financial statements and the external auditor's opinion rendered with respect

to such financial statements and ensure disclosure and transparency regarding the Bank's true financial performance and governance practices; oversee the internal audit function; oversee the external audit function; act as an independent, direct channel of communication between the Bank's board of directors and the internal and external auditors; conduct or authorize investigations into any matters within the audit committee's scope of responsibilities; ensure that senior management has established and is maintaining an adequate internal control system; ensure that senior management has established and is maintaining adequate policies and procedures to ensure that the Bank can assess, monitor and control compliance with its mission achievement policy as required in § 917.9(b)(1) of the proposed rule; and report periodically its findings to the Bank's board of directors.

Proposed § 917.5(e)(8) requires that the audit committee conduct not only financial audits but also audit the controls in place to ensure the Bank's compliance with its mission achievement policy. The audit committee is not required to assess the mission performance of the Bank. Review of the mission performance assessment of the Bank is the responsibility of the full board of directors, as more fully discussed in proposed § 917.9(b)(3) below.

An audit of the controls in place to ensure the Bank's compliance with its mission achievement policy is considered one type of a performance audit. In contrast to a financial audit, which is a financial statement or financial related audit, a performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of an organization, program, activity or function in order to provide information to improve public accountability and facilitate decision making by parties with responsibility to oversee or initiate corrective action. See U.S. General Accounting Office, *Government Auditing Standards* (GAO Yellow Book). Performance audits include economy and efficiency, program and compliance audits. Economy and efficiency audits evaluate whether the entity is using its resources economically and efficiently, and the causes of inefficiencies and uneconomical practices. *Id.* at 14. Program audits evaluate the extent to which the desired results as established by the authorized body are being achieved, and the effectiveness of organizations, programs, activities or functions. *Id.* Compliance audits



evaluate whether the entity complied with significant laws and regulations applicable to the organization or program. *Id.* at 13-14.

The Finance Board requests comments on whether the duties and responsibilities of the audit committee and the internal auditor should be broadened in the proposed rule to include economy and efficiency and program audits, as well as compliance and financial related audits.

Finally, proposed § 917.5(f) would require that each Bank's audit committee prepare written minutes of each audit committee meeting.

#### 6. Budget Preparation and Reporting Requirements—§ 917.6

Proposed § 917.6 is carried over unchanged from existing § 934.7 of the Finance Board's regulations.

#### 7. Dividends—§ 917.7

Proposed § 917.7 retains in large part the provisions of existing § 934.17 of the Finance Board's regulations, with certain proposed amendments as discussed below. The existing dividend regulation provides that the board of directors of each Bank, with the approval of the Finance Board, may declare and pay a dividend from net earnings, including previously retained earnings, on the paid-in value of capital stock held during the dividend period. See 12 CFR 934.17. Proposed § 917.7 would devolve the dividend process to the Banks and allow the payment of dividends without prior Finance Board approval, so long as such payment will not result in a projected impairment of the par value of the capital stock of the Bank. Because, under the regulatory regime proposed in this rulemaking, the earning assets of the Banks will be either core mission activities or assets that have not been acquired through debt issued with the benefit of the Banks' GSE status, the Finance Board's concerns about the proper use of the Banks' GSE funding advantage will have been addressed, and the need for prior Finance Board approval will have been obviated.

Each Bank's board of directors would then be responsible for ensuring that the benefits stemming from membership in the Bank System would be distributed in an equitable manner to all members of that cooperatively-owned Bank. Benefits can be distributed in the form of dividends, but can also be distributed in the form of lower pricing for advances and other Bank products. Lower product pricing, however, gives greater assurance that the Bank System's benefits are passed along to American consumers through increased

competition in the housing finance marketplace. The Finance Board expects the Banks, as cooperatively-owned institutions, to pass along a greater proportion of the benefits through lower product pricing (as opposed to higher dividends) than if the Banks were owned by private, third-party shareholders. The Finance Board requests comments on the reasonableness of this expectation or whether it should reconsider the need to have some mechanism to review or control the Banks' dividend decisions.

The current dividend regulation also provides that the Bank's dividend period may be quarterly, semiannual or annual periods ending on March 31, June 30, September 30 or December 31. Proposed § 917.7 would leave the determination of the dividend period to the discretion of the Banks.

Proposed § 917.7 retains without change the provisions in the current dividend regulation that dividends shall be computed without preference and only for the period the stock was outstanding during the dividend period, and that dividends may be paid in cash or in the form of stock. As discussed below under "Capital Stock Redemption Requirements—§ 930.9," the Finance Board recently published an Advance Notice of Proposed Rulemaking (ANPRM) that requested comment on whether the Banks should be prohibited from paying dividends in the form of stock. For the reasons discussed under that section, proposed § 917.7 does not include such a prohibition. Dividend payments by the Banks also have been subject to a Finance Board Dividend Policy, see Finance Board Res. No. 90-38 (Mar. 15, 1990), which, in addition to repeating provisions from the regulation, specifies target dividend rate formulae and requires the Banks to submit dividend recommendations and a certification that the recommendation is in compliance with the Dividend Policy at least 10 days prior to the payment of any dividend. These requirements from the Dividend Policy have not been included in proposed § 917.7. Furthermore, the Finance Board anticipates that, if proposed § 917.7 is adopted as proposed, the Finance Board will rescind the Dividend Policy.

#### 8. Approval of Bank Bylaws—§ 917.8

Proposed § 917.8 is carried over unchanged from existing § 934.16 of the Finance Board's regulations.

#### 9. Mission Achievement—§ 917.9

Proposed § 917.9 sets forth new requirements that each Bank must meet in developing a mission achievement policy and overseeing the Bank's

mission achievement. The Act establishes the Finance Board's primary responsibility for ensuring the safety and soundness of the Bank System and consistent with that duty, ensuring that the Banks fulfill their public policy mission. See 12 U.S.C. 1422a(a)(3). As with the risk management function, a Bank's board of directors must take its mission responsibilities seriously and impress the importance of mission achievement upon Bank management and staff. The Banks' boards of directors must be fully engaged so that there is a focus on mission achievement at all levels of the Bank.

Proposed § 917.9(a)(1) would require that each Bank's board of directors adopt and submit to the Finance Board for approval a mission achievement policy within 180 calendar days of the effective date of the rule in final form. This mission achievement policy would be required to detail how the Bank will comply with the core mission activity requirements set forth in proposed part 940 (discussed in more detail below), including contingent business strategies for meeting the core mission activity requirements under different assumptions about future economic and mortgage market conditions. The policy also would be required to outline a process for developing and implementing new mission-related products and services. The board should foster an environment that encourages management to be innovative and committed in developing products that provide assistance to Bank members in the financing of housing and community lending.

As with the risk management policy, proposed § 917.9(a)(2)(i) would require that the Bank's board of directors review the Bank's mission achievement policy on at least an annual basis. Proposed § 917.9(a)(2)(iii) would require a Bank's board of directors to re-adopt a mission achievement policy, including interim amendments, not less often than every three years, as appropriate based on the board's reviews of the policy. Again, as with the similar provision in proposed § 917.3(a)(2), this requirement is intended to ensure that, even given the turnover in board personnel that will occur over a number of years, all or most current members of a Bank's board of directors will be thoroughly familiar with the Bank's mission achievement policy, will have given meaningful consideration to its provisions and will have expressed their opinion regarding the adequacy of the policy through the voting process. Proposed § 917.9(a)(2)(iv) also would make clear that each Bank's board of directors has the ultimate responsibility to ensure

that the Bank is in compliance at all times with the mission achievement policy.

Under proposed § 917.9(a), each Bank would be required to submit its initial mission achievement policy to the Finance Board for approval; subsequent versions of the policy adopted thereafter or amendments would not be required to be submitted to, or approved by, the Finance Board. However, as with the risk management policies, Bank mission achievement policies will be reviewed by the Finance Board as part of the ongoing examination process.

Proposed § 917.9(b) would require that each Bank's board of directors: (1) direct the establishment and maintenance, by senior management, of adequate policies and procedures to ensure that the Bank can assess, monitor and control compliance with its mission achievement policy; (2) establish a mechanism to measure and assess the Bank's performance against its mission achievement goals and objectives; and (3) require that performance assessments be conducted at least annually that evaluate the Bank's mission achievement and measure its performance against the Bank's goals and objectives and that such performance assessments be reviewed by the Bank's board of directors.

These provisions are intended to ensure that the board of directors oversees the process of assessing mission achievement, but do not require that this responsibility reside with the audit committee or the internal auditor. It is not necessary that the requirements for the audit committee, which oversees the financial audit of the Bank, be applied to the oversight of mission performance. Thus, proposed § 917.9(b) requires that the board of directors oversee mission performance, but it allows the board to determine how, and by what mechanism, it will carry out this responsibility. However, as previously discussed, the audit committee shall be responsible for ensuring that proper controls exist to ensure that an assessment of mission achievement is carried out. In any event, the mission management assessments should follow the requirements for program audits contained in the GAO Yellow Book.

#### *B. Part 925—Members of the Banks*

Existing part 933 of the Finance Board's regulations, "Members of the Banks," has been proposed to be redesignated as new part 925 in the Finance Board's proposed rule to reorganize all of the Finance Board's regulations published separately in this issue of the **Federal Register**. Part 925

of the proposed reorganization rule retains in large part the provisions of existing part 933. Certain proposed amendments, which consist primarily of cross-references to sections of this proposed financial management and mission achievement regulation, are included in this rulemaking and discussed here.

Specifically, §§ 933.14, 933.22, and 933.24 through 933.28 of the Finance Board's existing membership regulations have been redesignated as §§ 925.14, 925.22, and 925.24 through 925.28 in the proposed reorganization regulation. Each of these sections contains provisions regarding the treatment of outstanding advances and Bank stock in different events: conditional membership approvals of de novo insured depository institution applicants deemed void (§ 925.14); ownership of excess shares of capital stock (§ 925.22); consolidations of members (§ 925.24); consolidations involving nonmembers (§ 925.25); member withdrawals (§ 925.26); removal of members (§ 925.27); and automatic termination of members placed in receivership (§ 925.28). In each of these situations, where applicable, liquidation of outstanding indebtedness owed to the Bank (mainly advances) in which membership has ceased is proposed to be handled in accordance with newly designated § 925.29. The redemption of stock in each circumstance described in these sections is proposed to be conducted pursuant to new § 930.9 (capital stock redemption requirements), proposed in this rulemaking.

#### *C. Part 930—Risk Management and Capital Standards*

##### 1. Overview

As discussed previously, the Banks' current capital requirements are determined according to a statutory formula, which uses either the asset size of a member or the amount of its borrowings from a Bank to determine the amount of stock the member must purchase from its Bank. See 12 U.S.C. 1426(b)(1), (b)(2), (b)(4); 1430(c), (e)(1), (e)(3). The Banks' risk management and investment practices are governed by the FMP. This proposal would create a modern risk-based capital system for the Banks. The Banks would be allowed greater flexibility to set their own risk tolerances, subject to the requirement that they hold sufficient capital to support the risks they chose to accept. The proposed rule also would allow for a more efficient and effective use of the Banks' capital than is currently possible.

The risk-based capital requirement, together with other provisions of this capital proposal, would replace the FMP, which the Finance Board currently uses to address the risks inherent in the financial management practices of the Banks. Given the advent of the Basle Accord, the practices of the other bank regulatory agencies, and the Finance Board's proposal for the Banks to become more mission oriented, the Finance Board has determined that the development of risk-based capital standards for the Banks should be an integral part of any comprehensive risk management system for overseeing the Banks. The FMP is a prescriptive risk control system with a series of detailed business and operating guidelines. It is based on policies originally adopted by the FHLBB, the predecessor agency to the Finance Board, and has been revised a number of times over the years. The FMP is a product of its history and reflects a now outmoded approach that emphasizes in considerable detail what is, and what is not, a permissible practice for the Banks. It is composed of a series of lists, which address matters such as allowable and prohibited assets, reserve requirements, funding guidelines, and hedging, credit, and interest rate risk guidelines. Federal banking regulation now focuses more on the adequacy of the audit and control systems, as well as risk management systems and managerial capability. The Finance Board is proposing to adopt a modern approach to overseeing the Banks, which would require the Banks to implement a comprehensive risk management system (including regulatory capital requirements) and would require the Finance Board to verify the integrity of those internal systems.

The bank regulatory authorities in the United States and in other industrialized countries have adopted some form of risk-based capital structure for the financial institutions they oversee. The basis for all of those risk-based capital systems is the Basle Accord, which was adopted in July 1988 and which measures credit risk through a system of risk-weight categories. As a matter of practice, the Basle Accord has been applied to all banks and thrifts in the United States and has become the global benchmark for credit risk capital standards.

The Basle Accord is based principally on a standardized system of risk weights, under which the book value of an on-balance sheet asset is assigned a particular risk weight based on the relative level of credit risk associated with that category of asset. The same method is used with respect to off-

balance sheet items, which are converted to "credit equivalent amounts" and assigned to the appropriate risk weight category. The risk weight categories range from zero percent, for items such as cash and Treasury obligations, to 100 percent, which includes claims on private obligors. The Basle Accord credit risk capital regime is based on an 8 percent benchmark, *i.e.*, that an institution must maintain total capital in an amount equal to 8 percent of the book value of any asset that is in the 100 percent risk weight category. Assets in lower risk-weight categories would carry a correspondingly lower capital requirement, such that an asset in the 50 percent category would require capital equal to 4 percent of its book value and an asset in the zero percent risk weight category would require no capital for credit risk. Because the Basle Accord made no explicit provision for market risk in the risk weight categorizations, the required capital percentage serves as protection against both credit and market risk.

The Finance Board, and other commentators, believe that the Basle Accord has a number of shortcomings. For example, for instruments within the same risk weight category, the Basle Accord does not distinguish between those instruments with different credit quality (*i.e.*, those with different credit ratings), which would, in fact, have markedly different credit risks. The Basle Accord also does not take into consideration how differences in the maturities of two instruments would affect their relative credit risk, nor does it distinguish between immediate exposure and possible future credit exposures, or between the credit risks associated with a diversified portfolio compared to those associated with a concentrated portfolio.

Under the 1996 amendment to the Basle Accord (the Amendment), debt instruments held in the trading portfolios of large banks are exempt from the risk-based capital requirements of the Basle Accord. The Amendment remedies some of the shortcomings of the 1988 Basle Accord discussed above and offers two alternatives for calculating the credit risk capital requirements for debt instruments held in the trading portfolios of large banks. These alternatives are based on publicly available credit ratings, or credit ratings that are internally generated by large banks. The first alternative for large banks is to use internal credit risk models to calculate value at risk due to credit risk on debt instruments held in trading portfolio. A second alternative for large banks lacking satisfactory

internal models is to use standardized credit risk capital percentage requirements specified in the Amendment. These percentage requirements are significantly lower than the risk-based capital requirements for the non-trading portfolio (banking book) and are related to the maturities of the investment grade instruments. The smaller percentage requirements mainly reflect the fact that holding periods, commonly referred to as default horizons, for debt instruments held in trading portfolios are generally shorter than the holding periods for the banking book.

Principally to address some shortcomings of the Basle Accord with respect to the banking book, the BCBS recently published the Framework, which proposes a system to better correlate regulatory solvency to the economic-capital needs of a bank, as well as with the risks and returns of their lending activities.<sup>4</sup> The Framework would base risk-based capital requirements more closely on the underlying credit risks, and would recognize the improvements in risk measurement and control that have occurred in recent years. The Framework would allow for the use of internal credit ratings and credit risk models to better assess a bank's capital requirement in relation to its risk profile. The BCBS also issued a separate paper on internal credit risk modeling, and invited comments on the issue of using a portfolio-based approach to calculating an overall capital requirement.<sup>5</sup> Portfolio credit risk modeling is a long-term project for the BCBS; ultimately, it is anticipated that sophisticated banking institutions would employ a comprehensive portfolio risk modeling approach, under which regulatory capital requirements would be based entirely on internal models. This proposed regulation addresses many of the concerns raised in the recent BCBS papers, by closely tying regulatory capital requirements to each Bank's level of credit risk.

As discussed above, the drive to incorporate a measure of general market risk into the Basle Accord has been spearheaded by the BCBS. The Basle Accord addressed credit risk but did not include a requirement for market risk. However, as depository institutions' involvement in both on- and off-balance sheet instruments containing structured and exotic features as well as complex

options grew, the BCBS became concerned with the market risk aspect of the risk-based capital standards. This led to the Amendment which, in addition to credit risk, addressed market risk from interest rates, foreign exchange rates, equity prices and commodity prices within the trading book and foreign exchange and commodity risks in the banking book. The Amendment is limited in that it essentially applies to large commercial banks; banking book interest rate risk is still not addressed. However, the BCBS has published a separate proposal providing guidance for the management of overall interest rate risk in a banking organization, including interest rate risk within the banking book.<sup>6</sup> In the recently published Framework, the BCBS has proposed to develop a specific capital requirement for interest rate risk in the banking book for banks where interest rates risks are significantly above average. The bank regulatory authorities in the United States and in other industrialized countries have adopted the Amendment to incorporate general market risk into the risk-based capital standards.

## 2. Requirements for Bank System and Individual Bank Credit Ratings—§ 930.2

Proposed § 930.2 addresses credit ratings for Bank System COs and for the overall capacity of individual Banks to meet their obligations. Section 930.2(a)(1) would require that the Banks, collectively, obtain from a NRSRO, and at all times maintain, a current credit rating on the Banks' COs. Under § 930.1 of the proposed rule, an NRSRO would be defined to include those credit rating organizations recognized as NRSROs by the SEC. To date, the SEC regards five credit rating organizations as NRSROs: Standard & Poor's; Moody's; Fitch IBCA; Duff & Phelps; and (for certain financial institutions) Thompson BankWatch, Inc. See 62 FR 68018-24 (Dec. 30, 1997).

The Banks' COs currently are rated by both Moody's and Standard & Poor's and have received the highest credit rating from both NRSROs, based upon the conservative management policies and consistent profitability of the Banks, both as a group and individually, and the status of the Banks as GSEs. Proposed § 930.2(a)(2) would require that each Bank operate in such a manner and take any actions necessary to ensure that the Banks' COs receive and continue to receive the highest credit rating from any NRSRO by which the COs have been then rated (*e.g.*, triple-A).

<sup>4</sup> *New Basle Committee Proposals Have Positive Bank Credit Implications*, Moody's Credit Perspectives, June 21, 1999, at 1, 18.

<sup>5</sup> BCBS, *Credit Risk Modeling: Current Practices and Applications* (Apr. 1999).

<sup>6</sup> See BCBS, *Principles for the Management of Interest Rate Risk* (Jan. 1997).

Regardless of whether any actual downgrade were to occur, a Bank still would be considered to be in violation of proposed § 930.2(a)(2) if that Bank were to take any action, or were to create a situation through a failure to act, that potentially could lead any NRSRO to downgrade the rating for COs to a level below that NRSRO's highest investment grade.

In addition to the requirements pertaining to the rating of the Banks' COs, § 930.2(b) of the proposed rule would require each Bank, individually, to operate in such a manner and take any actions necessary to ensure that the Bank has and maintains an individual issuer credit rating of not lower than the second highest credit rating from any NRSRO by which the Bank is rated (e.g. double-A), where the NRSRO states that the rating is a meaningful measure of the Bank's financial strength and stability apart from the GSE status of the Bank System. The latter requirement is intended to ensure that the Banks' boards of directors and senior management focus upon the business practices necessary to maintain not lower than the second highest credit rating on an individual basis without regard to the GSE status of the Bank System.

Proposed § 930.2(c) would require each Bank to obtain an individual issuer credit rating from an NRSRO within one year of the effective date of new part 930. In addition, under proposed § 930.2(b)(3), each Bank would be required to update its individual issuer credit rating on an annual basis, or more frequently, as required by the Finance Board. Eleven of the Banks already have obtained an individual credit rating from at least one NRSRO and all eleven have received the highest long-term credit rating from the NRSROs by which they have been rated.

In order to facilitate the Banks' fulfillment of the core mission activities requirements set forth in part 940 of the proposed rule, discussed below, the proposed rule would authorize the Banks to make a wider range of investments, and to offer their members and eligible nonmember borrowers a wider range of products and services, than is currently authorized in the absence of specific prior Finance Board approval. The risk-based capital requirements set forth in proposed part 930, also discussed below, are intended to require the Banks to manage effectively the increased risks that could accompany the broadened investment and programmatic authority that the Banks would enjoy under the proposed rule. As provided for under proposed § 930.2, it is of vital importance that the

Banks' COs continue to receive the highest possible credit rating so as to ensure that the Banks remain able to access to the capital markets at the lowest possible cost of funds and, consequently, to fund activities that safely and soundly further the Banks' housing finance and community lending mission.

At the same time, the Finance Board finds it appropriate to permit the Banks to maintain individual issuer credit ratings of at least the second highest credit rating given by any NRSRO from which a rating has been received, rather than continuing to require the highest credit rating, as individual Banks are required to maintain under the FMP. In meetings with Finance Board staff, representatives of both Moody's and Standard & Poor's indicated that the Bank's COs could continue to receive the highest credit rating, even if all of the Banks were to receive only the second highest issuer credit rating on an individual basis. Both NRSROs confirmed to Finance Board staff that the GSE status of the Banks plays a key role in the rating of the Banks' COs. While both NRSROs indicated that any significant changes to the Banks' management policies and profitability potentially could adversely affect the credit rating of the COs, both also stated that the proposed new regulatory structure does not give rise to any serious concern that the COs will not continue to receive the highest credit rating from both organizations.

### 3. Minimum Total Capital Requirement—§ 930.3

a. *Background.* Capital serves as a barrier against insolvency. Its purpose is to absorb the risks inherent in business endeavors, and to provide market discipline to limit risk-taking by management. To be effective, capital must be available to offset losses if economic conditions are unfavorable.

The capital requirements in the proposed rule represent a change in philosophy from the FMP. Rather than prohibiting certain types of investments, and establishing limits on Bank behavior towards risk such as duration of equity limits, the proposed rule would allow the Banks wide latitude to engage in mission-related activities, so long as they hold sufficient capital to cover the risks entailed by such activities.

The rule proposes two capital-based standards for the Banks. The first standard is a requirement that total outstanding Bank capital stock must equal at least 3.0 percent of the Bank's total assets. The second standard is a requirement generally that the Banks

must hold the most permanent forms of capital, referred to as risk-based capital, against the risks measured in the Bank's portfolio. The risk-based capital requirement is discussed further below under § 930.4.

b. *Minimum total capital requirement.* Section 930.3(a) of the proposed rule provides that each Bank shall have and maintain at all times total capital in an amount equal to at least 3.0 percent of the Bank's total assets. Total capital is defined in proposed § 930.1 as the sum of a Bank's retained earnings and total capital stock outstanding, less the Bank's unrealized net losses on available-for-sale securities. The minimum total capital requirement serves to limit the size of a Bank's balance sheet for a given quantity of capital.

As discussed above in the Overview of Proposal section, the Act sets forth minimum capital requirements for the Banks. See 12 U.S.C. 1426(b)(1), (b)(2), (b)(4); 1430(c), (e)(1), (e)(3); 12 CFR 933.20(a). Among these provisions is a requirement that members hold stock equal to at least 5 percent of their advances. Currently, the FMP limits the holding of mortgage-backed securities by the Banks to three times capital. Taken together, these two provisions limit advances plus mortgage-backed securities to no more than 23 times capital, as advances can be no more than 20 times capital, and mortgage-backed securities can be no more than 3 times capital. Thus the ratio of capital to advances plus mortgage-backed securities must be at least one twenty-third, or 4.35 percent.<sup>7</sup>

The numerically operative and, therefore, more important constraint contained in current regulations is a leverage limit, such that the ratio of COs plus unsecured senior liabilities for a Bank can be no more than 20 times capital. See FMP section IV.C. Because assets equal capital plus COs plus unsecured senior liabilities, a Bank's assets cannot exceed 21 times its capital or, inversely, capital must be at least 4.76 percent of assets. The Bank System had an average capital-to-assets ratio of 5.4 percent during 1998.

The proposed 3.0 percent minimum total capital requirement for the Banks would be more conservative than the 2.5 percent minimum total capital

<sup>7</sup>To the extent that a Bank chooses to accumulate retained earnings, its assets may be limited to something less than 23 times capital. This is because the capital held to support advances can, by statute, only be in the form of capital stock, while the capital held to support mortgage-backed securities (MBS) holdings can be either capital stock or retained earnings. Retained earnings are a small percentage of total capital for the Banks.

requirement imposed by statute on the on-balance sheet assets of Fannie Mae and Freddie Mac.<sup>8</sup> Also, the proposed minimum total capital requirement of 3.0 percent for the Banks is consistent with the minimum total capital requirements imposed by other financial institution regulators for the strongest financial institutions without supervisory concerns.

Section 930.3(b) of the proposed rule provides that, for reasons of safety and soundness, the Finance Board may require an individual Bank to have and maintain a higher minimum capital ratio than 3.0 percent.

#### 4. Minimum Total Risk-Based Capital Requirement—§ 930.4

*a. General requirement.* Section 930.4(a) of the proposed rule provides that each Bank shall have and maintain at all times total risk-based capital in an amount at least equal to the sum of its credit risk capital requirement, its market risk capital requirement, and its operations risk capital requirement, calculated in accordance with §§ 930.5, 930.6 and 930.7, respectively. As discussed above under the Overview of Proposal section, the proposed rule would implement, for the first time, a risk-based capital requirement for the Banks related to the risks inherent in the Banks' portfolios and business practices. The three separate capital components are discussed further below under their respective sections.

*b. Definition of Total Risk-Based Capital.* In order to serve as the primary barrier against insolvency, risk-based capital must be permanent in nature, *i.e.*, available to cover losses which may occur under adverse conditions without being subject to redemption by members. Proposed § 930.1 contains a definition of total risk-based capital for a Bank, the elements of which are discussed below.

The first element of total risk-based capital under the definition in proposed § 930.1 is retained earnings, less unrealized net losses on available-for-sale securities. Retained earnings clearly are permanent in nature because they are not subject to withdrawal at the request of individual member shareholders.

The second element of total risk-based capital under the definition in proposed § 930.1 is any outstanding non-

redeemable capital stock of the Bank. The Finance Board has authority under the Act to allow the Banks to create additional classes of stock if the Banks wish to include such other classes of stock as a part of their capital structure. Any non-redeemable outstanding capital stock that a Bank may be authorized to issue would be permanent by its non-redeemable nature.

The third element of total risk-based capital under the definition in proposed § 930.1 is all outstanding capital stock satisfying the minimum capital stock purchase requirement for membership under sections 6(b)(1) and 10(e)(3) of the Act (12 U.S.C. 1426(b)(1), 1430(e)(3)) for all mandatory members. Outstanding capital stock of mandatory members has permanent features, because a mandatory member may have its stock redeemed only if it changes its charter to a form that would make the member a voluntary member and withdraws from membership in the Bank System. Charter conversions generally are not effected by a member solely for the purpose of withdrawing from Bank membership and redeeming Bank stock. A charter conversion would have a serious impact on all aspects of an institution's business operations, and would require a significant amount of time and cost to complete. Mandatory members that convert to voluntary status also may be discouraged from withdrawing from the Bank System because the Act prohibits withdrawing members from rejoining the Bank System for ten years. See 12 U.S.C. 1426(h).

The fourth element of total risk-based capital under the definition in proposed § 930.1 is a percentage of the minimum capital stock purchase requirement for membership under sections 6(b)(1) and 10(e)(3) of the Act (12 U.S.C. 1426(b)(1), 1430(e)(3)) for all voluntary members. Each Bank may designate a percentage, not to exceed 50 percent, of the minimum capital stock of voluntary members as risk-based capital. The required capital stock of voluntary members is less permanent than the required capital stock of mandatory members, but is more permanent than stock which supports member borrowing. Although the ten-year prohibition on rejoining the Bank System after withdrawing may discourage voluntary members from withdrawing from the Bank System and redeeming their capital, they may, if they decide to withdraw, have their capital stock redeemed at par, provided that the Finance Board finds no impairment or likely impairment of the Bank's capital. See 12 U.S.C. 1426(e). This capital stock, therefore, has more

limited use as a loss absorber than the other forms of capital stock discussed above. However, a Bank may need more than its retained earnings and outstanding minimum capital stock of mandatory members in order to meet its risk-based capital requirement. Therefore, a percentage not to exceed 50 percent of minimum required voluntary member stock may serve as an element of total risk-based capital only if the Bank is willing to subject its redemption to Finance Board approval.

The fifth and final element of total risk-based capital under the definition in proposed § 930.1 is a percentage of the remaining capital stock of mandatory and voluntary members. Each Bank may designate a percentage, not to exceed 50 percent, of the remaining capital stock of mandatory and voluntary members as risk-based capital only if the Bank is willing to subject its redemption to Finance Board approval. The Act provides that a Bank has discretion, unless prohibited by the Finance Board, to determine whether to redeem a mandatory or voluntary member's capital stock that exceeds its statutory minimum capital stock purchase requirement. See 12 U.S.C. 1426(b)(1). Because a Bank can decline to redeem excess capital stock of members, such stock can serve as a permanent capital loss absorber.

The proposed definition allows each Bank to designate different percentages of stock as elements of total risk-based capital under the fourth and fifth elements of the definition (that is, up to 50 percent of the membership stock of voluntary members, and up to 50 percent of all remaining outstanding capital stock of mandatory and voluntary members). Therefore, some Banks may choose to designate a larger percentage of the minimum capital stock of voluntary members as risk-based capital stock, as this stock has a greater degree of permanence. This would allow a smaller percentage of capital stock which supports advance borrowing to be designated as an element of total risk-based capital, so that the use of advances by members would not be discouraged.

*c. Transition provisions.* The transition provisions in the proposed rule ensure that the Banks will continue to operate in a safe and sound manner, under proven standards, until such time as they have demonstrated the capacity to operate under the more flexible proposed regulation. Specifically, each Bank must demonstrate to the Finance Board that it has risk management policies and internal controls in place which are sufficient to manage its credit, market, and operations risk. Each

<sup>8</sup> A leverage requirement is imposed on Fannie Mae and Freddie Mac such that their capital must be at least 2.5 percent of their on-balance sheet assets. 12 U.S.C. 4612(a). Generally, they must also hold capital equal to at least .45 percent of their off-balance sheet obligations. Unlike the Banks, Fannie Mae and Freddie Mac have substantial volumes of guarantees and other off-balance sheet items.

Bank must also have an internal market risk model approved by the Finance Board. Finally, each Bank must have sufficient capital to meet the capital requirements in the proposed rule. Until these conditions are met by a Bank, the current rules as contained in the FMP will apply. See proposed §§ 930.4(b)(1) and 930.4(b)(2).

#### 5. Credit Risk Capital Requirement—§ 930.5

a. *Background.* Unlike commercial banks and savings associations, the Banks currently are not subject to statutory or regulatory risk-based capital requirements. As discussed previously, the Banks' capital requirements are determined according to a statutory formula, which uses either the asset size of a member or the amount of its borrowings from a Bank to determine the amount of stock the member must purchase from its Bank. The risk-based capital requirement for the Banks established in this proposal would include as one component a separate capital requirement to address the credit risk to which a Bank is exposed. The credit risk component of the capital requirement would encompass the credit risks associated with both on-balance sheet assets and off-balance sheet items of each Bank.

The objective of the Finance Board in proposing this credit risk capital standard for Banks is to provide a regulatory framework that would: (i) assess capital charges based on the extent of the underlying credit exposure; (ii) address on-and off-balance sheet exposures consistently; (iii) allow for changes to the portfolios of the Banks, as well as in the markets; and (iv) reflect improvements in risk measurement and control systems, as they develop and become available for use by the Banks. To the extent the proposed rule achieves these objectives, it would improve upon the Basle Accord.

b. *Finance Board determination of specific credit risk percentage requirements.* Proposed § 930.5(b) provides that for an on-balance sheet asset, the credit risk capital requirement would be equal to the book value of the asset multiplied by the "credit risk percentage requirement" to which the asset is assigned. Proposed § 930.5(c) provides that for off-balance sheet items, the credit risk capital requirement would be the "credit equivalent amount" of the item, multiplied by the specific credit risk percentage requirement to which the item is assigned.

Proposed § 930.5(d) provides that the Finance Board shall determine initially,

and update periodically, credit risk percentage requirements for various categories of credit risk for on-balance sheet assets and off-balance sheet items, using data from NRSROs and any other relevant sources to calculate estimates of credit losses associated with the particular categories. The estimates of credit risk are required to represent the credit losses that could be expected to occur on the particular categories of instruments during periods of extreme credit stress, based on historical data that reflect the longer-term nature of credit cycles and span multiple credit cycles. The periodic updates to initial credit risk percentage requirements will be implemented by the Finance Board as amendments to § 930.5(d)(3).

The proposal includes, in Table 1 of proposed § 930.5(d)(3), the percentages to be applied to the book value of on-balance sheet assets, or the credit equivalent amounts of off-balance sheet items, in determining a Bank's credit risk capital requirement. Cash and government securities are assigned to the zero percent category, meaning that they are deemed not to present any credit risk to the Bank. The proposal assigns increasing percentages (0.3, 0.6, 1.0, and 1.3) to each of the four levels of investment grade ratings assigned by an NRSRO (*i.e.*, triple-A, double-A, single-A, triple-B), and treats credit risk from advances as equivalent to credit risk associated with the highest category of investment grade credit ratings. The proposal also includes a credit risk percentage for a Bank's tangible assets, "Premises, Plant and Equipment," to be set at 8.0 percent, which is consistent with the Basle Accord. Investments that are downgraded below investment grade after being acquired by a Bank would be assigned higher credit risk percentages: 12.0 percent for assets with the highest rating below investment grade; 50.0 percent for assets with the second highest rating below investment grade; and 100 percent for all other assets downgraded below investment grade.

In assigning only cash and direct obligations of the U.S. government to the zero credit risk category, the proposal is more restrictive than the Basle Accord, which assesses zero credit risk capital for all Organization for Economic Cooperation and Development (OECD) government obligations, although proposed revisions to the Basle Accord would treat all triple-A and double-A rated sovereign obligations as free of credit risk. The proposal would treat Bank advances as a triple-A rated credit exposure. The assignment of advances to a triple-A credit risk category is based on factors such as the historical credit loss record

for Bank advances (no credit losses have been incurred on the advance portfolio), the conservative lending and collateral management policies of each Bank (all classes of collateral are discounted based on risk), the blanket lien arrangements that some Banks employ with certain members over all of the assets of that member, the statutory priority lien, which gives the Banks priority over other secured creditors (so long as those secured interests are not perfected, see 12 U.S.C. 1430(e)), and a statutory stock purchase requirement that requires a member to maintain an investment in the Bank at least equal to 5 percent of its outstanding advances. See *id.*

The Finance Board considered treating advances as cash or direct obligations of the U.S. government and assigning a zero credit risk capital requirement. However, two credit rating agencies expressed their opinion that such treatment is not appropriate for advances—*i.e.*, that advances should not be treated as equivalent to credit risk free investments. The two rating agencies expressed their preference for advances being treated as triple-A rated assets. Based on the historical (over 60 years) experience of zero credit losses for advances versus rating downgrades leading to eventual credit losses on triple-A rated corporate securities, an argument can be made that advances are a better credit than triple-A rated assets. As a result, advances may be treated as assets that pose credit risk somewhere between U.S. government securities and triple-A rated corporate securities. At this time, the Finance Board is proposing to treat advances as triple-A rated assets and is requesting comments from interested parties as to whether a satisfactory analytical framework exists that can be used to determine a more appropriate capital charge for the credit risk of advances.

Based on data obtained from Moody's, the worst default frequency over a two-year horizon for triple-A rated corporate debt is 0.0. In fact, a triple-A rated security has never defaulted at the time it was still rated triple-A. Given a sufficiently long period of time, however, even triple-A rated corporate credits will default following rating downgrades.<sup>9</sup> In fact, some triple-A rated credits have been downgraded within a year after receiving the triple-A rating. In addition, the market credit spreads for triple-A rated securities can widen without any change in credit

<sup>9</sup> According to Moody's data from 1970 to 1998, over a 4-year default horizon, the worst historical probability of default (default rate) for triple-A rated debt is 1.21 percent.

ratings.<sup>10</sup> Credit deterioration and spread widening can lead to losses in market value for triple-A rated securities within a relatively short time after such securities are assigned a triple-A rating. Because such risks exist and the holding periods associated with long-term held-to-maturity securities are relatively long, the proposal adopts a conservative approach and requires 0.3 percent capital to be maintained for triple-A rated credit exposures. This number is a linear interpolation of the estimated credit losses for U.S. government securities and double-A rated debt. Moreover, this requirement is consistent with the results from an internal models-based estimate for credit risk capital for triple-A rated corporate bonds held in a diversified trading portfolio of a large commercial bank, which is 0.26 percent.<sup>11</sup>

Credit risk capital requirements for double-A, single-A, triple-B and double-B rated credit exposures in the proposal are generally equal to the worst default rate observed over two-years by Moody's in data collected from 1970-1998. To preserve consistency between credit ratings and capital requirements, the proposed requirement for a single-A rated credit exposure is set equal to the average of the capital requirements for double-A and triple-B rated instruments.<sup>12</sup> Also, a conservative zero recovery rate in default has been assumed for purposes of calculating the credit risk capital requirements. Defaulted bond price data from Moody's provides support for the zero recovery rate assumption under extreme credit stress conditions.<sup>13</sup>

<sup>10</sup>This applies equally to triple-A rated securities issued by GSEs.

<sup>11</sup>This estimate is based on a 10 business day horizon and a 99th percentile of the value at risk distribution as required under the Amendment for calculating credit risk capital for debt instruments held in the trading portfolios of large banks. The estimate of 0.26 percent reflects a multiplier of 4 which is the highest multiplier that may be required under the Amendment. In addition to the possibility of default, this estimate captures potential deterioration in credit risk and widening of credit spreads in the market. If the underlying distribution of value at risk is approximately normal, the multiplier of 4 effectively extends the 10 day horizon to 160 business days, or approximately 8 months. The holding periods relevant to long-term debt instruments held in banking portfolios are longer and commercial banks generally use 1 year for calculating economic capital requirements.

<sup>12</sup>This is because over a 2 year horizon, the worst single-A rated default rate is lower than the corresponding double-A rated default rate.

<sup>13</sup>As for triple-A rated instruments, the proposed capital requirements for double-A, single-A, triple-B and double-B rated credit exposures are generally consistent with the results from an internal models-based estimate for credit risk capital for corporate bonds held in a diversified trading portfolio of a large commercial bank, which are 0.77, 1.00, 2.40 and 5.24 percent, respectively.

Under proposed § 955.3(a)(3), the Banks would not be authorized to invest in debt instruments rated below investment grade. If an investment were to be downgraded after acquisition by a Bank to the second highest rating below investment grade (single-B rating), the proposal would assign it to the 50 percent credit risk percentage, which the Finance Board believes to be a conservative level for such an exposure. Any credit exposures rated at triple-C or below would be placed in the 100 percent credit risk capital category.

Under proposed §§ 940.3(e) and 955.2(e), a Bank may make equity investments in the stock of a SBIC, in government-aided economic development entities, and in certain entities that are permissible investments for national banks, that are not rated but are defined in this proposal as core mission activities of the Banks. The proposal would assign investments in these types of entities to the 8.0 percent credit risk percentage category. This requirement is based upon, and is consistent with, the risk-based capital requirements for investments in such entities by national banks established by the OCC. For SBICs, the 8 percent requirement is likely conservative given changes to the SBIC program implemented in 1994. In addition, consistent with the public purpose of GSEs, the Finance Board wants to encourage the Banks to give every consideration to investments that will provide targeted assistance to people in underserved low and moderate-income communities.

The following table, which is set forth in proposed § 930.5(d)(3), presents the credit risk percentage capital requirements for each category of credit exposures described above:

CREDIT RISK CAPITAL REQUIREMENTS FOR BANKS

Credit risk category	Percent of on-balance sheet equivalent value
Authorized Investments Cash and U.S. Government Securities .....	0.0
Advances .....	0.3
Highest Investment Grade—triple-A .....	0.3
Second Highest Investment Grade—double-A .....	0.6
Third Highest Investment Grade—single-A .....	1.0
Fourth Highest Investment Grade—triple-B .....	1.3
Premises, Plant, and Equipment .....	8.0
Core Mission Equity Investments Under § 940.3(e) .....	8.0

CREDIT RISK CAPITAL REQUIREMENTS FOR BANKS—Continued

Credit risk category	Percent of on-balance sheet equivalent value
Investments Downgraded to Below Investment Grade After Acquisition by a Bank Highest Below Investment Grade—double-B .....	12.0
Second Highest Below Investment Grade—single-B .....	50.0
All Other Below Investment Grade—At or Below triple-C	100.0

The Finance Board expects that the above capital requirements may change as comments on proposed § 930.5(d)(3) are received and further research is undertaken before a final rule is published. Even after a final rule is adopted, the Finance Board anticipates that it will periodically amend the capital requirements reflected in the chart above as additional data is available and new methodologies become feasible.

One of the limitations of the Basle Accord was its failure to consider the term structure of credit risk, such that an overnight exposure would receive the same capital charge as a 2 or a 10 year exposure. However, under the Amendment, the term structure of credit risk can be fully recognized for trading portfolios of large banks with satisfactory internal models and is partially recognized for others through a standardized table. In addition, the recently proposed Framework addresses this limitation in the Basle Accord by according limited recognition to the term structure of credit risk. The Farm Credit Administration similarly accords limited recognition to the term structure of credit risk in their risk-based capital requirements for the farm credit banks. In proposed § 930.5(d)(3), there is no such recognition given to the term structure of credit risk. However, the Finance Board realizes that a significant proportion of the Banks' assets have maturities within 1 month and, therefore, intends to undertake further research on incorporating term structure of credit risk into § 930.5(d)(3). At this time, the Finance Board requests comments on the treatment of term structure of credit risk.

*c. Bank determination of specific credit risk percentage requirements.* Section 930.5(d)(4)(i) of the proposed rule would require each Bank to determine the credit risk capital requirement for each asset and item first by determining its type and its credit rating (if any), then by determining its



appropriate risk category and applying the applicable credit risk percentage for that risk category under Table 1. The proposal includes guidance for the Banks on how to determine the credit rating for a particular asset or item. If an asset or item is directly rated by an NRSRO, the Banks must use that rating. If an asset or item is not rated directly by an NRSRO, but its issuer or guarantor is so rated or the asset or item is backed by collateral that is so rated, then a Bank may use the highest rating given to the issuer, guarantor, or collateral, to the extent that the issuer, guarantor, or collateral supports the asset or item held by the Bank. If the asset or item is not fully backed by a rated issuer, guarantor, or collateral, then only the portion to which such rated support applies may receive the highest rating noted above; the portion of the asset or item that is not so supported must be assigned to the category that would be appropriate for such an asset on a stand alone basis. For example, if up to 25 percent of a triple-B asset is guaranteed by a triple-A-rated entity, then 25 percent of the value of the asset may be assigned to the highest investment grade category with a capital requirement of 0.3 percent and the remaining 75 percent of the value of the asset will be assigned to the fourth highest investment grade category with a capital requirement of 1.3 percent.

The proposal further provides that the Banks shall disregard modifiers attached to a particular credit rating. Thus, an asset with an A+ rating and an asset with an A – rating would both be placed in the A category for risk-based capital purposes. NRSROs generally assign rating modifiers such as “1”, “2” and “3” or “+” and “–” along with letter grades. Such modifiers are provided to further distinguish among credit risks that are assigned identical letter grades. Consequently, historical samples containing default activity for each modified letter grade are smaller than what they would be if modifiers were ignored. The smaller sample size makes it difficult to calculate credit risk capital requirements corresponding to modified ratings with some degree of statistical precision and confidence. Therefore, the Finance Board is proposing to disregard rating modifiers. This is consistent with the treatment specified for investment grade credit exposures under the Amendment and the Framework.

The proposal also provides that where a particular asset or item has been rated multiple times by the same NRSRO, the Bank must use the most recent rating from that NRSRO, and that if an asset or item has received ratings from multiple NRSROs, the Bank must use the lowest

of those ratings. If an asset is not rated by an NRSRO and does not fall within one of the categories in Table 1, the proposal would require a Bank to determine its own credit rating for the asset or item or relevant portion thereof using credit rating standards available from an NRSRO or other similar standards.

As a general matter, collateral may be used to enhance the creditworthiness of a particular asset or item, which can result in a lower credit risk capital requirement for a Bank. The BCBS has recognized that the Basle Accord did not provide sufficient incentive for banks to reduce their credit risk by taking an interest in other collateral, and recently has proposed to extend the scope of collateral recognition to all financial assets—not just marketable securities. The Finance Board proposal would allow a Bank to look through to the collateral supporting a given asset or instrument for risk-based capital purposes if certain conditions are met. In order to recognize such collateral for capital purposes, the collateral must be held by the Bank (which could include being held by a third party custodian or by the member), must be legally available to absorb losses (*i.e.*, the Bank must have a legal right to liquidate the collateral), must have a readily determinable value at which it can be liquidated, and must be held in conformance with the Bank's collateral management policy. This would include arrangements under which a third-party custodian holds collateral from a Bank's counterparty and may not return the collateral to the counterparty without the express permission of the Bank. In using collateral to reduce the credit risk capital requirement, a bank must make appropriate allowance for haircuts or overcollateralization reflecting the market risk underlying the collateral.

With respect to third-party guarantees, the proposal would recognize all third-party guarantees provided by any counterparty with an investment grade rating. This is consistent with that aspect of the proposal that would limit investments by the Banks to those with an investment grade rating. See proposed §955.3(a)(3).

The proposed rule would allow on-balance sheet assets (underlying assets) that are hedged with credit derivatives to be assigned to the zero risk category under three scenarios specified in the rule. Even if the credit risk capital requirement for the underlying asset is decreased through the use of a credit derivative, the applicable credit risk capital required for the derivative contract still would apply.

Within an internal credit risk model in which credit risks are marked-to-market, recognition of offsets, or credit hedges, whether perfect or imperfect, can be readily accommodated. Large commercial banks have accomplished this as part of their credit risk, value at risk models for trading portfolios. Under the proposed rule, some of the offsets will be recognized. If the offset is perfect (*i.e.*, the two positions are of identical remaining maturity and relate to exactly the same instrument) it is straightforward to reduce the credit risk capital requirement for the underlying asset to zero (*i.e.*, to grant full capital relief). For example, if a Bank purchases a triple-B rated corporate bond with a maturity of 5 years and at the same time enters into a 5-year credit default option contract based on the same bond (reference asset), the credit risk capital requirement for the underlying asset will be zero. The net credit risk capital requirement for the pair will equal the counterparty risk capital for credit exposure on the derivative contract.

If the underlying asset and the referenced asset of a credit derivative are identical, but the remaining maturities are different, the capital relief in the proposed rule would depend on a maturity comparison between the two. If the same triple-B rated 5-year corporate bond was hedged with a credit derivative with a remaining maturity of 2-years or longer, there would be no credit risk on the underlying asset within the Finance Board's proposed default horizon, which is 2 years. Therefore, such a hedge would be fully recognized and the capital requirement on the underlying asset would be zero. However, if the derivative maturity were less than 2 years, no capital relief would be granted under the proposal. In all cases, there will be a counterparty risk capital requirement for credit exposure on the derivative contract. This issue will continue to be researched by the Finance Board during the comment period.

If the remaining maturities of the underlying asset and a credit derivative are the same, but the underlying asset is different from the asset referenced in the credit derivative, capital relief for the underlying asset may or may not be granted. It is proposed that the capital requirement on the underlying asset be reduced to zero only if the referenced and the underlying assets have been issued by the same obligor, the referenced asset ranks *pari passu* to or more junior than the underlying asset, and cross-default clauses are in effect.

If the remaining maturities of the two assets are identical but the underlying

asset and the referenced asset have been issued by different obligors, the proposed rule does not provide any capital relief for the underlying asset. For example, a Bank may invest in a triple-B rated bond issued by corporate entity X, but hedge the credit risk with a derivative based on triple-B rated bond issued by corporate entity Y, and where X and Y belong to the same industry. The Finance Board recognizes that such a hedge may provide significant credit protection to the Bank as there may be a high degree of default correlation between X and Y, and that capital relief for such hedges can be accommodated under an internal portfolio credit risk model. Thus, the Finance Board requests comments on whether to allow affected Banks to petition the Finance Board for capital relief on a case by case basis, provided the petition is accompanied by adequate data and analysis.

*d. Credit risk percentage requirements for off-balance sheet items.* Off-balance sheet items may expose a Bank to credit risks similar to those associated with on-balance sheet assets. The Finance Board is proposing to apply the credit risk capital framework consistently to all on- and off-balance sheet instruments. Under proposed §§ 930.5 (e) and (f), the Banks are required to convert all off-balance sheet credit exposures into equivalent on-balance-sheet credit exposures (credit equivalent amounts) and then apply the ratings-based framework in Table 1 to estimate the credit risk capital requirement. The Finance Board would allow the Banks to use Finance Board approved internal models to convert some or all off-balance sheet credit exposures into equivalent on-balance-sheet credit exposures. For Banks that lack appropriate internal models, the Finance Board is proposing to adopt the Basle Accord treatment for such instruments as used by the other federal bank regulatory agencies to convert an off-balance sheet credit exposure into an equivalent on-balance-sheet exposure.

Under the Basle Accord as incorporated by the federal bank regulatory agencies, off-balance sheet instruments, other than derivative contracts, that are substitutes for loans (e.g., standby letters of credit serving as financial guarantees for loans and securities) have the same credit risk as an on-balance sheet direct loan. For some off-balance sheet instruments, the full face value, or notional amount, is not exposed to credit risk. This means

that a dollar of off-balance sheet exposure may be equivalent to less than a dollar of on-balance sheet exposure. The following table (Table 2 in proposed § 930.5(e)), which includes the same categories as are used by the federal bank regulatory agencies and those proposed under the Framework, presents credit exposure conversion factors that are to be multiplied by the face amount of an off-balance sheet instrument other than a derivative contract.

CREDIT CONVERSION FACTORS FOR OFF-BALANCE SHEET ITEMS OTHER THAN DERIVATIVE CONTRACTS

Instrument	Credit conversion factor (in percent)
Standby letters of credit .....	100
Asset sales with recourse, where credit risk remains with the Bank .....	.....
Sale and repurchase agreements .....	.....
Forward asset purchases .....	.....
Commitments to make advances or other loans with certain drawdown <sup>1</sup> .....	.....
Other commitments with original maturity of over one year .....	50
Other commitments with original maturity of one year or less .....	20

<sup>1</sup> *i.e.*, where it is known during the pendency of the commitment that the advance or loan funds definitely will be drawn in full.

The credit conversion factor would be zero for Other Commitments that are unconditionally cancelable, or that effectively provide for automatic cancellation, due to deterioration in a borrower's creditworthiness, at any time by the Bank without prior notice. The Finance Board would allow the Banks to use Finance Board approved internal models to calculate credit conversion factors instead of those specified in Table 2. These factors were developed by the BCBS and adopted by other federal bank regulatory agencies. Under the Basle Accord, a 100 percent conversion factor is assigned to an off-balance sheet instrument where the instrument is a direct credit substitute and the credit risk is equivalent to that of an on-balance sheet exposure to the same counterparty. A 50 percent conversion factor is assigned to an off-balance sheet instrument where there is a significant credit risk but mitigating circumstances exist which suggest less

than full credit risk. A 20 percent conversion factor is assigned to an off-balance sheet instrument where there is a small credit risk but not one which can be ignored. The Finance Board intends to undertake further research on the magnitude and appropriateness of the credit conversion factors set forth in proposed § 930.5(e) and may revise them before a final rule is published.

*e. Credit risk percentage requirements for derivative contracts.* Proposed § 930.5(f) provides that for market driven instruments (over-the-counter derivative contracts such as swaps, forwards, options, etc.) subject to counterparty default, the credit risk capital requirement will be based on both current and potential credit exposures. In recognizing collateral, the haircuts requirement under proposed § 930.5(d)(4)(iv) to reflect the market risk embedded in the collateral would apply. The derivatives contracts may be based on underlying market interest rates or prices and may include credit-linked contracts. The credit equivalent amount for a derivative contract is equal to the sum of: the current credit exposure (sometimes referred to as the replacement cost) of the contract; and the potential future credit exposure (sometimes referred to as the potential future replacement cost) of the contract.

Proposed § 930.5(f)(1) provides that the current credit exposure is equal to the maximum of the mark-to-market value of the contract and zero, as contracts with negative mark-to-market values do not create any current credit exposure for a Bank.

Proposed § 930.5(f)(2) provides that the potential future credit exposure (PFE) of a contract shall be determined by using an internal market risk model approved by the Finance Board or, in the case of Banks that lack appropriate internal models to calculate PFE, using the Basle Accord's standardized approach set forth in Table 3 of the proposed rule.<sup>14</sup> Under this approach, the PFE of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the effective notional principal amount of the contract by a credit conversion factor for the underlying market risk as specified in Table 3, as follows:

<sup>14</sup> See BCBS, *Basle Capital Accord: Treatment of Potential Credit Exposure for Off-Balance Sheet Items* (Apr. 1995). The BCBS ran Monte Carlo simulations on numerous contracts before determining the conversion factors included in Table 3.

CREDIT CONVERSION FACTORS FOR POTENTIAL FUTURE CREDIT EXPOSURE DERIVATIVE CONTRACTS  
[In percent]

Residual maturity	Underlying market rate or price				
	Interest rate	Foreign exchange and gold	Equity	Precious metals except gold	Other commodities
One year or less .....	0	1	6	7	10
Over 1 year to five years .....	.5	5	8	7	12
Over five years .....	1.5	7.5	10	8	15

Under the proposed rule, forwards, swaps, purchased options and similar derivative contracts that are not included in the Interest Rate, Foreign Exchange and Gold, Equity, or Precious Metals except Gold categories shall be treated as Other Commodities for purposes of Table 3. If a Bank determines not to use an internal model for single currency interest rate swaps in which payments are made based upon two floating indices (floating/floating or basis swaps), the PFE for such swaps shall be zero. If a Bank determines to use Table 3 for credit derivative contracts, the credit conversion factors applicable to Interest Rate Contracts under Table 3 shall apply.<sup>15</sup> If a Bank determines to use an internal model for a particular type of derivative contract, the Bank shall use the same model for all other similar types of contracts. However, the Bank may use an internal model for one type of derivative contract and Table 3 for another type of derivative contract. In other words, within each category of market risks, a Bank would not be allowed to arbitrage between capital requirements based on Table 3 and internal models.<sup>16</sup>

The proposed rule does not contain any specific means to account for portfolio diversification effects. Consequently, the proposal would require the same regulatory capital charge for two portfolios that are of the same credit quality, but where the credit risk of one is significantly more

<sup>15</sup>The BCBS has yet to determine conversion factors for credit derivatives. Given that fluctuations in investment grade credit spreads are generally of a smaller magnitude than shifts in the level of interest rates, it appears that the potential future changes in the market value of credit-linked contracts should not generally exceed potential shifts in the market value of interest rate linked contracts. The Finance Board plans to examine any credit derivative contracts that the Banks may enter into and require larger conversion factors for credit derivatives, if necessary.

<sup>16</sup>A Bank that uses an internal model for simple interest rate contracts may utilize Table 3 for interest rate contracts with embedded options, stand-alone interest rate options or other complex/structured contracts. The reverse may not be allowed as a Bank that is capable of internally calculating PFE for complex/structured contracts must use such internal model for simple contracts.

concentrated than that of the other. However, as noted by the BCBS, this limitation may be effectively addressed in a portfolio-based internal credit risk capital framework. Portfolio credit risk modeling is a long-term project for the BCBS; ultimately, it is anticipated that sophisticated banking institutions would employ a comprehensive portfolio risk modeling approach under which regulatory capital requirements would be based entirely on internal models. Similarly, the Finance Board will encourage the Banks to develop internal credit risk models. Building such an internal model should not be a formidable task for the Banks, given that their portfolios largely consist of credit exposures that may be rated and almost all the Banks' counterparties are financial institutions. The remaining unrated exposures are insignificant and may be dealt with outside a credit risk model.

Proposed § 930.5(g) sets forth the requirements for calculation of credit equivalent amounts for multiple derivative contracts subject to a qualifying bilateral netting contract. The provisions in the proposal are consistent with the requirements set forth in the risk-based capital guidelines of the federal bank regulatory agencies.

#### 6. Market Risk Capital Requirement—§ 930.6

*a. Background.* Section 930.6(a) of the proposed rule provides that a Bank's market risk capital requirement shall equal the market value of the Bank's portfolio at risk from movements in market prices, *i.e.*, interest rates, foreign exchange rates, commodity prices and equity prices, as could occur during periods of extreme market stress, as determined using the Bank's internal market risk model approved by the Finance Board.

Market risk may be defined as the risk that the market value of a Bank's portfolio will decline as a result of changes in the general level of interest rates, foreign exchange rates, equity and commodity prices.

The Banks engage in activities that carry complex on- and off-balance sheet market risks. For example, CO issuances, for which the Banks are jointly and severally liable, include: structured notes having embedded options and exotic features; callable, puttable and index amortizing bonds; bonds that amortize based on a particular mortgage pool; bonds denominated in foreign currencies; and bonds linked to equity prices or foreign interest rates. To hedge the market risk on such complex instruments, the Banks enter into off-balance sheet derivative contracts that reflect the risks embedded in those bonds.

The Banks also make advances on a simple fixed or floating rate basis, as well as callable, puttable/convertible and amortizing advances. The Banks also have invested in agency bonds with callable and structured features, mortgage and mortgage-backed instruments with embedded options, and collateralized mortgage obligations.

Given that the Banks undertake transactions that carry market risks similar to the risks incurred by large banks or securities dealers, the Finance Board believes that the capital regime for the Banks' market risks should be similar to the market risk capital requirements established or recommended by the Basle Committee and other financial institution regulatory agencies, but broader in scope.

As previously discussed, the drive to institute a risk-based capital system for general market risk has been spearheaded by the BCBS. Following the BCBS's lead, the federal bank regulatory agencies (Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB) and Federal Deposit Insurance Corporation (FDIC)) issued a joint final rule in September 1996 (12 CFR parts 3, 208, 225 and 325) to incorporate a measure for market risk, effective as of January 1, 1998 (Joint Rule). Institutions whose trading activity (defined in the Joint Rule as total assets plus total liabilities in the trading portfolio) equals 10

percent or more of their total assets, or whose trading activity equals \$1 billion or more, must use an internal model (with standardized parameters as set in the Joint Rule) to calculate the capital they must hold to support their exposure to general market risk. Positions covered by the rule include: (i) all positions in an institution's trading account; and (ii) foreign exchange and commodity positions whether or not in the trading account.

Overall, the Joint Rule implements market risk based capital requirements that are based on actual risks undertaken by large banks. This is the only market risk capital framework that has been both agreed to internationally and implemented in a number of countries. Under the Joint Rule, large banks in the United States generally have adopted a simulation-based approach that is capable of capturing market risks from holding a wide range of simple, exotic and structured instruments—with or without options and based on mortgages or other types of transactions.

Financial institutions regulated by the Office of Thrift Supervision (OTS) (12 CFR 567.5) and the Farm Credit Administration (12 CFR 615.5205, 615.5210) currently are subject to the Basle Accord's credit risk capital requirements that contain no market risk capital components (consistent with the small bank regulatory capital framework). However, the Office of Federal Housing Enterprise Oversight (OFHEO) recently published a Notice of Proposed Rulemaking including its regulatory model for calculating risk-based capital for Fannie Mae and Freddie Mac; that model does account for both interest rate risk and credit risk. See 12 CFR part 1750. The OFHEO interest rate risk based capital rule is based on the Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (1992 Act), which requires that capital requirements account for market risks. The market risk capital requirement is determined by a stress test, which examines the effects of two specified interest rate shocks. See 12 U.S.C. 4611(a)(2).

Currently, the Banks are not subject to any market risk capital requirements. The FMP requires that the Banks limit their interest rate risk based on a methodology that uses interest rate shocks similar to those proposed but never adopted by the three U.S. bank regulatory agencies (the OCC, the FRB and the FDIC) and the OTS. The FMP requires the Banks to limit interest rate risk by maintaining the duration of their equity to within  $\pm 5$  years. The FMP also requires the Banks to maintain the

duration of their equity to  $\pm 7$  years under an assumed change in interest rates of  $\pm 200$  basis points.

The Finance Board does not believe that the FMP interest rate risk methodology is sufficiently flexible to continue to capture the market risks undertaken by the Banks in line with the developments in market risk measurement and management. Accordingly, this proposed rule sets forth market risk measures consistent with the value at risk (VAR) framework for calculation of market risk capital adopted by the BCBS and other financial institution regulators, an approach that can be implemented with commercially available models, is practical, and is sufficiently rigorous.

*b. Measurement of market value at risk under Bank internal market risk model.* Section 930.6(b)(1) of the proposed rule requires each Bank to measure, as the market risk component of its risk-based capital requirement, the market value at risk using an internal VAR model, subject to the parameters in the proposed rule. The VAR must be calculated for interest rate, foreign exchange rate, equity price, and commodity price risks undertaken by the Bank, including related options. Currently, the Banks are required by the FMP to hedge risk associated with foreign exchange rates, equity prices, and commodity prices with matching derivative contracts. Therefore, the bulk of the proposed market risk capital requirement will reflect interest rate and related options risks. Although the Banks will have to consistently apply the VAR framework to instruments linked to foreign exchange rates, equity prices, and commodity prices, these other market risks currently pose a smaller amount of risk, relative to interest rate risk.

Under proposed § 930.6(b)(1), each Bank must use an internal market risk model that measures the market value of its portfolio at risk during periods of extreme market stress arising from all sources of market risks based on the Bank's holdings of on-balance sheet assets and liabilities and off-balance sheet items, including risks associated with related options. Proposed § 930.6(b)(2) provides that the Bank's internal market risk model may use any generally accepted measurement technique, such as variance-covariance models, historical simulations, or Monte Carlo simulations, for estimating the market value of the Bank's portfolio at risk, provided that any measurement technique used must cover the Bank's material risks. Proposed § 930.6(b)(3) provides that the Bank's internal market risk model must measure the risks

arising from the non-linear price characteristics of options and the sensitivity of the market value of options to changes in the volatility of the option's underlying rates or prices. For example, a variance-covariance methodology may be sufficient for instruments that contain no optionality, while it would be essential to use a simulation technique for instruments with options characteristics.

Section 930.6(b)(4) of the proposed rule provides that the Bank's internal market risk model must use interest rate and market price scenarios for estimating the market value of the Bank's portfolio at risk, but must at a minimum include: (i) Monthly estimates of the market value of the Bank's portfolio at risk so that the probability of a loss greater than that estimated shall be no more than 1 percent; (ii) scenarios that reflect changes in rates and market prices equivalent to those that have been observed over 90-business day periods of extreme market stress<sup>17</sup> (for interest rates, the relevant historical observation period specified in § 930.6(b)(4) is to start from the end of the previous month and go back to the beginning of 1978 and the VAR measure may incorporate empirical correlations among interest rates, subject to a Finance Board determination that the model's system for measuring such correlations is sound); and (iii) the two interest rate scenarios required to be used by OFHEO to determine the risk-based capital requirements for Fannie Mae and Freddie Mac, pursuant to 12 U.S.C. 4611(a)(2).

Proposed § 930.6(b)(5) provides that if a Bank participates in COs denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, and these instruments have been hedged for foreign exchange, equity and commodity risks, the Bank's internal market risk model must be used to calculate the market value of its portfolio at risk due to these market risks and using the qualitative and quantitative requirements specified in the proposed rule, *i.e.*, the probability of a loss greater than that estimated must not exceed 1 percent and must include scenarios that reflect changes in rates and market prices that have been observed over 90-business day periods of extreme market stress. This requirement reflects the conservative approach adopted by the Finance Board

<sup>17</sup> If the underlying distribution for VAR is approximately normal, the multiplier of 3 effectively extends the 10 business day horizon required under the Amendment to 90 business days and applies to large banks with satisfactory internal models, as determined by regulators.

with respect to the Banks' safety and soundness and the comprehensive measurement of all market risks throughout each Bank.

The market valuations for COs may differ from valuations for matching hedging instruments in the derivative market because of different assumptions concerning the underlying discount curves, volatilities and correlations. Prices in the two markets may not be the same and may fail to move in perfect correlation over time. Therefore, some measure of market risk remains even if the foreign exchange, equity or commodity risks are hedged with matching derivative contracts. The Finance Board believes foreign exchange rates, equity prices, and commodity prices pose a relatively small amount of market risk to the Banks at this time. For calculation of value at risk due to foreign exchange rates, equity and commodity prices, historical observation data from an appropriate period satisfactory to the Finance Board must be used. The value at risk measure may incorporate empirical correlations within foreign exchange rates, equity prices, and commodity prices, but not among the three risk categories, subject to a Finance Board determination that the model's system for measuring such correlations is sound.

Proposed § 930.6(b)(5)(iv) provides that if there is a default on the part of a counterparty to a derivative contract linked to foreign exchange rates, equity prices or commodity prices, the Bank must enter into a replacement contract in a timely manner and as soon as market conditions permit. Besides strengthening safety and soundness, this requirement formalizes the long standing practice at the Banks under which the Banks have not assumed an open (unhedged) foreign exchange, equity or commodity position and is consistent with the requirement in proposed § 955.3(b) that the Banks shall not engage in an open foreign exchange, equity and commodity position.

c. *Independent validation of Bank internal market risk model.* Section 930.6(c) of the proposed rule provides that each Bank shall conduct an independent validation of its internal market risk model within the Bank or obtain independent validation by an outside party qualified to make such determinations, on an annual basis, or more frequently as required by the Finance Board. In order for validations conducted within the Bank to be considered independent, the validation must be carried out by personnel not reporting to the business line responsible for conducting business

transactions for the Bank. Such validation may include periodic comparisons, such as on a quarterly basis, of model generated mark-to-market values with values obtained from dealers/markets and periodic comparisons, such as on an annual basis, of model generated VAR values with values obtained from an independent third-party source. A Bank may use a representative sample of its on- and off-balance sheet instruments for this source. An integral part of this process is the necessity to validate key assumptions and associated parameters underlying the Bank's market risk models. For example, a Bank must periodically determine the impact on VAR of shifts in key parameters such as correlations or regime shifts in volatility parameters. The results of such validations must be reviewed by the Bank's board of directors and provided to the Finance Board.

d. *Finance Board approval of Bank internal market risk model.* Section 930.6(d)(1) of the proposed rule provides that each Bank must obtain approval from the Finance Board of its internal market risk model, including subsequent material adjustments to the model made by the Bank, prior to the model's use. A Bank must make any subsequent adjustments to its model that may be directed by the Finance Board.

e. *Basis risk.* Banks are exposed to basis risk, which is the risk that rates or prices of different instruments on the two sides of the balance sheet (after taking associated off-balance instruments into account) do not change in perfect correlation over time. The BCBS has emphasized the importance of basis risk as part of a comprehensive process for the management of interest rate risk.<sup>18</sup> In the final rule, the Finance Board may require the Banks to submit a monthly report identifying the relevant interest rate or price indices along with related basis risk exposures. Based on an analysis of such reports and with the help of other relevant data, an assessment will be made as to the necessity of developing a basis risk measure to incorporate into the market risk capital requirement as an amendment to the final regulation. At this time, the Finance Board is requesting comments on the treatment of basis risk.

f. *Transition provision.* Section 930.6(d)(2) of the proposed rule would require each Bank to submit its initial internal market risk model to the Finance Board for approval within one

calendar year of the effective date of the final rule.

#### 7. Operations Risk Capital Requirement—§ 930.7

Proposed § 930.7 provides that each Bank's operations risk capital requirement shall at any time equal 30 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement at such time. Operations risk is defined in proposed § 930.1 as the risk of an unexpected loss to a Bank resulting from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems. There is currently no generally accepted methodology for measuring the magnitude of operations risk. Therefore, the proposed rule adopts the same requirement imposed by statute on Fannie Mae and Freddie Mac. See 12 U.S.C. 4611(c)(2).

#### 8. Reporting Requirements—§ 930.8

Proposed § 930.8 provides that each Bank shall report to the Finance Board by the 15th day of each month its minimum total risk-based capital requirement, by component amounts (credit risk capital, market risk capital, and operations risk capital), and its actual total capital amount and risk-based capital calculated as of the last day of the preceding month, or more frequently as may be required by the Finance Board.

#### 9. Capital Stock Redemption Requirements—§ 930.9

a. *General.* The Act establishes minimum stock purchase requirements for members for purposes of membership, see 12 U.S.C. 1426(b)(1), 1430(e)(3), and for purposes of taking advances. *Id.* at 1430 (c), (e)(1). For a variety of reasons, such as a member's anticipation of a seasonal increase in advance borrowing, many members of the Bank System currently hold stock in a Bank in excess of the statutory minimum requirements.

Pursuant to proposed § 930.1 (definition of "total risk-based capital for a Bank"), a Bank may allocate a percentage not exceeding 50 percent of all outstanding capital stock satisfying the minimum capital stock purchase requirements for membership under sections 6(b)(1) and 10(e)(3) of the Act of all voluntary members, and a percentage not exceeding 50 percent of all other outstanding capital stock, towards meeting the Bank's total risk-based capital requirement.

Proposed § 930.9(a) provides that the capital stock designated by a Bank to meet the Bank's total risk-based capital

<sup>18</sup> See *Principles for the Management of Interest Rate Risk* (Jan. 1997).

can only be redeemed by the Bank with the approval of the Finance Board. This would be true even for institutions withdrawing from membership in the Bank System pursuant to section 6(e) of the Act. *Id.* at 1426(e). Proposed § 930.9(b) provides that a Bank may at any time redeem any portion of a member's capital stock not included in or allocated by the Bank to the Bank's total risk-based capital, provided that the member's minimum capital stock purchase requirement for membership in the Bank System under sections 6(b)(1) and 10(e)(3) of the Act, *id.* at 1426(b)(1), 1430(e)(3), is maintained. The Bank may subject such redemptions to the six-month notice provision in section 6(e) of the Act, *id.* at 1426(e), or may shorten or waive the six-month notice provision.

The Finance Board's current regulations allow a Bank, after providing 15 calendar days advance written notice to a member, to conduct mandatory, unilateral redemption of excess stock, provided that the minimum stock requirements for membership under the Act are maintained. See 12 CFR 935.15(b)(1). This provision is retained in the proposed rule as § 930.9(b)(3). Section 935.15(b)(2) of the Finance Board's current regulations, 12 CFR 935.15(b)(2), provides that a Bank may not impose on or accept from a member a fee in lieu of the mandatory redemption of the member's capital stock. This provision also is being retained in the proposed rule as § 930.9(b)(4).

The redemption scheme in the proposed rule is designed to maintain a level of permanence in the Bank's capital within the flexible overall risk-based capital framework of the proposal. In this way, the most permanent forms of capital are measured and used as a limitation on risk-taking activity. The permanent capital of each Bank, retained earnings and the minimum stock requirement of mandatory members, may be supplemented by less permanent capital only to the extent that each Bank designates it as risk-based and imposes on its members the risk that capital impairment will impede its redemption.

*b. Advance Notice of Proposed Rulemaking; Interim Final Rule.* The Finance Board recently published an ANPRM requesting comment on whether each Bank should be required to unilaterally redeem its members' excess Bank capital stock to help achieve the goal of reducing the excess capital stock in each Bank and thereby to reduce each Bank's arbitrage of its GSE status in non-core mission assets. See 64 FR 16792 (Apr. 6, 1999). Each of

the Banks today holds investments that would not be core mission assets under the proposed rule. Banks with relatively high amounts of such investments also tend to have relatively high levels of excess capital stock. See *id.* at 16793-94.

As discussed in the ANPRM, the Finance Board believes that the Banks' arbitrage activities for the purpose of generating sufficient earnings to pay adequate dividends on excess capital stock detract from the mission of the Banks to promote housing finance and community lending, by encouraging activities not related to the Banks' mission and thereby detracting from the financial incentive to engage in mission-related activity. See *id.* at 16794. A reduction in the amount of excess capital stock would reduce the amount of capital stock on which dividends must be paid, thereby reducing the level of arbitrage activities conducted in order to generate earnings to pay dividends on such capital stock. See *id.* Accordingly, the ANPRM requested comment on whether the Banks should be required to unilaterally redeem members' excess capital stock as a way to reduce excess capital stock in the Bank System and thereby reduce arbitrage activities in non-core mission assets by the Banks. See *id.* at 16795.

For the reasons discussed above, the Finance Board also adopted an interim final rule amending § 935.15(b) of its Advances Regulation to prohibit the Banks from imposing or accepting a fee in lieu of redeeming a member's excess capital stock. See 64 FR 16788 (Apr. 6, 1999) (to be codified in 12 CFR 935.15(b)(2)).

The Finance Board received 68 comment letters on the ANPRM, mostly opposing requiring the Banks to unilaterally redeem members' excess capital stock, for reasons including that it would adversely impact the Banks' financial management, daily operations, long-term customer relationships and flexibility in responding to market needs. The Finance Board received 4 comment letters on the interim final rule, with two commenters supporting and two commenters opposing the rule. The concerns about a Bank's arbitrage of its GSE status with non-core mission assets that the ANPRM and interim final rule attempted to address through mandatory reduction of excess capital stock, are addressed in a different fashion under the financial management and mission achievement provisions of this proposed rule. Accordingly, the Finance Board does not intend to pursue at this time the proposals raised for comment in the ANPRM, but is retaining § 935.15(b)(2) of its Advances

Regulation regarding the fee in lieu prohibition (as proposed § 930.9(b)(4)).

#### 10. Minimum Liquidity Requirements—§ 930.10

Liquidity risk is defined in proposed § 917.1 as the risk that a Bank would be unable to meet its obligations as they come due or meet the credit needs of its members and eligible nonmember borrowers in a timely and cost-efficient manner. In general, the liquidity needs of the Banks may be classified as: (1) operational liquidity; and (2) contingency liquidity. Operational liquidity addresses day-to-day or ongoing liquidity needs under normal circumstances, and may be either anticipated or unanticipated. Contingency liquidity addresses liquidity needs under abnormal or unusual circumstances in which a Bank's access to the capital markets is temporarily impeded. Under such unusual circumstances, a Bank may still need funds to meet all of its obligations that are due or to meet some of the credit needs of its members and eligible nonmember borrowers.

Currently, the Banks operate under two general liquidity requirements. Both are easily met by the Banks. However, neither is structured to meet the Banks' liquidity needs should their access to the capital markets be limited for any reason. The first requirement is statutory and requires the Banks to maintain an amount equal to total deposits invested in either obligations of the United States, deposits in banks or trusts, or advances to members that mature in 5 years or less. See 12 U.S.C. 1421(g). The second liquidity requirement is in the FMP. It requires each Bank to maintain a daily average liquidity level each month in an amount not less than 20 percent of the sum of the Bank's daily average demand and overnight deposits and other overnight borrowings during the month, plus 10 percent of the sum of the Bank's daily average term deposits, COs, and other borrowings that mature within one year. See FMP section III.C.

The proposed rule specifies a contingency liquidity requirement, but does not specify an operational liquidity requirement. However, proposed § 917.3(b)(3)(iii) would require that each Bank's risk management policy indicate the Bank's sources of liquidity, including specific types of investments to be held for liquidity purposes, and the methodology to be used for determining the Bank's operational liquidity needs.

Section 930.10 of the proposed rule provides that the Banks must meet not only the statutory liquidity

requirements contained in section 11(g) of the Act, 12 U.S.C. 1431(g), but also each Bank shall hold contingency liquidity in an amount sufficient to enable the Bank to cover its liquidity risk, assuming a period of not less than seven calendar days of inability to borrow in debt markets. Contingency liquidity may be provided through Banks: (1) selling liquid assets; (2) pledging government, agency and mortgage-backed securities as collateral for repurchase agreements; and (3) borrowing in the federal funds market. Consequently, contingency liquidity is defined in proposed § 930.1 as: (1) marketable assets with a maturity of one year or less; (2) self-liquidating assets with a maturity of seven days or less; and (3) assets that are generally accepted as collateral in the repurchase agreement market. Proposed § 930.10 provides that an asset that has been pledged under a repurchase agreement cannot be used to satisfy the contingency liquidity requirement, since such an asset will not be available to provide liquidity should a contingency arise.

The proposed seven-day contingency liquidity requirement would help to ensure that the Banks maintain sufficient liquidity to meet their funding needs should their access to the capital markets be temporarily limited by occurrences such as: (1) a power outage at the Bank System's Office of Finance (OF); (2) a natural disaster; or (3) a real or perceived credit problem. This requirement was calculated using daily data on CO redemptions during 1998. The Finance Board found that the 99th percentile of the 5-business day CO redemption distribution resulted in liquidity requirements that ranged from about 5 percent to 17 percent of each Bank's total assets.

It is expected that the contingency liquidity requirement and the Banks' operational liquidity needs can be met within the core mission activities requirement in proposed § 940.4. The Banks' capital and deposits are available to fund liquidity assets, and some core mission assets may also serve as liquidity assets. In addition, the Finance Board expects that the Banks' liquidity requirements will generally decline as they restructure their balance sheets to comply with the core mission activities requirements in proposed § 940.4.

The seven-day requirement may be viewed as conservative when examined in the context of events which could impair the normal operations of the OF. The likelihood that there would be no access to the capital markets for as long as five business days is extremely remote, given OF contingency plans to

be back in operation within the same business day following a disaster. The OF contingency plans include back-up power sources and two back-up facilities, plus procedures to back-up their databases at both their main location as well as the primary alternative site. A back-up data tape from OF's main location is sent and stored off-site on a daily basis.

Real or perceived concerns about creditworthiness of the Bank System could lead to a widening of the spreads to U.S. Treasury securities at which the Bank System COs are issued. Depending on the size of the increase in credit spreads, such an event could substantially impair the Banks' ability to carry out their mission. Two such episodes affecting other GSEs took place in the 1980s. In both cases, the interest rate spread narrowed back to normal levels only after the GSEs received assistance from the federal government.<sup>19</sup> In the first instance, the spread to comparable U.S. Treasury securities for a Farm Credit System issue increased approximately 80 basis points within a 6 month period during 1985 as the Farm Credit System ran into financial difficulty and started posting losses. Fannie Mae underwent a similar episode in which its debt spread widened substantially.

The likelihood that such an event could take place with respect to the Banks is remote and, in any event, would need to be addressed with resources beyond those dedicated to the contingency liquidity requirement. The seven-day contingency liquidity requirement provides policy makers with some time to address the underlying problem. Further, should a crisis arise affecting liquidity at all financial institutions, assistance would be needed from the Federal Reserve System, the U.S. Treasury, or the Congress.

Other regulators also recognize the importance of adequate levels of liquidity but, for the most part, have not imposed liquidity requirements with the degree of specificity contained in the proposed rule. Specifically, depository institution regulators have not implemented any numeric ratios or other quantitative requirements with respect to liquidity. However, the importance of liquidity is reflected in the fact that it is one of the six components of the Uniform Financial Institutions Rating System (UFIRS) that was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979 and

revised as of January 1, 1997. The UFIRS has been used as an internal supervisory tool for evaluating the soundness of financial institutions and for identifying those institutions requiring special attention or concern. Under 12 CFR 615.5134, each banking institution regulated by the Farm Credit Administration is required to maintain a minimum liquidity reserve. This liquidity reserve requirement ensures that Farm Credit System banks have a pool of liquid investments to fund their operations for approximately 15 days should their access to the capital markets become impeded. OFHEO has not published any regulation concerning liquidity requirements for Fannie Mae and Freddie Mac.

Rating agencies also consider adequate liquidity an important component in a financial institution's rating. Liquid investments held by the Banks are stated by Moody's as one of the reasons behind the triple-A rating for the Banks.<sup>20</sup>

11. Limits on Unsecured Extensions of Credit to One Counterparty or Affiliated Counterparties; Reporting Requirements For Total Secured and Unsecured Extensions of Credit to One Counterparty or Affiliated Counterparties—§ 930.11

a. *Limits on unsecured extensions of credit.* Section 930.11(a) of the proposed rule establishes maximum capital exposure limits for unsecured extensions of credit by a Bank to a single counterparty or to affiliated counterparties. Section 930.11(b) of the proposed rule establishes reporting requirements for total unsecured extensions of credit and total secured and unsecured extensions of credit to single counterparties and affiliated counterparties that exceed certain thresholds.

Concentrations of unsecured credit by a Bank with a limited number of counterparties or group of affiliated counterparties raise safety and soundness concerns. Unlike Bank advances, which must be secured, unsecured credit extensions are more likely to result in limited recoveries in the event of default. Thus, significant credit exposures to a few counterparties increase the probability that a Bank may experience a catastrophic loss in the event of default by one of the counterparties. In contrast, holding small credit exposures in a large number of counterparties, while making a small

<sup>19</sup> See Federal Reserve Bank of Richmond, *Instruments of the Money Market* 153 (1993).

<sup>20</sup> Moody's Investor Service, Global Credit Research, *Moody's Credit Opinions—Financial Institutions*, (June 1999).



loss more likely, reduces the probability of a catastrophic loss to a Bank.

Safety and soundness concerns also arise where a Bank's credit extensions are concentrated in a single counterparty whose debt, in turn, is concentrated in one or a few lenders. The fact that the counterparty's debt is concentrated may suggest that other lenders have declined to lend to such counterparty due to concerns about the counterparty's ability to repay a loan. The Bank's concentration of credit in such a counterparty may put the Bank's extensions of credit more at risk.

In addition, where a Bank's extensions of credit to a single counterparty are in jeopardy of nonpayment, the Bank may be reluctant to take appropriate actions to reduce losses, such as declaring a default, or selling the loans, which could depress their price. Further, a Bank may even be tempted to lend additional funds to the counterparty to keep the counterparty in business, if that Bank has a significant credit exposure to the counterparty.

Affiliated counterparties generally share aspects of common ownership, control or management. Thus, if one member of a group of affiliates defaults, the likelihood is high that other members of the affiliated group also are under financial stress. A Bank's unsecured extensions of credit to a group of affiliated counterparties thus should be aggregated in considering the Bank's unsecured credit exposure to any one counterparty in the affiliated group.

Concentrations of credit by multiple Banks in a few counterparties also may raise safety and soundness concerns at the Bank System level. Several Banks in recent years have had unsecured credit exposures to affiliated counterparties that exceeded 20 percent of each Bank's capital. These credit exposures were to counterparties ranked at the second highest investment grade. A few counterparties have spread their exposure among several Banks. Such credit concentrations may result in large aggregate credit exposures for the Bank System, raising concerns regarding the liquidity of such debt in the event of adverse information regarding a counterparty.

The risk-based capital requirements in the proposed rule do not take into account the increase in credit risk associated with concentrations of unsecured credit. Therefore, the Finance Board believes that it is necessary, for safety and soundness reasons, to impose separate limits on unsecured extensions of credit by a Bank to single counterparties and to affiliated counterparties. This is consistent with the regulatory approaches of other

financial institution regulators. *See, e.g.*, 12 CFR 32 (OCC's loans-to-one-borrower limit is generally 15 percent of a national bank's capital and surplus).

Currently, the FMP limits Bank unsecured extensions of credit to a single counterparty based on the credit rating of the counterparty. *See* FMP section VI. Under the FMP, the lower the credit rating of the counterparty, the lower the maximum permissible credit exposure limit, because the probability of default increases as the counterparty's rating decreases. The FMP does not impose limits on unsecured lending to affiliated counterparties, but does require the Banks to monitor such lending and impose limits if necessary. As of December 31, 1998, five Banks had adopted explicit unsecured credit exposure limits to affiliated counterparties.

Consistent with the general approach of the FMP, § 930.11(a)(1)(i) of the proposed rule provides that unsecured extensions of credit by a Bank to a single counterparty that arise from authorized Bank investments or hedging transactions shall be limited to the maximum capital exposure percent limit applicable to such counterparty, as set forth in Table 4 of the proposed rule, multiplied by the lesser of: (i) the Bank's total capital; or (ii) the counterparty's Tier 1 capital, or total capital if Tier 1 capital is not available. The maximum capital exposure percent limits applicable to specific counterparties in Table 4 range from a high of 15 percent for counterparties with the highest investment grade rating, to a low of 1 percent for counterparties with a below investment grade rating. These limits are consistent with those established internally by large lenders.

Section 930.11(a)(1)(ii)(D) of the proposed rule provides that where a counterparty has received different credit ratings for its transactions with short-term and long-term maturities: (i) the higher credit rating shall apply for purposes of determining the allowable maximum capital exposure limit under Table 4 applicable to the total amount of unsecured credit extended by the Bank to such counterparty; and (ii) the lower credit rating shall apply for purposes of determining the allowable maximum capital exposure limit under Table 4 applicable to the amount of unsecured credit extended by the Bank to such counterparty for the transactions with maturities governed by that rating. For example, if a counterparty has received a lower rating on its long-term debt than its short-term debt, the Bank will be more severely limited in the amount of the counterparty's long-term

debt that it can hold. If the Bank wishes to hold any more of this counterparty's debt, it will be limited to holding the higher rated short term debt, up to a total amount of credit exposure governed by proposed § 930.11(a)(1)(ii)(D)(I).

Section 930.11(a)(1)(ii)(E) of the proposed rule provides that if a counterparty is placed on a credit watch for a potential downgrade by an NRSRO, the Bank shall determine its remaining available credit line for unsecured credit exposures under Table 4 by assuming a rating from that NRSRO at the next lower grade.

Section 930.11(a)(2) of the proposed rule provides that the total amount of unsecured extensions of credit by a Bank to all affiliated counterparties may not exceed: (i) the maximum capital exposure limit applicable under Table 4 based on the highest credit rating of the affiliated counterparties; (ii) multiplied by the lesser of: (A) the Bank's total capital; or (B) the combined Tier 1 capital, or total capital if Tier 1 capital is not available, of all of the affiliated counterparties.

*b. Reporting requirement for total unsecured credit concentrations.* Currently, there is no centralized mechanism for maintaining and measuring aggregate unsecured credit concentration exposure data at the Bank System level. As discussed above, Bank unsecured credit concentrations raise safety and soundness concerns at the Bank System level, as well as at the individual Bank level. The FMP does not establish maximum unsecured credit exposure limits or reporting requirements for aggregate unsecured credit concentrations at the Bank System level.

Accordingly, § 930.11(b)(1) of the proposed rule requires each Bank to report monthly to the Finance Board the amount of the Bank's total unsecured extensions of credit to any single counterparty or group of affiliated counterparties that exceeds 5 percent of: (i) the Bank's total capital; or (ii) the counterparty's Tier 1 capital (or total capital if Tier 1 capital is not available), or in the case of affiliated counterparties, the combined Tier 1 capital (or total capital if Tier 1 capital is not available) of all of the affiliated counterparties.

The Finance Board will be considering limits on aggregate unsecured credit concentration exposures at the Bank System level for the final rule. The Finance Board specifically requests comments on whether such limits should be imposed and what the size and form of such limits should be.

*c. Reporting requirement for total secured and unsecured credit concentrations.* Bank concentrations of secured credit, primarily advances, to a single counterparty or group of affiliated counterparties also may present safety and soundness concerns for individual Banks and the Bank System. Other financial institution regulators impose loans-to-one-borrower limits for secured as well as unsecured extensions of credit, with exceptions for loans secured by high-quality collateral. *See, e.g.,* 12 CFR 932. There may be reasons to exclude concentrations of advances from such limits, given the extent of their overcollateralization, their statutory superlien protection and core mission activity status.

Accordingly, § 930.11(b)(2) of the proposed rule requires each Bank to report monthly to the Finance Board the amount of the Bank's total secured and unsecured extensions of credit to any single counterparty or group of affiliated counterparties that exceeds 5 percent of the Bank's total assets. Because secured credit is supported by collateral, not capital, in the first instance, the Finance Board believes that exposures as a percent of assets rather than of capital is a more appropriate measure of the size of the exposure.

The Finance Board will be considering limits on total secured and unsecured credit concentration exposures applicable to the Banks or the Bank System for the final rule. The Finance Board specifically requests comments on whether such limits should be imposed and what the size and form of such limits should be.

#### *D. Part 940—Core Mission Activities Requirements*

##### 1. Bank Investment Practices

By virtue of their GSE status, the Banks enjoy two major advantages over non-GSE borrowers in the capital markets: (1) the ability to borrow in the capital markets at rates only slightly above U.S. Department of the Treasury borrowing rates; and (2) the ability to issue large amounts of debt, including debt with complex structures. Given its duty under the Act to ensure that the Banks carry out their housing finance mission, the Finance Board has been concerned for some time that the Banks have used substantial amounts of the proceeds of their GSE borrowings to finance arbitrage investments.

Prior to the thrift crisis of the late 1980s and the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. 101-73, 103 Stat. 183 (1989), the Banks' assets were primarily advances

to thrift members for the purpose of funding home mortgage loans. The Banks' balance sheets expanded and contracted with thrift member demand for advances, and thus, generally reflected the cyclical nature of the housing and credit markets. During this period, the Banks maintained relatively small portfolios of investments in assets other than advances, generally for liquidity purposes. For the period from 1980 through 1988, advances represented, on average, about 84 percent of Bank System total assets, while total investments other than advances represented about 14 percent of Bank System total assets. Over the same time period, advances averaged 118 percent of COs, indicating that the Banks funded advances not only with COs, but also with a portion of deposits and capital. As a result of using all COs issued to fund advances, the Banks were using their GSE funding advantage only to enhance the availability of housing finance.

Significant and rapid changes in the structure of the Bank System's balance sheet and its profitability occurred following the enactment of FIRREA. Among other things, the results of FIRREA included: (1) the liquidation of hundreds of failed thrift institutions, and the concomitant advance prepayments and stock redemptions; (2) the imposition of new and higher statutory capital requirements for thrifts that caused many Bank System thrift members to either reduce their asset size and prepay advances or to stop growing and reduce their demand for new advances during the early 1990s; (3) the transfer of \$2.5 billion in Bank System retained earnings to the Resolution Funding Corporation (REFCorp) to help pay for the cost of thrift resolutions (in addition to the Banks' payment of \$700 million in retained earnings to defease the Financing Corporation bonds as required under the Competitive Equality Banking Act of 1987); (4) the requirement that the Bank System make a \$300 million annual payment of interest on the REFCorp bonds; and (5) the requirement that the Bank System make a payment, beginning in 1990, of the greater of five percent of net income or \$50 million, and increasing by steps to the greater of ten percent of net income or \$100 million in 1995 and thereafter, to fund the newly-required Affordable Housing Program (AHP). One other important provision of FIRREA allowed federally-insured commercial banks with at least ten percent of their assets in residential mortgage loans to join the Bank System.

After the enactment of FIRREA, the Banks needed to generate a level of

income sufficient to cover the decline in earnings associated with the transfer of over \$3 billion in retained earnings to other government agencies, the statutorily mandated annual fixed REFCorp obligation of \$300 million, contributions to the AHP and the prepayment of advances as a result of resolutions of insolvent members, while still providing dividends and benefits, primarily in the form of advances priced to reflect the Banks' GSE funding advantage, that would attract and retain member institutions. Reduced spreads on earning assets and a lower interest rate environment also contributed to the decline in System net income during the early 1990s. For these reasons, Bank investments in assets bearing little or no relation to the Banks' public purpose (primarily money market investments and mortgage backed securities (MBS)) increased during the years following the enactment of FIRREA. Of these two investment options, MBS have been appreciably more profitable per dollar invested.

Therefore, to assist the Banks during this time, the Finance Board increased the Banks' MBS investment authority from 50 percent to 200 percent of capital when it adopted the FMP in 1991. *See* Finance Board Res. No. 91-214 (June 25, 1991). In December 1993, the Finance Board again raised the Banks' MBS investment authority from 200 percent to 300 percent of capital based on continuing concerns about the Banks' ability to generate income. *See* Finance Board Res. No. 93-133 (Dec. 15, 1993). The Finance Board also increased the Bank System's regulatory leverage limit during this period. *See* Finance Board Res. No. 93-074 (Sept. 22, 1993).

The Finance Board initially limited MBS investment, as described above, in part because of concern about the Banks' ability to manage the interest rate and options risk associated with these assets. However, now that the Banks have developed more effective techniques for hedging these risks, and there are policy limits in place constraining the Banks' interest rate risk exposure, the MBS limit can be viewed less as a safety and soundness constraint and more as a means to restrain a non-mission related activity. Although MBS are housing-related, the extent to which these investments support the Banks' housing finance mission is debatable. MBS generally are traded in large, well-established and liquid markets. The Banks' presence in these markets may not result in increased availability of funds for housing, or in lower cost of funds. Moreover, and perhaps most importantly for the Finance Board, the Banks' MBS investments generally do

not involve the Banks working with or through Bank System members and thus do not contribute to the cooperative nature of the Bank System as advances do.

Another major change in the Bank System following the enactment of FIRREA was the growth of commercial bank membership. Until 1989, Bank System membership consisted almost exclusively of thrift institutions. Bank System membership declined from 1989 to 1990 due to the closing of failed institutions, but rose rapidly thereafter as commercial banks joined the Bank System. Total Bank System membership increased from 2,855 at year-end 1990 to 6,884 at year-end 1998. Voluntary members, primarily commercial banks, represented over 86 percent of total membership at December 31, 1998. Voluntary members held \$143 billion in advances, representing almost 50 percent of total advances, and held \$13 billion (59 percent) of the capital stock of the Bank System as of December 31, 1998. Given the large increase in voluntary members since 1989, maintaining dividends and membership benefits to retain voluntary members has been considered necessary for ensuring a stable Bank System.

The increase in investments not directly related to the Banks' public purpose was a rational response to the sharp fall-off in Bank System advances and net income that occurred during the period following the enactment of FIRREA. However, Bank System earnings and advances are now at record levels. Outstanding advances, surpassing the previous all time high of \$167 billion in the second quarter of 1997, reached \$288 billion at year end 1998. Net income has steadily increased to \$1.8 billion in 1998 after dropping to a low of \$850 million in 1992.

In addition, although the Banks initially grew investments as a substitute for advances, Bank investments generally have increased since 1992 along with advances. Investments grew 73 percent between 1992 and 1998, increasing from \$79 billion to \$137 billion over the period. To some extent, this growth was because of lower spreads on advances due to increased funding competition from other sources. At the end of 1998, advances represented 66 percent of Bank System total assets while investments represented 32 percent of Bank System total assets. Bank System liabilities also increased over this period to fund the growth in investments and advances. Bank System COs outstanding increased over 225 percent between 1992 and 1998, growing from \$115 billion at year end 1992 to \$377 billion

at year end 1998, however, only 76 percent of COs funded advances at year end 1998.

Once the Banks' ability to generate income had demonstrably improved, the Finance Board initiated steps to address the Bank System-wide growth of non-mission related investments. A first step was to recognize that, while the detailed list of restrictions and limits placed on the Banks' investment authority by the FMP successfully ensured safety and soundness, it provided little, if any, flexibility and incentive for the Banks to seek out and develop new assets and activities that are permissible under the Act and that are consistent with the mission of the Bank System.

Therefore, to address the lack of flexibility in developing mission related investments, the Finance Board amended the FMP in 1996 to permit the Banks, among other things, to engage in new activities designed in part to add higher yielding and more mission-related assets to their balance sheets that would also preserve and promote the cooperative nature of the Bank System. See FMP section II.B.12. These activities were first approved on a pilot program basis in 1996 and 1997 and have been in operation since then. The Finance Board has determined, based on the experience of these programs, that certain mortgage assets, as further discussed below, can be acquired by the Banks from their members while preserving and promoting the cooperative nature of the Bank System and providing for greater mission achievement. It is anticipated that expansion of these activities will permit the Banks to reduce their holdings of money market investments and MBS.

In May 1998, the Finance Board held a public hearing on Bank investment practices in response to concerns about the growth of money market investments and MBS. In preparation for the hearing, the Finance Board published a staff paper on the implications of Bank investment practices for Finance Board investment policy which discussed several options for limiting money market and MBS investments, including limiting money market investments to the amount of deposits and capital held by the Banks. See 63 FR 16505-37 (Apr. 3, 1998).

A second major step taken by the Finance Board to address concerns about the Bank System-wide growth of non-mission related investments is the proposed rule, which provides the Banks even greater flexibility, as well as an incentive, to acquire mission related assets compared to what now exists in the FMP. Greater flexibility is provided in proposed § 955.2, as limited by

proposed § 955.3 discussed below, which, among other things, expands the allowable credit rating for authorized investments from primarily triple-A in the FMP to triple-B. Incentive to acquire mission related assets is provided in proposed § 940.4, discussed below, which requires that 100 percent of Bank System COs must be used to finance mission related activities. The Finance Board has determined that this requirement is appropriate in view of the improved financial condition of the Bank System. The process for implementing this requirement is discussed below.

## 2. Mission of the Banks—§ 940.2

Part 940 of the proposed rule sets forth the core mission activities (CMA) requirements that would apply to the Banks under the proposed new regulatory regime. Proposed § 940.2 defines the mission of the Banks as providing to members and eligible nonmember borrowers, *i.e.*, entities that have been approved as a nonmember mortgagee pursuant to subpart B of part 950 of the Finance Board's regulations, financial products and services, including but not limited to advances, that assist and enhance such members' and eligible nonmember borrowers' financing of: (a) housing in the broadest sense including single-family and multi-family housing serving consumers at all income levels, and (b) community lending as defined in § 953.3 of the Finance Board's regulations. This statement of mission and the regulatory provisions that would implement it are intended to ensure maximum use of the cooperative structure of the Bank System to provide funds for housing finance and community lending.

## 3. Core Mission Activities—§ 940.3

Proposed § 940.3 lists those Bank activities that would qualify as CMA. Under proposed § 940.3(a)(1), all Bank advances and commitments to make advances with certain drawdown to members or eligible nonmember borrowers with assets of \$500 million or less would qualify as CMA. There were 6,207 members, representing 89 percent of all members, with assets of \$500 million or less as of March 31, 1999.

Under proposed § 940.3(a)(2), advances and commitments to make advances with certain drawdown to members or eligible nonmember borrowers with assets greater than \$500 million would qualify as CMA in an amount up to the total book value of certain assets held by such member or eligible nonmember borrower. These assets are: (1) housing-related whole loans; (2) loans and investments that are

generated by community lending (as that term is used in the Finance Board's CICA regulation, *see* 12 CFR 970); and (3) MBS that comprise the types of loans falling into either of the preceding two asset categories and that are originated by the member or eligible nonmember borrower. The term "housing-related whole loans" is defined in proposed § 940.1 to include all whole loans, or participation interests in whole loans (excluding mortgage backed-securities), secured by one-to-four family property, multifamily property, or manufactured housing. The definition mentions loans for the construction, purchase, improvement, rehabilitation, or refinancing of housing as a non-exclusive list of loans that would be considered housing-related under the proposed rule. This broad definition corresponds with the mission of the Banks, stated in proposed § 940.2, to finance housing in the broadest sense.

Thus, if a member with over \$500 million in assets were to have on its books such loans and investments in an amount equal to or exceeding that member's total advances outstanding, the Bank would be able to count all advances to that member as CMA. On the other hand, if the member were to have on its books such loans and investments in an amount less than its total advances outstanding, the Bank would be able to count as CMA only those advances to that member equal to the amount of such loans and investments. A review of members with assets greater than \$500 million shows that, as of June 30, 1999, only 54 members had advances outstanding that exceeded their holdings of residential mortgage loans (as defined in existing 12 CFR 933.1(bb), but excluding MBS), a narrower group of assets than allowed under proposed § 940.3(a)(2). Excess advances over residential mortgage loans were only \$14 billion or 4 percent of total advances outstanding as of June 30, 1999.

The purpose of proposed § 940.3(a)(1) and (2) is to ensure that those advances that will count as CMA are, at the very least, aligned with housing and community lending assets held by the member. The provision allows all advances to members with assets of \$500 million or less to qualify as CMA so that the CMA designation does not result in any restrictions or limits being imposed on the access of smaller institutions to advances from the Banks. This provision recognizes that smaller banks face substantial hurdles in obtaining funds because they lack access on their own to the capital markets and have been subjected to a prolonged decline in deposits. This

provision also is consistent with provisions of H.R. 10, passed by the House of Representatives on July 1, 1999, and S. 900, passed by the U.S. Senate on May 6, 1999, each of which provides substantially greater latitude to Bank members with assets equal to or less than \$500 million with respect to how they can use the proceeds of Bank advances.

The methodology proposed for institutions with assets of over \$500 million is necessary since it is not possible to track advances to specific member loans. Limiting the advances that such members may count as CMA to the amount that can be supported by specific types of loans and securities, mitigates against including advances that support large commercial and business loans that do not otherwise qualify as community lending under the CICA regulation, and securities supported by such loans, as CMA. It is likely that such loans are not related to community lending in the community where the large member is located. The Finance Board requests comments on the practicality of this provision and suggestions for any alternative methodology.

Under proposed §§ 940.3(b) and 940.4(c), standby letters of credit (SLOCs) would count as CMA at a partial value of their face amount, to be gradually phased out over the transition period. Following the transition period, SLOCs would qualify as CMA valued at the fee charged to members for issuance or confirmation of the SLOC (*see* discussion below of § 940.4(c)).

Under proposed § 940.3(c), intermediary derivative contracts (primarily interest rate swaps) valued at the fee charged to members would qualify as CMA because the fee represents the value of a risk-management related service provided by the Banks to the members.

Under proposed § 940.3(d), member mortgage assets (MMA) held pursuant to proposed part 954 (discussed in detail below) would qualify as CMA.

Three general types of equity investments also would count as CMA under proposed § 940.3(e). First, equity investments that primarily benefit low- or moderate-income individuals, or areas, or other areas targeted for redevelopment by local, state, tribal or Federal government, would be considered to be CMA if the investment provides or supports: affordable housing; community services; permanent jobs for low- or moderate-income individuals; or area revitalization or stabilization. This type of equity investment is included within the definition of CMA based on the

regulatory definition of equity investments that are permitted to national banks. *See* 12 CFR 24.3(a). Second, investments in the stock of SBICs formed pursuant to 15 U.S.C. 681(d) would qualify as CMA to the extent that the investment is structured to be matched by an investment in the same SBIC by a member or eligible nonmember borrower of the Bank making the investment in SBIC stock. This is also explicitly authorized under section 11(h) of the Act. *See* 12 U.S.C. 1431(h). The member matching requirement will satisfy the statutory requirement that Bank investments in SBICs be for the purpose of aiding members. Third, equity investments in governmentally-aided economic development entities structured similarly to SBICs, and where the investment primarily benefits low- or moderate-income individuals or areas, would qualify as CMA.

Three other specific investments would be considered CMA under proposed §§ 940.3 (f), (g), and (h): the short-term tranche of SBIC securities guaranteed by the Small Business Administration (SBA); Section 108 Interim Notes and Participation Certificates guaranteed by HUD pursuant to section 108 of the Housing and Community Development Act of 1994 (as amended); and investments and obligations for housing and community development issued or guaranteed under Title VI of the Native American Housing Assistance and Self-Determination Act of 1996 (NAHASDA). These investments are all related to housing and community lending and supported by various government programs at the federal level. The Finance Board proposes to treat these special equity investments as CMA because of their potential to move the private markets to better assist low- and moderate-income communities to become more prosperous. By treating these investments as CMA, the Board is intentionally creating a greater incentive for the Banks to make these investments.

The Finance Board specifically requests comment on whether any other investment instruments, which are products of federal programs designed to support housing and community lending programs, should also be included.

Proposed § 940.3(i) includes as CMA certain assets previously acquired, or authorized to be acquired, under the FMP. Assets acquired under section II.B.11 of the FMP, primarily state and local housing finance agency (HFA) bonds acquired from out-of-district HFAs that may or may not be eligible

nonmember borrowers, would be considered to be CMA if acquired before the effective date of the final rule. Any new investments in state and local HFA bonds would need to meet the requirements for MMA under proposed part 954, as discussed below, to continue to qualify as CMA. This means that only state and local HFA bonds acquired from in-district eligible nonmember borrowers, or from or through another Bank that acquired such bonds from eligible nonmember borrowers in its district, would be considered to be CMA under part 954 of the proposed rule and, therefore, would qualify as CMA.

Assets authorized by the Finance Board, by resolution or otherwise, to be acquired or held pursuant to Finance Board approval under section II.B.12 of the FMP will be considered to be CMA up to the greater of: (1) the amount permitted under the authorization; or (2) the amount acquired prior to the effective date of this section. Pilot programs approved under section II.B.12 may continue to operate under their authorizing resolutions until the dollar cap prescribed in the applicable resolution is reached. Any subsequent transactions would need to meet the requirements for MMA under proposed part 954 in order to qualify as CMA.

#### 4. CMA Requirement—§ 940.4

Proposed § 940.4(a) provides that, following a transition period that ends on January 1, 2005, each Bank must maintain an annual average ratio of at least 100 percent of CMA to the book value of the Bank's total outstanding COs. For purposes of this calculation, on-balance sheet CMA (*i.e.*, certain advances, MMA, certain equity investments, the short-term tranche of SBIC securities guaranteed by SBA, Section 108 Interim Notes and Participation Certificates guaranteed by HUD, investments and obligations for housing and community development issued or guaranteed under Title VI of NAHASDA, and grandfathered assets acquired under sections II.B.11 and II.B.12 of the FMP) would be counted at book value. Off-balance sheet CMA (*i.e.*, SLOCs, intermediary derivative contracts and commitments to make advances with certain drawdown) would be counted at an amount prescribed in the off-balance sheet conversion factor chart contained in proposed § 940.4(c) discussed below. This ratio would be calculated based on a 12-month moving average. Proposed § 940.4(b) would require that each Bank report to the Finance Board its actual CMA ratio as of the last day of each calendar quarter, based on the preceding

12 months. A Bank would be free to undertake authorized activities that do not qualify as CMA, so long as the ratio of its CMA to its total COs outstanding meets the requirement of proposed § 940.4(b).

While it is unrealistic to expect a return to the pre-FIRREA ratios of advances to COs for a number of reasons, the Finance Board considers the 100 percent CMA ratio requirement to be both appropriate public policy and economically feasible. The primary source of funds for the Banks is the issuance of COs in the capital markets at rates reflecting the Banks' GSE funding advantage. Therefore, as a matter of public policy, the Finance Board believes that 100 percent of the assets funded with COs should be mission-related. In developing the CMA requirement, the Finance Board generated simulations that applied a CMA requirement, *i.e.*, a stated percentage of COs invested in CMA, to each Bank's average balance sheet for the first six months of 1999. For these simulations, capital, deposits, and advances were held constant. Further, the simulations did not incorporate any behavioral responses on the part of the Banks. Thus, while the results should not be considered predictions of what will happen as a result of the proposed rule, they should be considered an indication of the magnitude and feasibility of the Banks' required balance sheet adjustments. The simulation results were evaluated based on the aggregate balance sheet and aggregate earnings for the Bank System as a whole. The CMA requirement, however, would be imposed separately on each Bank. As the proposed rule allows Banks to buy and sell CMA among each other, Banks with CMA ratios below the required CMA ratio would be permitted to purchase CMA from Banks with CMA ratios above the required CMA ratio. For this reason simulations at the Bank System level are appropriate.

Based on analysis of empirical data and discussions with Bank staff, spreads over the CO rate for money market instruments (MMI) were assumed to be approximately one-seventh that assumed for MBS, and spreads for MMA, which are discussed in connection with proposed part 954 below, were assumed to be roughly comparable to those for MBS, based on their similar risk characteristics. The low return on MMI relative to MMA would allow the Banks to roll-off substantial amounts of MMI, which could be replaced with relatively smaller amounts of MMA, while earning the same net income.

A simulation imposing the 100 percent CMA requirement indicates that the Bank System could continue to pay a dividend comparable to the annualized dividend for the first half of 1999 and achieve the 100 percent CMA requirement. To do so would require the Banks to reduce MMI by \$43 billion and increase MMA by \$65 billion.<sup>21</sup>

Currently, the Banks' ratios of advances to COs, a more conservative measurement than total CMA to COs, range from 50 percent to 85 percent. The Finance Board believes it is reasonable and necessary that there should be a graduated phase-in of the 100 percent CMA requirement to allow the Banks time to restructure their balance sheets to include more profitable CMA and to accomplish the transition in such a manner as to ensure the continued safety and soundness of the Banks. A simulation of the transition period indicates that by reducing MMI by \$43 billion (a reduction of almost 50 percent from current levels) so that the level of MMI would equal the sum of deposits and capital for the Bank System, and increasing MMA by \$10 billion,<sup>22</sup> the Bank System could continue to pay a dividend comparable to the annualized dividend for the first half of 1999 while raising the ratio of CMA to COs from its current level of 75 percent to the 85 percent transition target for January 1, 2002, as set forth in § 940.4(d) of the proposed rule discussed below.

If the level of advances or deposits were to increase over the transition period, then the target CMA to CO ratios could be achieved with smaller increases in MMA than indicated in the above simulations. In both the transition and the final simulations, capital substantially exceeds 3 percent of Bank System assets. Therefore, Bank System assets and earnings could expand substantially beyond the amounts in the simulation without the need to attract more total capital.<sup>23</sup>

<sup>21</sup> MBS holdings would be reduced by \$59 billion. Essentially, the Banks would replace MBS with MMA on a dollar for dollar basis, and add an additional \$6 billion in MMA to compensate for the reduced income from the reduction in MMI. The \$65 billion of MMA to be acquired would equal about 1.5 percent of residential mortgage debt outstanding at the end of 1998.

<sup>22</sup> MBS holdings would be reduced by \$4 billion, which could be achieved by a run-off of the Banks' existing holdings. The level of COs is reduced by \$37 billion, the difference between the \$43 billion decrease in MMI and the \$6 billion increase in the net holding of mortgage assets, so that assets would continue to equal liabilities plus capital.

<sup>23</sup> Bank System assets growth may be constrained by risk-based capital. As both the risk-based capital requirement and the level of risk-based capital would be determined by decisions made by each Bank under the proposed rule, the Finance Board

The Finance Board expects, however, that in order to comply with the CMA requirement, the Banks will need to adjust the management of their operational liquidity in some way, perhaps by acquiring assets that qualify as CMA and also contribute to operational liquidity. The Banks also may need to adjust their balance sheets by acquiring assets that qualify as CMA and also meet liquidity requirements to ensure continued compliance with the contingency liquidity requirements in proposed § 930.10. For example, certain GNMA securities would qualify as CMA and could also meet operational and contingency liquidity needs. The Finance Board requests comment on how the CMA requirement is likely to impact the ability of the Banks to achieve their liquidity needs.

In addition, the Finance Board requests comment and empirically-based analyses regarding the potential impact of the CMA ratio requirement on the Banks' earnings, dividends and membership benefits in the form of the pricing of advances, and whether there might be an effect on voluntary members' decisions to join, remain in, or leave the Bank System. The Finance Board also requests comment and empirically-based analyses on whether there will be an impact on the level of funding for the Bank System's AHP, and if so, whether the Bank System's contribution to the AHP should be maintained, at a minimum, at 1998 levels, either by voluntary agreement by the Banks or by Finance Board regulation.

The Finance Board also requests comments on whether all types of CMA should receive equal weight in calculating a CMA total book value. Imposing different weights could serve as an incentive for the Banks to pursue classes of CMA, particularly CMA that might be targeted to harder-to-serve needs or populations, but in which the Banks might otherwise hesitate to invest because such classes of CMA may be less profitable or more risky. However, weighting could undermine the meaningfulness of a 100 percent CMA target, as the 100 percent target would no longer represent a true maximum with respect to the allocation of CO funding to CMA.

#### 5. Conversion of Off-Balance Sheet Items—§ 940.4(c)

Proposed § 940.4(c) sets forth conversion factors in Table 1 for the conversion of off-balance sheet items to on-balance sheet value equivalents for

has not included the effects of the proposed risk-based capital requirements in these simulations.

inclusion in the overall CMA ratio calculation required under proposed § 940.4(a). Intermediary derivative contracts would count in the CMA calculation at 100 percent of the value of the fee charged to members on such transactions. This fee is an objective measure of value to the members for these instruments given that the Banks do not need to fund these transactions. Advance commitments with certain drawdown will count in the CMA calculation at 100 percent of the value of the contractual commitment, given that a Bank would be likely to fund the commitment with COs ahead of the commitment date.

During the transition, SLOCs would count at the current year's CMA ratio requirement (expressed as a percentage) subtracted from 100 percent, then multiplied by the face amount of the SLOC. Thus, for SLOCs, the conversion factor would be 20 percent or 0.20 in the first year of the rule's effectiveness (100 percent or 1.00 minus CMA ratio requirement of 80 percent or 0.80) and would shrink to zero by the end of the transition period (100 percent minus CMA ratio requirement of 100 percent). The intent of this conversion provision is to ensure that the financial nature of the transaction, rather than its regulatory treatment, determines whether a Bank issues an SLOC or an advance. The conversion factor leaves a Bank indifferent in terms of financial opportunity as to whether it issues an advance or SLOC, because either instrument would then have the same impact on the ratio of CMA to COs. An alternative weighting mechanism could create an incentive for the Bank to distort the prices of advances and SLOCs such that the nature of the transaction might no longer guide the choice of instrument. When the transition period ends, SLOCs would be valued at the fee charged to members to make this off-balance sheet item consistent with the treatment of intermediary derivative contracts.

#### 6. Transition Period—§ 940.4(d)

Proposed § 940.4(d) sets forth the transition period that would apply to the CMA ratio requirement. Beginning on January 1, 2001, each Bank would be required to have a CMA in an amount equal to at least 80 percent of the average book value of the Bank's total outstanding COs. The CMA ratio requirement would increase by five percentage points on January 1 of every year until the full 100 percent requirement would take effect on January 1, 2005.

#### 7. Transfers of CMA to Another Bank—§ 940.5

Section 940.5 of the proposed rule makes clear that a CMA of a Bank, if transferred to another Bank, retains its status as a CMA with respect to the transferee Bank. This provision allows the Banks to improve the diversification of the various risks associated with the CMA by redirecting CMA from one Bank district to another Bank district.

#### 8. Safe Harbor for Anticipated Noncompliance—§ 940.6

Under § 940.6(a) of the proposed rule, if a Bank's board of directors determines that the Bank cannot meet the CMA ratio requirement for a specified future period without jeopardizing the safety and soundness of the Bank, the Bank would not be considered to be out of compliance with the rule for the time period specified. In order for a Bank to qualify for this safe harbor, the board of directors' determination would need to be based upon an objective finding that the Bank: (1) would likely be unable to meet the liquidity requirement of proposed § 930.10, or any other regulatory requirement related to safety and soundness of its financial operation; or (2) would likely be unable to provide a return on equity sufficient to retain members intending to make use of such Bank's products and services. The decision-making process of the Bank's board of directors and the bases for its conclusions, including justification for the time period that the Bank anticipates being out of compliance, would need to be fully documented. In addition, the Bank's board of directors would be required to adopt a plan to achieve compliance with the CMA ratio requirement at the earliest feasible and prudent date.

The Finance Board believes that proposed § 940.6(a) will provide regulatory flexibility when business conditions are not amenable to achieving CMA compliance consistent with the safe and sound operation of the Bank. However, this safe harbor provision is not intended to provide regulatory immunity for lack of effort on the part of Bank management or for reaching such conclusions based on analysis found by the Finance Board through the examination process to be inadequate as to substance or documentation.

#### 9. Waivers—§ 940.6(b)

Proposed § 940.6(b) would make explicit that, under circumstances that do not meet the safe harbor requirements of proposed § 940.6(a), a Bank may request a waiver of the

requirements in part 940, pursuant to the regulatory waiver provisions of the Finance Board's regulations that would appear at 12 CFR part 907 (existing part 903).

#### *E. Part 950—Advances*

The proposed rule would delete existing § 935.2 of the Finance Board's Advances regulation, which states the primary credit mission of the Banks and how the Banks must fulfill such mission. Section 940.2 of the proposed rule, as discussed above, defines the mission of the Banks, and no separate or duplicative statements or definitions would be necessary under the new regulatory structure.

Proposed § 950.1 would amend the definition of "long-term advance" in existing § 935.1 of the Finance Board's Advances regulation from advances with maturity terms over five years to advances with maturity terms of greater than one year. The Act provides that all long-term advances shall only be made for the purpose of providing funds for residential housing finance. See 12 U.S.C. 1430(a). This provision is implemented by existing § 935.14, which provides that prior to approving an application for a long-term advance, a Bank shall determine that the principal amount of all long-term advances currently held by the member does not exceed the total value of residential housing finance assets held by such member. See 12 CFR 935.14(b)(1).

#### *F. Part 954—Member Mortgage Assets*

##### 1. Definition of MMA—§ 954.2

Part 954 of the proposed rule addresses MMA, that is, generally mortgages and interests in mortgages that a Bank may acquire from its members or eligible nonmember borrowers in a transaction that is in purpose and economic substance functionally equivalent to the business of making advances in that: (1) it allows the member or eligible nonmember borrower to use its mortgage assets to access liquidity for further mortgage lending; and (2) all or a material portion of the credit risk attached to the mortgage asset is being borne by the member or eligible nonmember borrower.

Proposed § 954.2 authorizes a Bank to hold MMA acquired from or through its members or eligible nonmember borrowers, either by purchasing MMA from the member or eligible nonmember borrower, or funding the loan through the member or eligible nonmember borrower. Proposed § 954.2 sets forth a three-part test to be used in determining

which assets qualify as MMA. First, under proposed § 954.2(a), an asset must fall within one of the following categories of assets: (1) mortgages, or interests in mortgages, excluding one-to-four family mortgages where the loan amounts exceed the conforming loan limits that apply to Fannie Mae and Freddie Mac, see 12 U.S.C. 1717(b)(2), but including community lending mortgages; (2) loans, or interests in loans, secured by manufactured housing, even if the manufactured housing is considered to be personal property in the state in which the home is located; or (3) state and local HFA bonds.

Second, under proposed § 954.2(b), a connection of the asset with the member or eligible nonmember borrower from whom the asset is acquired must exist, *i.e.*, there must be a member or eligible nonmember borrower nexus.

Specifically, the asset must be either: (1) originated, if a loan, or issued, if bonds, by or through the member or eligible nonmember borrower; or (2) held for a valid business purpose by the member or eligible nonmember borrower prior to acquisition by the Bank. Assets held for a valid business purpose would not include, for example, loans that are passed from a nonmember through a member to a Bank with the intended purpose of extending the benefits of membership to the nonmember. The valid business purpose requirement is intended to acknowledge that a member may acquire loans from a nonmember and then sell them to a Bank.

Third, under proposed § 954.2(c), the member or eligible nonmember borrower must bear a material portion of the credit risk attached to the mortgage asset. Through this requirement, MMA activities would serve to promote and preserve the basic business relationship between the Banks and their members that has been established and maintained throughout the history of the Bank System through advance transactions. The Bank would manage the interest rate risk while the member would bear all or a material portion of the credit risk. This requirement emphasizes the cooperative nature of the Bank System by ensuring that the member or eligible nonmember borrower shares with the Bank the financial benefits and responsibilities of the asset. Furthermore, it does so in a rational manner because such shares are allocated between the Bank and the member or eligible nonmember borrower in a way that best employs their respective core competencies in managing risk.

An asset will be considered to fulfill this requirement if it meets the "credit

risk-sharing" test set forth in proposed § 954.2(c). First, under proposed § 954.2(c)(1), the member or eligible nonmember borrower must bear the amount of credit risk necessary to raise the asset or pools of assets to the fourth highest credit rating category (*e.g.*, triple-B), which is the minimum credit rating for any asset that may be acquired by a Bank under the safety and soundness provisions of proposed § 955.3(a)(3). Second, under proposed § 954.2(c)(2), to the extent that the Bank requires, either at the time of acquisition or subsequently, that the assets or pools of assets have a credit rating higher than the fourth highest credit rating category, the member or eligible nonmember borrower must bear at least 50 percent of any credit risk necessary to raise the assets or pools of assets from the fourth highest credit rating category to such higher credit rating category, up to the second highest credit rating category (*e.g.*, double-A.). Third, under proposed § 954.2(c)(3), notwithstanding the first two parts of the credit risk-sharing test, the member or eligible nonmember borrower must bear a material portion of any credit risk up to the second highest credit rating. This provision is intended to ensure that the member or eligible nonmember borrower does bear enough credit risk to share in the financial consequences of the asset quality no matter what transaction structure might be devised with a consequence of mitigating the credit risk-sharing requirement of the first two parts.

Under proposed § 954.2(c)(4), to the extent that the U.S. government has insured or guaranteed the credit risk of the asset or pool of assets, the member or eligible nonmember borrower may rely upon that insurance or guarantee to meet all or part of the above-mentioned credit risk-sharing requirements. For example, loans that are fully insured by the Federal Housing Administration (FHA), and GNMA securities, which are fully guaranteed by the U.S. government, would be considered to meet the credit risk-sharing requirement. Such loans and securities, however, also would have to meet the member or eligible nonmember borrower nexus requirement in proposed § 954.2(b) in order to qualify as MMA. To the extent that the U.S. government insurance or guarantee is insufficient or incomplete to cover the member's or eligible nonmember borrower's credit risk-sharing requirement, that portion of the requirement not so covered must be borne by the member or eligible nonmember borrower. This provision allows that the federal government,



alone, may substitute for the member or eligible nonmember borrower in meeting the credit risk-sharing requirement.

The Finance Board specifically requests comment on whether authorizing the Banks to acquire federally-insured or guaranteed mortgages or mortgage pools without any such member or eligible nonmember borrower nexus would enhance the liquidity of the marketplace for investments that promote housing and targeted economic development sufficiently to justify any diminution in the cooperative nature of the Bank System that may result. The Finance Board also seeks comment on whether loans originated by municipalities, pursuant to section 108 of the Housing and Community Development Act of 1974 (amended in 1994), or by tribes pursuant to Title VI of NAHASDA, where the municipalities or tribes are not eligible nonmember borrowers, should be authorized to be acquired by the Banks because of the enhancement to the liquidity of the marketplace for such housing, notwithstanding any diminution in the cooperative nature of the Bank System that might result.

The MMA tests set forth in proposed part 954 are intended to allow the Banks and their members and eligible nonmember borrowers the freedom to employ a variety of transactional structures so long as the transaction involves a qualifying asset or pool of assets, is acquired by a Bank pursuant to a transaction with a member or eligible nonmember borrower, and satisfies the credit risk-sharing requirement. Examples of two types of purchases that would meet the requirements are: (1) the Bank originates a loan or pool of loans and gets the needed credit enhancement from the member (*i.e.*, the member provides a direct credit substitute); or (2) the member or eligible nonmember borrower sells the loan to the Bank with recourse.

## 2. MPF

The purchase by a Bank of one-to-four family mortgages that fall within the conforming loan limits applicable to the secondary market GSEs was approved by the Finance Board under section II.B.12 of the FMP in December 1996. See Finance Board Res. No. 96-111 (Dec. 23, 1996). At that time, the Finance Board approved a pilot program proposed by the Federal Home Loan Bank of Chicago (Chicago Bank), known as the Mortgage Partnership Finance program (MPF), to fund one-to-four family residential mortgage loans originated by member institutions. The

objective of the pilot program was to unbundle the risks associated with home mortgage lending and allocate the individual risk components between the Chicago Bank and its members in a manner that best employs their respective core competencies. That is, the members would continue to manage the customer relationship and the credit risk, while the Chicago Bank would retain the liquidity, interest rate and options risks—the risks that the Banks have the most expertise in managing.

MPF transactions are functionally equivalent to, though technically more sophisticated than, advances transactions authorized under section 10(a) of the Act. The Finance Board considered the two transactions to be functionally equivalent because, in both cases, the Bank takes an interest in mortgages originated by its member or eligible nonmember borrower and, in return, provides that member or eligible nonmember borrower with liquidity for further mortgage lending. In both cases, the member or eligible nonmember borrower bears all or a significant portion of the credit risk: in the case of advances, because the member or eligible nonmember borrower still owns the mortgage; in the case of MPF, because the member or eligible nonmember borrower provides a credit enhancement when selling the mortgage to, or funding the mortgage through, the Bank. Although, under the MPF program, the Bank acquires an ownership interest in the mortgage loans—as opposed to a mere security interest, as it would in the case of an advance transaction—the Finance Board found this structure to be permissible because the Banks may invest in mortgages pursuant to their statutory investment powers.

Based on the experience with the MPF program to date, the Finance Board has concluded that this line of business could constitute a major business activity for the Banks that, along with their more traditional advances business, is consistent with the cooperative structure of the Banks—*i.e.*, that does not cause the Banks to compete with members and, in fact, makes members participating in the program more competitive. As a result, mortgage acquisition activities by the Banks that meet the requirements of proposed part 954 will no longer be treated as pilot activities.

The proposed rule will thus encourage the Banks to purchase more MMA, with the anticipated consequence of increasing competition in the home mortgage markets and thus lowering home prices for consumers. The Finance Board requests comment on whether

this anticipated benefit to consumers is a reasonable expectation.

The Finance Board also specifically requests comment on whether all MBS should be counted in whole or in some limited amount as CMA, and how counting such MBS could be reconciled with the member or eligible nonmember borrower nexus and credit risk-sharing requirements of MMA.

Once the Banks have developed more experience in acquiring MMA, the Finance Board intends to set housing targets for MMA similar to those that HUD is required by statute to set for Fannie Mae and Freddie Mac. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 directed GSEs to establish housing goals for the GSEs' mortgage purchases in three specific areas: (1) housing for low- and moderate-income families; (2) housing located in central cities, rural areas, and other underserved areas; and (3) special affordable housing to meet unaddressed needs of low-income families in low-income areas and very-low-income families. See 12 U.S.C. 4541 *et seq.* The purpose of subjecting the Banks to such targets would be to assure that all GSE-funded mortgage originators have similar incentives and pressures to reach underserved markets. This is an element of creating a level playing field among the housing GSEs.

## G. Part 955—Bank investments

### 1. Authorized Investments—§ 955.2

As previously discussed, the Banks' investment authority is derived from sections 11(g), 11(h) and 16(a) of the Act. 12 U.S.C. 1431(g), 1431(h), 1436(a). Section 934.1 of the Finance Board's current regulations limits the Banks' investment authority by requiring Finance Board approval for investments not already authorized by stated policy or otherwise. See 12 CFR 934.1(a). The Finance Board adopted the FMP as its stated investment policy pursuant to the regulation. The FMP restricts Bank investments to those listed in the FMP. Sections 955.2 and 955.3 of the proposed rule would establish the parameters of the Banks' investment authority under the proposed new regulatory structure.

Proposed § 955.2 would authorize the Banks to invest in all instruments in which they are permitted to invest under the Act (with the exception of Fannie Mae common stock), see 12 U.S.C. 1431(g), 1431(h), 1436(a), subject to the restrictions set forth in proposed § 955.3. These investments include: (a) obligations of the United States, see 12 U.S.C. 1431(g), 1431(h) and 1436(a); (b) deposits in banks or trust companies (as

defined in proposed § 955.1), *see id.* at 1431(g); (c) obligations, participations or other instruments of, or issued by, Fannie Mae or Ginnie Mae, *see id.* at 1431(h), 1436(a); (d) mortgages, obligations, or other securities that are, or ever have been sold by Freddie Mac, *see id.* at 1431(h), 1436(a); (e) stock, obligations, or other securities of any SBIC formed pursuant to 15 U.S.C. 681(d) (to the extent such investment is made for purposes of aiding Bank members),<sup>24</sup> *see* 12 U.S.C. 1431(h); and (f) instruments that the Bank has determined are permissible investments for fiduciary and trust funds under the laws of the state in which the Bank is located, *see id.* at 1431(h), 1436(a).

The Banks' investment authority under the proposed rule essentially tracks the parameters of that which may be permitted under the Act. Because several different provisions of the Act address the investment powers of the Banks, the Finance Board has consolidated and restated the substance of these investment authorities in proposed § 955.2. The only investment that is explicitly mentioned in the Act that is not permitted under proposed § 955.2 is investment in the stock of Fannie Mae. As discussed in more detail below, proposed § 955.3(a)(1) would restrict equity investments to those that qualify as CMA under proposed part 940. Because the Finance Board does not believe that Fannie Mae stock could under any circumstances qualify as a CMA, and because Fannie Mae stock is not an authorized investment under the FMP and is not currently held as an investment by any Bank, it has simply been omitted from the list of authorized investments in proposed § 955.2 in order to avoid confusion.

Both sections 11(h) and 16(a) of the Act state that the Banks may be authorized to invest in "such securities as fiduciary and trust funds may be invested in under the laws of the state in which the . . . Bank is located." *See id.* at 1431(h), 1436(a). In restating this authority in § 955.2(f) of the proposed rule, the word "instruments" has been substituted for the word "securities" to reflect in the rule the Finance Board's construction of the term "securities" as it is used in sections 11(h) and 16(a) of the Act to encompass the broad range of financial investment instruments and not merely those instruments that are within the technical definition of "securities" set forth in the federal securities laws. *See* 15 U.S.C. 77b(1).

## 2. Prohibited Investments and Prudential Rules—§ 955.3

The broad investment authority established under proposed § 955.2 would be limited by a number of safety and soundness- and mission-related restrictions set forth in proposed § 955.3. Proposed § 955.3(a)(1) would prohibit the Banks from making any investment in instruments that would provide an ownership interest in an entity (e.g., common or preferred stock, rights, warrants or convertible bonds), other than those investments that would qualify as CMA under proposed § 940.3, as discussed more fully above. Thus, under the proposed rule, the actual equity investment powers of the Banks will be quite narrow and focused upon core mission activities.

Proposed § 955.3(a)(2) would prohibit the Banks from investing in instruments issued by foreign entities, except United States branches and agency offices of foreign commercial banks. Such instruments conceivably could qualify as permissible investments for fiduciary and trust funds and, therefore, would be permissible Bank investment unless specifically prohibited. This is consistent with the current prohibition in the FMP. *See* Finance Board Res. No. 97-05 (Jan. 14, 1997).

Proposed § 955.3(a)(3) would prohibit the Banks from investing in debt instruments that are not rated as investment grade (*i.e.*, one of the four highest rating categories given by an NRSRO). Despite the risk management provisions in the proposed rule under which the Banks are expected to manage whatever risks they might incur as part of their business operations, the Finance Board is imposing this specific prohibition on the acquisition of non-investment grade debt as a further safety and soundness measure. Under proposed § 955.3(a)(3), the Banks would not be required to divest themselves of debt instruments that are downgraded to below investment grade after they already have been acquired by the Bank. Any additional risk that would arise from such a scenario would be managed through the application of the higher credit risk capital requirement applicable to the downgraded instrument. *See* proposed § 930.4(d)(3).

Finally, proposed § 955.3(a)(4) would prohibit the Banks from acquiring whole mortgages or other whole loans, or interests in mortgages or loans, except for: (i) MMA, as defined under part 954 of the proposed rule; (ii) MBS that would meet the definition of "securities" in the Securities Act of 1933, 15 U.S.C. 77b(a)(1); and (iii) loans held or acquired pursuant to section

12(b) of the Act, 12 U.S.C. 1432(b). As described in detail above, proposed part 954 establishes parameters regarding the types of mortgages and loans, or interests in mortgages and loans, that the Banks may acquire and the nature of the transactions through which such assets may be acquired. Proposed § 955.3(a)(4) is designed to prohibit the holding, purchase or acquisition of jumbo mortgages and whole mortgages other than MMA, and otherwise prevent the Banks from circumventing the requirements of part 954. However, the Banks are not prohibited from holding, purchasing and acquiring MBS that would meet the definition of that term under the federal securities laws.

The reference in proposed § 955.3(a)(4)(ii) to the definition of securities in the Securities Act of 1933 is consistent with the Finance Board's analysis of the term securities as it is used in the Bank investment authority provisions of the Act. *See* discussion above of proposed § 955.2. As discussed above, for purposes of the Bank's investment authority generally, the Finance Board has construed the term "securities" as it is used in sections 11(h) and 16(a) of the Act, 12 U.S.C. 1431(h), 1436(a), to encompass the broad range of financial investment instruments in a common business sense, and not merely to mean those instruments that are within the technical definition of "securities" in the federal securities laws. However, for purposes of proposed § 955.3, the Finance Board has proposed limitations and restrictions on otherwise-authorized investments, which it is explicitly authorized to do under sections 11(h) and 16(a) of the Act. Limiting investments in mortgage-backed securities to those that would meet a narrower definition of the term "securities" than is contemplated under the investment authority provisions of the Act only serves to emphasize the differences in the use of the term under the different statutes and to bolster the Finance Board's construction of the term under the Act.

Proposed § 955.3(b) would prohibit a Bank from taking a position in any commodity or foreign currency. Proposed § 955.3(b) also provides that, in the event that a Bank becomes exposed to currency, commodity or equity risks through participation in COs that are linked to a foreign currency or to equity or commodity prices, such risks must be hedged. The Banks currently do not have expertise in these areas and the Finance Board can discern no reason for the Banks to have or develop expertise in managing the risks

<sup>24</sup>The Finance Board has determined that the phrase "for the purpose of aiding members of the . . . Bank System" relates not just to the formation of the SBIC but also to the nature and purpose of the investment.

associated with foreign exchange rates or commodities.

Section 955.3(c) of the proposed rule prohibits a Bank from making investments that are not permitted under the FMP as to such Bank until the Bank: (1) has received Finance Board approval of its initial internal market risk model; (2) demonstrates to the Finance Board that it has sufficient risk-based capital to meet the minimum total risk-based capital requirement under proposed § 930.4(b) for its then-current portfolio; and (3) demonstrates to the Finance Board adequate credit risk assessment and procedures and controls sufficient to show control over credit, market and operations risks.

As discussed above, one of the reasons that the Finance Board is proposing to allow the Banks broadened investment authority is because, under the proposed rule, the Banks will have risk-based capital and other risk management requirements to counterbalance any increased risk that might be associated with new investments. Therefore, until a Bank has sufficient risk-based capital in place to support its current portfolio, and until the Bank demonstrates to the Finance Board that it has adequate risk management capabilities, the Finance Board finds it necessary, as a safety and soundness measure, to continue to require the Banks to operate within the existing FMP framework.

Although proposed § 955.3 would impose several safety and soundness- and mission-related restrictions upon the Banks' general investment authority set forth in proposed § 955.2, the overall effect of these proposed investment provisions would be to allow the Banks considerably more freedom in making investment decisions within the statutory parameters than is currently permitted. Under the FMP, the Banks are authorized to invest in a list of specific investments that is narrower than that in which the Banks may invest under the parameters set by the Act. Under the FMP, Banks wishing to make investments that may be permissible under the statute, but that are not specifically enumerated in the FMP, must obtain the permission of the Finance Board before making the investment.

The approach to Bank investment authorizations reflected in the FMP allows for little discretion on the part of Banks' senior management and boards of directors in determining the appropriate investments and optimal risk/return strategy for their Banks. This approach was designed to limit the Banks' exposure to risk because the Banks do not currently operate under a

risk-based capital structure, which would allow the Banks to assume more investment risk, provided that there is sufficient capital in place to support that risk. Because, under the proposed rule, the Banks would operate under such a risk-based capital structure, it would no longer be necessary to impose such stringent limits on the investment authority for safety and soundness purposes.

Some of the limits on the investment authority reflected in the FMP also were intended, to some extent, to focus the Banks' investments on mission-related activities. As more fully described above, under proposed part 940, each Bank would be required to invest 100 percent of the proceeds from its share of the COs in CMA. This requirement would eliminate the need to focus the Banks' investments upon mission activities through the use of a specific list of authorized investments and specific limits on certain types of investments. In addition, a specific list intended to include all authorized investments would not provide the Banks with the flexibility to adapt to new developments in the marketplace and would stifle the development of new types of mission-related activities and investments.

Under the proposed rule, the Banks would be permitted to make any authorized investment with sources of funds other than those provided by the COs. Consistent with the Finance Board's ongoing devolution of management and governance functions to the Banks, the Finance Board believes that the selection of appropriate investments to be made with that portion of a Bank's funds that are not obtained through use of the capital market funding advantage that arises from the Banks' status as GSEs is an area more appropriate for oversight by the Banks' boards of directors (subject to safety and soundness constraints imposed by the proposed rule) than by their regulator. Nonetheless, it is expected that the Banks' boards of directors would establish appropriate guidelines for investments when adopting the risk management policy required under this proposed rule.

### 3. Use of Hedging Instruments—§ 955.4

Section 955.4 of the proposed rule addresses the Banks' use of hedging instruments. Proposed § 955.4(a) would prohibit the Banks from making speculative use of hedging instruments. This is not an activity that is appropriate for the Banks to enter, as it would do nothing to further the mission of the Banks, while posing risks to the safety and soundness of the Banks.

Section 955.4(b) of the proposed rule would subject all Bank hedge transactions to the hedge requirements set forth in Generally Accepted Accounting Principles (GAAP) and statements promulgated by the Financial Accounting Standards Board (FASB). Because GAAP prescribes extensive rules for hedging transactions that are followed by most market participants, the Finance Board finds it prudent to subject the Banks to these same requirements, rather than attempting to establish separate rules over such a complex subject.

Section 955.4(c) of the proposed rule would govern the documentation that each Bank must have and maintain during the life of each hedge. Proposed § 955.4(c)(1) would require that each Bank's hedging strategies be explicitly documented at the time of the execution of the hedge, and adequate documentation of the hedge must be maintained for the life of the hedge. Proposed § 955.4(c)(2) would require that transactions with a single counterparty be governed by a single master agreement when practicable. Proposed § 955.4(c)(3) would govern Bank agreements with counterparties for over-the-counter derivative contracts by requiring each agreement to include: (i) a requirement that market value determinations and subsequent adjustments of collateral be made on at least a monthly basis; (ii) a statement that failure of a counterparty to meet a collateral call will result in an early termination event; (iii) a description of early termination pricing and methodology; and (iv) a requirement that the Bank's consent be obtained prior to the transfer of an agreement or contract by a counterparty.

All of these requirements are carried over from the FMP. The requirements are intended to ensure that the Banks monitor and manage their exposure to counterparties and that the agreements in place with counterparties provide adequate legal protection to the Banks. Because the risk-based capital requirements contained in the proposed rule do not directly alter or replace the need to address these issues, the Finance Board finds it appropriate to continue to impose these requirements on Bank hedge transactions.

Under the FMP, the Banks' use of hedging instruments is limited to a specific list of hedging instruments. The use of the various hedging instruments by the Banks is permitted provided they assist the Bank in achieving its interest rate and/or basis risk management objectives. Like the FMP's Investment Guidelines, the Hedge Transaction Guidelines of the FMP contain some

detailed requirements that are no longer necessary. The unsecured credit concentration limits set forth in proposed § 930.11 and the credit risk-based capital requirements set forth in proposed § 930.5 would eliminate the need for provisions addressing unsecured credit exposure and collateralization. In addition, because the Finance Board is removing the restrictions on certain types of investments, it would be inconsistent to continue to restrict swaps with characteristics similar to those investments.

#### H. Part 958—Off-Balance Sheet Items

Proposed § 958.2(a) authorizes the Banks to enter into the following types of off-balance sheet transactions: SLOCs; derivative contracts; forward asset purchases and sales; and commitments to make advances or other loans. This authorization essentially codifies the types of off-balance transactions that already have been authorized by the Finance Board. The Finance Board specifically requests comment on whether there are additional types of off-balance sheet transactions that it should consider authorizing.

Proposed § 958.2(b) prohibits the Banks from making speculative use of derivative contracts. As previously discussed in the general context of hedging instruments, speculating with derivatives contracts is not an activity that would be appropriate for the Banks to enter, as it would do nothing to further the mission of the Banks, while posing risks to the safety and soundness of the Banks.

#### I. Part 965—Sources of Funds

Proposed § 965.2 sets forth the types of liabilities authorized for Bank business operations. The Funding Guidelines section of the FMP sets forth the parameters for the use of alternative funding sources and structures by the Banks in funding their activities. The guidelines differentiate between Bank specific liabilities and COs, which are the joint and several liabilities of the Banks. See FMP sections IV.B. and C.

Under the FMP, authorized Bank specific liabilities generally include: (1) deposits from members, from any institution for which a Bank is providing correspondent services, from another Bank, and from other instrumentalities of the United States; (2) federal funds purchased from any financial institution that participates in the federal funds market; and (3) repurchase agreements, with the provision that those requiring the delivery of collateral by a Bank may be only with Federal Reserve Banks, U.S.

Government Sponsored Agencies and Instrumentalities, primary dealers recognized by the Federal Reserve Bank of New York, eligible financial institutions,<sup>25</sup> and states and municipalities with a Moody's Investment Grade rating of 1 or 2.

Under the FMP, a Bank is authorized to participate in the proceeds from COs, so long as entering into such transactions will not cause the Bank's total COs and unsecured senior liabilities to exceed 20 times its capital. See *id.* at IV.C. The FMP authorizes a Bank to participate in certain types of standard and non-standard debt issues. See *id.* Specifically, the FMP requires that Banks participating in non-standard debt issues must enter into a contemporaneous hedging arrangement that allows the interest rate and/or basis risk to be passed through to the hedge counterparty unless the Bank is able to document that the debt will: (a) be used to fund mirror-image assets in an amount equal to the debt; or (b) offset or reduce interest rate or basis risk in the Bank's portfolio, or otherwise assist the Bank in achieving its interest rate and/or basis risk management objectives. If a Bank participates in debt denominated in a currency other than U.S. Dollars, it is required to hedge the currency exchange risk. See *id.* at IV.C.3.

The FMP also prohibits a Bank from directly placing COs with another Bank. See *id.* at IV.C.4.

Proposed § 965.2(a) sets forth each Bank's authority to act as joint and several obligor with other Banks on COs, as authorized under proposed part 966. The proposed rule does not draw the distinction between standard and non-standard debt issues contained in the FMP. Instead, proposed § 955.3(b) requires that some types of debt issues previously defined as non-standard be hedged. The types of debt issues that must be hedged under the proposed rule are those linked to equity or commodity prices or those denominated in foreign currencies. Other types of debt issues previously defined as non-standard need not be hedged, but these debt issues will be included in the market risk calculation in the proposed rule. The proposed rule does not include the 20 to 1 leverage limit from § 910.1(b) of the Finance Board's existing regulations,

<sup>25</sup> Eligible financial institutions include Banks and FDIC-insured financial institutions, including U.S. subsidiaries of foreign commercial banks, whose most recently published financial statements exhibit at least \$100 million of Tier I (or tangible) capital if the institution is a member of the investing Bank or at least \$250 million of tangible capital for all other FDIC-insured institutions, and which have been rated at least a level III institution as defined in section VI.C of the FMP.

or the 20 to 1 leverage limit on each Bank contained in the FMP. Instead, the proposed rule requires each Bank to have total capital in an amount equal to at least 3 percent of total assets, and requires each Bank to hold risk-based capital to meet a risk-based capital requirement. See proposed §§ 930.3(a) and 930.4(a).

Proposed § 965.2(b) continues the existing prohibition on directly placing COs with another Bank. It is the opinion of the Finance Board that such placements do not further the mission of the Bank System.

COs have been the traditional source for most of the funds required for Bank operations. The remaining sources of funds have been deposits and member capital. As discussed above under proposed part 940, once the rule is fully phased in, 100 percent of COs would be required to be invested in CMA. The Banks, therefore, still would be able to invest deposits and member capital in any assets authorized under the proposed rule. Growing sophistication in the creation of off-balance sheet instruments could lead to efforts to circumvent the CMA requirement. For example, it may be possible to create tradeable deposits, which would be more similar to bonds than to deposits as the term is traditionally understood. The Banks also could use repurchase agreements to leverage deposits or capital. COs used to finance MBS may be replaced with repurchase agreements, using the MBS as collateral. In this way, the letter of the CMA requirement, but not the substance of the requirement—a shift in the composition of the balance sheet towards CMA—might be met. A Bank could hold non-CMA assets, including MBS, equal to several times its level of deposits plus capital.

Therefore, proposed § 965.2(b) continues each Bank's authority to accept deposits from members, other Banks and instrumentalities of the United States, but provides that the deposit transaction may not be conducted in such a way as to result in the offer or sale of a security in a public offering as those terms are used in 15 U.S.C. 77b(3). In addition, recognizing the importance of federal funds and repurchase agreements for the Banks' liquidity management, proposed § 965.2(c) allows a Bank to purchase federal funds and enter into repurchase agreements, but only in order to satisfy the Banks' short-term liquidity needs.

Proposed § 965.3 would require each Bank to invest an amount equal to current deposits received from members in: (1) Obligations of the United States; (2) deposits in banks or trust companies;

and (3) advances with a maturity of five years or less made to members in conformity with the advances provisions of the Finance Board regulations (existing part 935; redesignated part 950).

Section 11(g) of the Act, 12 U.S.C. 1431(g), requires each Bank to maintain deposit reserves in: (1) obligations of the United States; (2) deposits in banks or trust companies; (3) advances with a maturity of five years or less made to members, upon such terms and conditions as the Finance Board may prescribe; or (4) unsecured advances with a maturity of not to exceed five years which are made to members whose creditor liabilities do not exceed five percent of their net assets. Proposed § 965.3 is intended to implement this statutory requirement and to clarify the types of advances that count toward the deposit reserve requirement (the Banks currently are not permitted to make unsecured advances). The definition of the term "deposits in banks or trust companies" contained in proposed § 965.1 is identical to the definition of that term set forth in existing § 934.4.

#### *J. Part 966—Consolidated Obligations and Debentures*

Existing part 910 of the Finance Board's regulations, "Consolidated Bonds and Debentures," has been proposed to be redesignated as new part 966 in the proposed reorganization regulation. Part 966 of this proposed rule retains in large part the provisions of existing part 910, with certain proposed amendments, which are included in this rulemaking and discussed here.

Specifically, §§ 910.0 through 910.6 of the Finance Board's existing regulations, would be redesignated as §§ 966.1 through 966.7 and existing § 910.1(b) (which imposes a 20-to-1 COs and unsecured senior liabilities to capital stock leverage limit on the Bank System) would be deleted. Proposed § 966.7 has been revised from existing § 910.6 to: delete references to the leverage limit; clarify and simplify the provision whereby the Finance Board may implement changes to the negative pledge requirement<sup>26</sup> in § 966.2(b) if the principal and interest on outstanding senior bonds have been fully defeased; and delete current § 910.6(b)(2), which purports to impose limitations on the Finance Board's ability to change the leverage limit provision in current § 910.1(b). In connection with these

<sup>26</sup>The "negative pledge requirement" is the regulatory requirement that the Banks maintain certain types of unpledged assets in an amount equal to the amount of the Banks' senior bonds (as defined in existing § 910.0(c)) outstanding.

proposed amendments, it is the intention of the Finance Board to preserve the existence of the special asset accounts at the Banks established when the leverage limit in current part 910 was raised in 1992 from 12-to-1 to 20-to-1. See Finance Board Res. No. 92-751 (Dec. 21, 1992). Current § 910.6(b)(2) provides that current § 910.1(b) may be changed by the Finance Board if the Finance Board receives either: (i) written evidence from at least one major nationally recognized securities rating agency that the proposed change will not result in the lowering of that rating agency's then-current rating or assessment on senior bonds outstanding or next to be issued; or (ii) a written opinion from an investment banking firm that the proposed change would not have a materially adverse effect on the creditworthiness of senior bonds outstanding or next to be issued. The Finance Board has consulted with the ratings agencies in developing this proposed rule. The proposal requires that the Banks maintain the triple-A rating of Bank System COs.

#### *K. Part 980—New Business Activities*

The proposed changes to the Banks' authorized investment authority would create opportunities for the Banks to undertake new business activities that they have not undertaken in the past and, therefore, could expose the Banks to risks that they have not had to manage in the past. In order to ensure that entering into new types of business activities will not create safety and soundness concerns, § 980.2 of the proposed rule would require each Bank to provide 30 days notice to the Finance Board of any new business activity that the Bank wishes to undertake—including investing in new types of instruments—so that the Finance Board may disapprove or restrict such activities, as necessary, on a case-by-case basis. Proposed § 980.1 defines a "new business activity" as meaning, with respect to a particular Bank's activities: (1) an activity that was not previously undertaken by that Bank, or was undertaken under materially different terms and conditions; (2) an activity that entails risks not previously and regularly managed by that Bank or its members; or (3) an activity that introduces operations not substantially equivalent to operations currently managed by that Bank. The test of what constitutes a new activity for a particular Bank is intended to focus attention on worthy new activities. The prior notice requirement would apply to any Bank desiring to pursue a new

activity, even if another Bank has already undertaken the same activity.

#### **IV. Regulatory Flexibility Act**

The proposed rule applies only to the Banks, which do not come within the meaning of "small entities," as defined in the Regulatory Flexibility Act (RFA). See 5 U.S.C. 601(6). Therefore, in accordance with section 605(b) of the RFA, *see id.* at 605(b), the Finance Board hereby certifies that this proposed rule, if promulgated as a final rule, will not have a significant economic impact on a substantial number of small entities.

#### **V. Paperwork Reduction Act**

This proposed rule does not contain any collections of information pursuant to the Paperwork Reduction Act of 1995. See 44 U.S.C. 3501 *et seq.* Therefore, the Finance Board has not submitted any information to the Office of Management and Budget for review.

#### **List of Subjects in 12 CFR Parts 917, 925, 930, 940, 950, 954, 955, 958, 965, 966 and 980**

Community development, Credit, Housing and Federal home loan banks.

Accordingly, the Finance Board hereby proposes to amend title 12, chapter IX, Code of Federal Regulations, as follows:

1. New part 917 is added to subchapter C to read as follows:

#### **PART 917—POWERS AND RESPONSIBILITIES OF BANK BOARDS OF DIRECTORS AND SENIOR MANAGEMENT**

Sec.

- 917.1 Definitions.
- 917.2 General duties of Bank boards of directors.
- 917.3 Risk management.
- 917.4 Internal control system.
- 917.5 Audit committees.
- 917.6 Budget preparation and reporting requirements.
- 917.7 Dividends.
- 917.8 Approval of Bank bylaws.
- 917.9 Mission achievement.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a)(1), 1427, 1432(a), 1436(a), 1440.

#### **§ 917.1 Definitions.**

As used in this part:  
*Business risk* means the risk of an adverse impact on a Bank's profitability resulting from external factors as may occur in both the short and long run.  
*Contingency liquidity* has the meaning set forth in § 930.1 of this chapter.  
*Credit risk* has the meaning set forth in § 930.1 of this chapter.  
*Eligible nonmember borrower* has the meaning set forth in § 930.1 of this chapter.

*Immediate family member* means a parent, sibling, spouse, child, dependent, or any relative sharing the same residence.

*Liquidity risk* means the risk that a Bank is unable to meet its obligations as they come due or meet the credit needs of its members and eligible nonmember borrowers in a timely and cost-efficient manner.

*Market risk* has the meaning set forth in § 930.1 of this chapter.

*Operations risk* has the meaning set forth in § 930.1 of this chapter.

#### § 917.2 General duties of Bank boards of directors.

The board of directors of each Bank shall have the duty to direct the operations of the Bank in conformity with the requirements set forth in this chapter. Each board director shall carry out his or her duties as director in good faith, in a manner such director believes to be in the best interests of the Bank, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

#### § 917.3 Risk management.

(a) *Adoption of risk management policy.* (1) Within 180 calendar days of the effective date of this section, each Bank's board of directors shall adopt, and submit to the Finance Board for approval, a risk management policy that addresses the Bank's exposure to credit risk, market risk, liquidity risk, business risk and operations risk and that conforms to the requirements of paragraph (b) of this section and part 930 of this chapter.

(2) *Review and compliance.* Each Bank's board of directors shall:

- (i) Review the Bank's risk management policy at least annually;
- (ii) Have the authority to amend the risk management policy at any time;
- (iii) Re-adopt the Bank's risk management policy, including interim amendments, not less often than every three years; and
- (iv) Ensure Bank compliance at all times with the risk management policy.

(b) *Risk management policy requirements.* In addition to meeting any other requirements set forth in this part, or in part 930 of this chapter, each Bank's risk management policy shall:

- (1) Describe how the Bank will comply with the risk-based capital standards set forth in part 930 of this chapter;
- (2) Set forth the Bank's tolerance levels for the market and credit risk components; and
- (3) Set forth standards for the Bank's management of each risk component, including but not limited to:

- (i) Regarding credit risk arising from all secured and unsecured transactions, standards and criteria for, and timing of, periodic assessment of the creditworthiness of issuers, obligors, or other counterparties including identifying the criteria for selecting dealers, brokers and other securities firms with which the Bank may execute transactions; and

- (ii) Regarding market risk, standards for the methods and models used to measure and monitor such risk;

- (iii) Regarding day-to-day operational liquidity needs and contingency liquidity needs for periods during which the Bank's access to capital markets is impaired:

- (A) An enumeration of specific types of investments to be held for such liquidity purposes; and

- (B) The methodology to be used for determining the Bank's operational and contingency liquidity needs;

- (iv) Regarding operations risk, standards for an effective internal control system, including periodic testing and reporting; and

- (v) Regarding business risk, strategies for mitigating such risk, including contingency plans where appropriate.

(c) *Risk assessment.* The senior management of each Bank shall perform, at least annually, a risk assessment that identifies and evaluates all material risks, including both quantitative and qualitative aspects, that could adversely affect the achievement of the Bank's performance objectives and compliance requirements. The risk assessment shall be in written form and shall be reviewed by the Bank's board of directors promptly upon its completion.

#### § 917.4 Internal control system.

(a) *Establishment and maintenance.*

(1) Each Bank shall establish and maintain an effective internal control system that is adequate to ensure:

- (i) The efficiency and effectiveness of Bank activities;
- (ii) The safeguarding of assets;
- (iii) The reliability, completeness and timely reporting of financial and management information and transparency of such information to the Bank's board of directors and to the Finance Board; and

- (iv) Compliance with applicable laws, regulations, policies, supervisory determinations and directives of the Bank's board of directors and senior management.

(2) Ongoing internal control activities necessary to maintain the internal control system required under paragraph (a)(1) of this section shall include, but are not limited to:

- (i) Top level reviews by the Bank's board of directors and senior management, including review of financial presentations and performance reports;

- (ii) Activity controls, including review of standard performance and exception reports by department-level management on an appropriate periodic basis;

- (iii) Physical controls adequate to ensure the safeguarding of assets;

- (iv) Monitoring for compliance with the risk tolerance limits set forth in the Bank's risk management policy;

- (v) Any required approvals and authorizations for specific activities; and

- (vi) Any required verifications and reconciliations for specific activities.

(b) *Internal control responsibilities of Banks' boards of directors.* Each Bank's board of directors shall direct the establishment and maintenance of the internal control system required under paragraph (a)(1) of this section, and oversee senior management's implementation of such a system on an ongoing basis, by:

- (1) Conducting periodic discussions with senior management regarding the effectiveness of the internal control system;

- (2) Ensuring that an effective and comprehensive internal audit of the internal control system is performed annually;

- (3) Ensuring that internal control deficiencies are reported to the Bank's board of directors in a timely manner and are addressed promptly;

- (4) Conducting a timely review of evaluations of the effectiveness of the internal control system made by internal auditors, external auditors and Finance Board examiners;

- (5) Ensuring that senior management promptly and effectively addresses recommendations and concerns expressed by internal auditors, external auditors and Finance Board examiners regarding weaknesses in the internal control system;

- (6) Reporting any internal control deficiencies found, and the corrective action taken, to the Finance Board in a timely manner;

- (7) Establishing, documenting and communicating an organizational structure that clearly shows lines of authority within the Bank, provides for effective communication throughout the Bank, and ensures that there are no gaps in the lines of authority;

- (8) Ensuring that all delegations of authority to specific personnel or committees state the extent of the authority and responsibilities delegated; and

(9) Establishing reporting requirements, including specifying the nature and frequency of reports it receives.

(c) *Internal control responsibilities of Banks' senior management.* Each Bank's senior management shall be responsible for carrying out the directives of the Bank's board of directors, including the establishment, implementation and maintenance of the internal control system required under paragraph (a)(1) of this section, by:

(1) Establishing, implementing and effectively communicating to Bank personnel policies and procedures that are adequate to ensure that internal control activities necessary to maintain an effective internal control system, including the activities enumerated in paragraph (a)(2) of this section, are an integral part of the daily functions of all Bank personnel;

(2) Ensuring that all Bank personnel fully understand and comply with all policies and procedures;

(3) Ensuring that there is appropriate segregation of duties among Bank personnel and that personnel are not assigned conflicting responsibilities;

(4) Establishing effective paths of communication upward, downward and across the organization in order to ensure that Bank personnel receive necessary and appropriate information, including:

(i) Information relating to the operational policies and procedures of the Bank;

(ii) Information relating to the actual operational performance of the Bank;

(iii) Adequate and comprehensive internal financial, operational and compliance data; and

(iv) External market information about events and conditions that are relevant to decision making;

(5) Developing and implementing procedures that translate the major business strategies and policies established by the Bank's board of directors into operating standards;

(6) Ensuring adherence to the lines of authority and responsibility established by the Bank's board of directors;

(7) Overseeing the implementation and maintenance of management information and other systems;

(8) Establishing and implementing an effective system to track internal control weaknesses and the actions taken to correct them; and

(9) Monitoring and reporting to the Bank's board of directors the effectiveness of the internal control system on an ongoing basis.

#### **§ 917.5 Audit committees.**

(a) *Establishment.* The board of directors of each Bank shall establish an

audit committee, consistent with the requirements set forth in this section.

(b) *Composition.* (1) The audit committee shall comprise five or more persons drawn from the Bank's board of directors, each of whom shall meet the criteria of independence set forth in paragraph (c) of this section.

(2) The audit committee shall include representatives of large and small members and appointive and elective directors of the Bank.

(3) The terms of audit committee members shall be appropriately staggered so as to provide for continuity of service.

(4) All members of the audit committee shall have a working familiarity with basic finance and accounting practices, and at least one member of the audit committee shall have extensive accounting or financial management expertise. If the board of directors determines that there are not a sufficient number of board directors possessing the necessary skills and expertise to qualify for service on the audit committee (considering the representation requirements of paragraph (b)(2) of this section), the board of directors shall:

(i) In the case of audit committee representation of appointive directors, provide written notification to the Finance Board for consideration when appointing directors; and

(ii) In the case of audit committee representation of elective directors, include in the Election Announcement required under § 915.6(a) of this chapter, a statement describing the skills or expertise needed.

(c) *Independence.* Any member of the Bank's board of directors shall be considered to be sufficiently independent to serve as a member of the audit committee if that director does not have a disqualifying relationship with the Bank or its management that would interfere with the exercise of that director's independent judgment. Such disqualifying relationships shall include, but shall not be limited to:

(1) Being employed by the Bank in the current year or any of the past five years;

(2) Accepting any compensation from the Bank other than compensation for service as a board director;

(3) Serving or having served in any of the past five years as a consultant, advisor, promoter, underwriter, or legal counsel of or to the Bank; or

(4) Being an immediate family member of an individual who is, or has been in any of the past five years, employed by the Bank.

(d) *Charter.* (1) The audit committee of each Bank shall adopt, and the Bank's

board of directors shall approve, a formal written charter that specifies the scope of the audit committee's powers and responsibilities, as well as the audit committee's structure, processes and membership requirements.

(2) The audit committee and the board of directors of each Bank shall:

(i) Review the Bank's audit committee charter on an annual basis; and

(ii) Have the authority to adopt and approve, respectively, amendments to the audit committee charter at any time; and

(iii) Re-adopt and re-approve, respectively, the Bank's audit committee charter not less often than every three years.

(3) Each Bank's audit committee charter shall:

(i) Provide that the internal auditor may be removed only with the approval of the audit committee;

(ii) Provide that the internal auditor shall report directly to the audit committee on substantive matters and to the Bank President on administrative matters;

(iii) Empower the audit committee to retain outside counsel, independent accountants, or other outside consultants; and

(iv) Provide that both the internal auditor and the external auditor shall have unrestricted access to the audit committee without the need for any prior management knowledge or approval.

(e) *Duties.* Each Bank's audit committee shall have the duty to:

(1) Ensure that senior management maintains the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the Bank;

(2) Review the basis for the Bank's financial statements and the external auditor's opinion rendered with respect to such financial statements (including the nature and extent of any significant changes in accounting principles or the application therein) and ensure disclosure and transparency regarding the Bank's true financial performance and governance practices;

(3) Oversee the internal audit function by:

(i) Reviewing the scope of audit services required, significant accounting policies, significant risks and exposures, audit activities and audit findings;

(ii) Assessing the performance, and determining the compensation, of the internal auditor; and

(iii) Reviewing and approving the internal auditor's work plan;

(4) Oversee the external audit function by:

(i) Approving the external auditor's annual engagement letter;



(ii) Reviewing the performance of the external auditor; and

(iii) Making recommendations to the Bank's board of directors regarding the appointment, renewal, or termination of the external auditor;

(5) Provide an independent, direct channel of communication between the Bank's board of directors and the internal and external auditors;

(6) Conduct or authorize investigations into any matters within the audit committee's scope of responsibilities;

(7) Ensure that senior management has established and is maintaining an adequate internal control system within the Bank by:

(i) Reviewing the adequacy of the Bank's internal control system and the resolution of identified material weaknesses and reportable conditions in the internal control system, including the prevention or detection of management override or compromise of the internal control system; and

(ii) Reviewing the programs and policies of the Bank designed to ensure compliance with applicable laws, regulations and policies and monitoring the results of these compliance efforts;

(8) Ensure that senior management has established and is maintaining adequate policies and procedures to ensure that the Bank can assess, monitor and control compliance with its mission achievement policy; and

(9) Report periodically its findings to the Bank's board of directors.

(f) *Meetings.* The audit committee shall prepare written minutes of each audit committee meeting.

#### § 917.6 Budget preparation and reporting requirements.

(a) *Adoption of annual Bank budgets.* (1) Each Bank's board of directors shall be responsible for the adoption of an annual operating expense budget and a capital expenditures budget for the Bank, and any subsequent amendments thereto, consistent with the requirements of the Act, this section, other regulations and policies of the Finance Board, and with the Bank's responsibility to protect both its members and the public interest by keeping its costs to an efficient and effective minimum.

(2) Pursuant to the requirement of section 12(a) of the Act (12 U.S.C. 1432(a)), a Bank must obtain prior approval of the Finance Board before purchasing or erecting, or leasing for a term of more than 10 years, a building to house the Bank.

(3) A Bank's board of directors may not delegate the authority to approve the Bank's annual budgets, or any

subsequent amendments thereto, to Bank officers or other Bank employees.

(4) A Bank's annual budgets shall be prepared based upon an interest rate scenario as determined by the Bank.

(5) A Bank may not exceed its total annual operating expense budget or its total annual capital expenditures budget without prior approval by the Bank's board of directors of an amendment to such budget.

(b) *Budget reports.* Each Bank shall submit to the Finance Board, by January 31 of each year, in a format and as further prescribed by the Finance Board, such Bank budgets and other financial information as the Finance Board shall require, including the following:

(1) Balance sheet projections; (2) Income statement projections, including operating expense budget data and staffing levels;

(3) Capital expenditures budget data;

(4) Management discussion of expected financial performance;

(5) Strategic or business plan;

(6) Interest rate assumptions; and

(7) A copy of the Bank's board of directors resolution adopting the Bank's annual operating expense budget and capital expenditures budget.

(c) *Report on amendments to total annual budgets.* A Bank shall submit promptly to the Finance Board a copy of the Bank's board of directors resolution adopting any amendment increasing a Bank's total annual operating expense budget or total annual capital expenditures budget above originally-approved budget limits.

(d) *Mid-year reforecasting report.* Each Bank shall submit to the Finance Board, by July 31 of each year, in a format and as further prescribed by the Finance Board, a report containing a balance sheet and income statement setting forth reforecasted projections for the year relative to the budget projections for that year as originally approved or amended, including a management discussion explaining any significant changes in the reforecasted projections from the budget projections as originally approved or amended.

(e) *Annual actual performance results report.* Each Bank shall submit to the Finance Board, by January 31 of each year, in a format and as further prescribed by the Finance Board, a report containing a balance sheet and income statement setting forth the actual performance results for the prior year relative to the budget projections for that year as originally approved or amended, including a management discussion explaining any significant changes in the actual performance results from the budget projections as originally approved or amended.

#### § 917.7 Dividends.

The board of directors of each Bank may, without the Finance Board's prior approval, declare and pay a dividend from net earnings, including previously retained earnings, on the paid-in value of capital stock held during the dividend period, as determined by the Bank, so long as such payment will not result in a projected impairment of the par value of the capital stock of the Bank. Dividends on such stock shall be computed without preference and only for the period such stock was outstanding during the dividend period. Dividends may be paid in cash or in the form of stock.

#### § 917.8 Approval of Bank bylaws.

The board of directors of a Bank may prescribe, amend, or repeal bylaws governing the manner in which the Bank administers its affairs without the Finance Board's prior approval, provided that the bylaws or amendments are consistent with applicable statutes, regulations and Finance Board policies.

#### § 917.9 Mission achievement.

(a) *Mission achievement policy.* (1) *Adoption.* Within 180 calendar days of the effective date of this section, each Bank's board of directors shall adopt, and submit to the Finance Board for approval, a mission achievement policy that:

(i) Details how the Bank will comply with the core mission activity requirements set forth in part 940 of this chapter, including contingent business strategies for meeting such requirements under different assumptions about future economic and mortgage market conditions; and

(ii) Outlines a process for developing and implementing new mission-related products and services.

(2) *Review and compliance.* Each Bank's board of directors shall:

(i) Review the Bank's mission achievement policy at least annually;

(ii) Have the authority to amend the mission achievement policy at any time;

(iii) Re-adopt the Bank's mission achievement policy, including interim amendments, not less often than every three years; and

(iv) Ensure Bank compliance at all times with the mission achievement policy.

(b) *Mission achievement oversight.* Each Bank's board of directors shall:

(1) Direct the establishment and maintenance, by senior management, of adequate policies and procedures to ensure that the Bank can assess, monitor and control compliance with its mission achievement policy;

(2) Establish a mechanism to measure and assess the Bank's performance against its mission achievement goals and objectives;

(3) Require that performance assessments be conducted at least annually that evaluate the Bank's mission achievement and measure its performance against the Bank's goals and objectives, which performance assessments shall be reviewed by the Bank's board of directors.

**PART 925—MEMBERS OF THE BANKS**

2. The authority citation for part 925 continues to read as follows:

**Authority:** 12 U.S.C. 1422, 1422a, 1422b, 1423, 1424, 1426, 1430, 1442.

3. Amend § 925.14 by revising paragraph (a)(4)(iv) to read as follows:

**§ 925.14 De novo insured depository institution applicants.**

\* \* \* \* \*

(a) \* \* \*

(4) \* \* \*

(iv) *Treatment of outstanding advances and Bank stock.* If the applicant's conditional membership approval is deemed null and void pursuant to paragraph (a)(4)(ii) of this section:

(A) The liquidation of any outstanding indebtedness owed by the applicant to the Bank shall be carried out in accordance with § 925.29; and

(B) The redemption of stock of such Bank shall be carried out in accordance with § 930.9.

\* \* \* \* \*

4. Amend § 925.22 by removing paragraph (b)(2) and redesignating paragraph (b)(1) as paragraph (b).

5. Amend § 925.24 by revising paragraph (b)(2) to read as follows:

**§ 925.24 Consolidation of members.**

\* \* \* \* \*

(b) \* \* \*

(2) *Treatment of outstanding advances and Bank stock.* (i) The liquidation of any outstanding indebtedness owed to the disappearing institution's Bank shall be carried out in accordance with § 925.29.

(ii) The redemption of stock of the disappearing institution's Bank shall be carried out in accordance with § 930.9 of this chapter.

\* \* \* \* \*

6. Amend § 925.25 by revising paragraph (d)(3) to read as follows:

**§ 925.25 Consolidations involving nonmembers.**

\* \* \* \* \*

(d) \* \* \*

(3) *Upon failure to apply for or be approved for membership.* If the

consolidated institution does not apply for membership, or if its application for membership is denied, then:

(i) The liquidation of any outstanding indebtedness owed to the disappearing institution's Bank shall be carried out in accordance with § 925.29; and

(ii) The redemption of stock of the disappearing institution's Bank shall be carried out in accordance with § 930.9 of this chapter, and the consolidated institution shall have the limited rights associated with such stock in accordance with paragraph (e) of this section.

\* \* \* \* \*

7. Amend § 925.26 by revising paragraphs (a), (b) and (c) to read as follows:

**§ 925.26 Procedure for withdrawal.**

(a) *Notice of withdrawal.* Any member that is eligible under applicable law to withdraw from Bank membership may do so after providing its Bank with written notice of the member's intention to withdraw from membership in accordance with the requirements of § 930.9 of this chapter.

(b) *Cancellation of notice of withdrawal.* A member may cancel its notice of withdrawal by providing its Bank written notice of cancellation any time before the effective date of the withdrawal.

(c) *Treatment of outstanding advances and Bank stock.* (1) The liquidation of any outstanding indebtedness owed to the Bank in which membership has been terminated shall be carried out in accordance with § 925.29.

(2) The redemption of stock of the Bank in which membership has been terminated shall be carried out in accordance with § 930.9 of this chapter.

\* \* \* \* \*

8. Amend § 925.27 by revising paragraph (e) to read as follows:

**§ 925.27 Procedure for removal.**

\* \* \* \* \*

(e) *Treatment of outstanding advances and Bank stock.* (1) The liquidation of any outstanding indebtedness owed to the Bank in which membership has been terminated shall be carried out in accordance with § 925.29.

(2) The redemption of stock of the Bank in which membership has been terminated shall be carried out in accordance with § 930.9 of this chapter.

\* \* \* \* \*

9. Amend § 925.28 by revising paragraph (b) to read as follows:

**§ 925.28 Automatic termination of membership for institutions placed in receivership.**

\* \* \* \* \*

(b) *Treatment of outstanding advances and Bank stock.* (1) The liquidation of any outstanding indebtedness owed to the Bank in which membership has been terminated shall be carried out in accordance with § 925.29.

(2) The redemption of stock of the Bank in which membership has been terminated shall be carried out in accordance with § 930.9 of this chapter.

\* \* \* \* \*

**Subpart G—Orderly Liquidation of Advances**

10. Revise the heading of subpart G to read as set forth above.

11. Amend § 925.29 by:

- a. Revising the heading;
- b. Removing paragraphs (b) and (c);
- c. Redesignating paragraphs (a)(1) and (a)(2) as paragraphs (a) and (b), respectively; and
- d. Revising newly designated paragraph (b).

The revisions read as follows:

**§ 925.29 Orderly liquidation of advances.**

(b) The indebtedness of the institution that has ceased to be a member of a Bank owed to such Bank shall be liquidated in an orderly manner as determined by the Bank in accordance with § 950.19 of this chapter.

\* \* \* \* \*

12. New part 930 is added to subchapter E to read as follows:

**PART 930—RISK MANAGEMENT AND CAPITAL STANDARDS**

- Sec.
- 930.1 Definitions.
- 930.2 Bank System and individual Bank credit ratings.
- 930.3 Minimum total capital requirement.
- 930.4 Minimum total risk-based capital requirement.
- 930.5 Credit risk capital requirement.
- 930.6 Market risk capital requirement.
- 930.7 Operations risk capital requirement.
- 930.8 Reporting requirements.
- 930.9 Capital stock redemption requirements.
- 930.10 Minimum liquidity requirements.
- 930.11 Limits on unsecured extensions of credit to one counterparty or affiliated counterparties; reporting requirements for total extensions of credit to one counterparty or affiliated counterparties.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1429, 1430, 1430b, 1431, 1436, 1440.

**§ 930.1 Definitions.**

As used in this part:  
*Affiliated counterparty* means a counterparty that is an affiliate of

another counterparty, as the term "affiliate" is defined in 12 U.S.C. 371c(b) (as amended).

*Certain drawdown* means, in relation to commitments to make advances or other loans, that it is known during the pendency of the commitment that the advance or loan funds definitely will be drawn in full.

*Contingency liquidity* means:

(1) Marketable assets with a maturity of one year or less;

(2) Self-liquidating assets with a maturity of seven days or less; and

(3) Assets that are generally accepted as collateral in the repurchase agreement market.

*Credit derivative contract* means a derivative contract that transfers credit risk.

*Credit risk* means the risk that an obligation will not be paid in full and loss will result.

*Derivative contract* means generally a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indexes of asset values, or credit-related events. Derivative contracts include interest rate, foreign exchange rate, equity, precious metals, commodity, and credit contracts, and any other instruments that pose similar risks.

*Eligible nonmember borrower* means an entity that has been approved as a nonmember mortgagee pursuant to subpart B of part 950 of this chapter.

*Exchange rate contracts* include cross-currency interest rate swaps, forward foreign exchange rate contracts, currency options purchased, and any similar instruments that gives rise to similar risks.

*Financial Management Policy* means the Financial Management Policy For The Federal Home Loan Bank System approved by the Finance Board pursuant to Finance Board Resolution No. 96-45 (July 3, 1996), as amended by Finance Board Resolution No. 96-90 (Dec. 6, 1996), Finance Board Resolution No. 97-05 (Jan. 14, 1997), and Finance Board Res. No. 97-86 (Dec. 17, 1997).

*GSE, or Government Sponsored Enterprise*, means a United States Government-sponsored agency originally established or chartered to serve public purposes specified by the United States Congress, but whose obligations are not obligations of the United States and are not guaranteed by the United States.

*Interest rate contracts* include: Single currency interest rate swaps; basis swaps; forward rate agreements; interest rate options; and any similar instrument that gives rise to similar risks, including when-issued securities.

*Investment grade* means:

(1) A credit quality rating in one of the four highest credit rating categories by an NRSRO and not below the fourth highest rating category by any NRSRO; or

(2) If there is no credit quality rating by an NRSRO, a determination by a Bank that the issuer, asset or instrument is the credit equivalent of investment grade using credit rating standards available from an NRSRO or other similar standards.

*Issuer credit rating* means an opinion issued by an NRSRO of an institution's overall capacity to meet its obligations (i.e., the institution's creditworthiness).

*Market risk* means the risk that the market value of a Bank's portfolio will decline as a result of changes in the general level of interest rates, foreign exchange rates, equity and commodity prices.

*Marketable means*, with respect to an asset, that the asset can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

*Market value at risk* is calculated as the maximum loss in the market value of a portfolio under various stress scenarios.

*NRSRO* means a credit rating organization regarded as a Nationally Recognized Statistical Rating Organization by the Securities and Exchange Commission.

*OFHEO* means the Office of Federal Housing Enterprise Oversight.

*Operations risk* means the risk of an unexpected loss to a Bank resulting from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems.

*Repurchase agreement* means an agreement between a seller and a buyer whereby the seller agrees to repurchase a security at an agreed upon price, with or without a stated time for repurchase.

*Retained earnings* means the retained earnings required to be reported by a Bank to the Finance Board for regulatory purposes.

*Total assets* means the total assets required to be reported by a Bank to the Finance Board for regulatory purposes.

*Total capital* means the sum of a Bank's retained earnings and total capital stock outstanding, less the Bank's unrealized net losses on available-for-sale securities.

*Total capital stock outstanding* means all forms and types of outstanding capital stock required to be reported by a Bank to the Finance Board for regulatory purposes.

*Total risk-based capital for a Bank* means the sum of:

(1) Such Bank's retained earnings, less unrealized net losses on available-for-sale securities;

(2) Any outstanding non-redeemable capital stock of such Bank;

(3) All outstanding capital stock satisfying the minimum capital stock purchase requirements for membership under sections 6(b)(1) and 10(e)(3) of the Act (12 U.S.C. sections 1426(b)(1), 1430(e)(3)) for all institutions required by law to be members of such Bank (mandatory members);

(4) A percentage not exceeding 50 percent, as determined by such Bank's board of directors, of all outstanding capital stock satisfying the minimum capital stock purchase requirements for membership under sections 6(b)(1) and 10(e)(3) of the Act (12 U.S.C. sections 1426(b)(1), 1430(e)(3)) for all Bank members not required by law to be members of the Bank (voluntary members); and

(5) A percentage (which is not required to be identical to any percentage determined for purposes of paragraph (4) of this definition not exceeding 50 percent, as determined by such Bank's board of directors, of all remaining outstanding capital stock.

*Unrealized net losses on available-for-sale securities* means the unrealized net losses on available-for-sale securities required to be reported by a Bank to the Finance Board for regulatory purposes.

*Walkaway clause* means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

#### § 930.2 Bank System and individual Bank credit ratings.

(a) *Bank System credit rating.* (1) The Banks, collectively, shall obtain from an NRSRO, and at all times maintain, a current credit rating on the Banks' consolidated obligations.

(2) Each Bank shall operate in such a manner and take any actions necessary to ensure that the Banks' consolidated obligations receive and continue to receive the highest credit rating from any NRSRO by which the consolidated obligations have been then rated.

(b) *Individual Bank credit rating.* Each Bank shall operate in such a manner and take any actions necessary to ensure that the Bank has and maintains an individual issuer credit rating of at least the second highest credit rating from any NRSRO providing a rating, where such rating is:

(1) A meaningful measure of the individual Bank's financial strength and stability, apart from the GSE status of the Bank System;

(2) Obtained from an NRSRO that states in writing to the Bank that its rating conforms with paragraph (b)(1) of this section; and

(3) Updated at least annually, or more frequently as required by the Finance Board to reflect any material changes in the condition of the Bank.

(c) *Transition provision.* Each Bank shall obtain the credit rating from an NRSRO required under paragraph (b) of this section within one calendar year of the effective date of this part.

**§ 930.3 Minimum total capital requirement.**

(a) *Minimum total capital ratio.* Each Bank shall have and maintain at all times total capital in an amount equal to at least 3.0 percent of the Bank's total assets.

(b) *Safety and soundness exception.* For reasons of safety and soundness, the Finance Board may require an individual Bank to have and maintain a higher minimum capital ratio than the ratio set forth in paragraph (a) of this section.

**§ 930.4 Minimum total risk-based capital requirement.**

(a) *General.* Each Bank shall have and maintain at all times total risk-based capital in an amount at least equal to the sum of its credit risk capital requirement, its market risk capital requirement, and its operations risk capital requirement, calculated in accordance with §§ 930.5, 930.6 and 930.7, respectively.

(b) *Transition provisions.* (1) Each Bank shall be required to meet its minimum total risk-based capital requirement under paragraph (a) of this section within 90 calendar days after the Finance Board's approval of the Bank's internal market risk model.

(2) No Bank shall be governed by the capital requirements of this part, and each Bank shall continue to be governed by the Financial Management Policy, until:

(i) The Bank has received Finance Board approval of the Bank's internal market risk model and the Bank's risk management policy;

(ii) The Bank demonstrates to the Finance Board that it has sufficient risk-based capital to meet the minimum total risk-based capital requirement under paragraph (a) of this section for its then-current portfolio; and

(iii) The Bank demonstrates to the Finance Board, in its risk management policy or otherwise, risk assessment procedures and controls sufficient to

manage the Bank's credit, market and operations risks.

**§ 930.5 Credit risk capital requirement.**

(a) *General requirement.* A Bank's credit risk capital requirement equals the sum of the Bank's credit risk capital requirements for all on-balance sheet assets and off-balance sheet items.

(b) *Credit risk capital requirements for on-balance sheet assets.* A Bank's credit risk capital requirement for a specific on-balance sheet asset shall be equal to the book value of the asset multiplied by the specific credit risk percentage requirement assigned to that category of credit risk pursuant to paragraph (d) of this section.

(c) *Credit risk capital requirement for off-balance sheet items.* A Bank's credit risk capital requirement for a specific off-balance sheet item shall be equal to the credit equivalent amount of such item, as determined pursuant to paragraphs (e), (f), or (g) of this section, as applicable, multiplied by the specific credit risk percentage requirement assigned to that category of credit risk pursuant to paragraph (d) of this section.

(d) *Determination of specific credit risk percentage requirements—(1) Finance Board determination of specific credit risk percentage requirements.* The Finance Board shall determine, and update periodically, specific credit risk percentage requirements for particular credit risk categories applicable to on-balance sheet assets and off-balance sheet items, based on the type of asset or item and its credit rating, if any, as set forth in paragraph (d)(3) of this section.

(2) *Finance Board underlying methodology.* (i) In determining the specific credit risk percentage requirements, the Finance Board shall use data made available by NRSROs and other relevant sources to derive estimates of credit risk (or, "credit losses") corresponding to particular categories of credit risks.

(ii) The estimates of credit risk shall represent credit losses as could occur during periods of extreme credit stress. Historical data used in deriving estimates of credit losses shall reflect the longer-term nature of credit cycles and span multiple credit cycles. Estimates of credit losses shall be equal to the product of extreme values of the distributions of both the default frequency and the recovery rate in default for each credit risk category.

(3) *Specific credit risk capital requirements by credit risk category.* The specific credit risk percentage requirements applicable to a Bank's on-balance sheet assets and off-balance

sheet items are as provided in the following Table 1:

TABLE 1.—CREDIT RISK CAPITAL REQUIREMENTS BY CREDIT RISK CATEGORY

Credit risk category	Percent of on-balance sheet equivalent value
(i) Authorized Investments	
(A) Cash; Government Securities .....	0.0
(B) Advances .....	0.3
(C) Highest Investment Grade	0.3
(D) Second Highest Investment Grade .....	0.6
(E) Third Highest Investment Grade .....	1.0
(F) Fourth Highest Investment Grade .....	1.3
(G) Premises, Plant, and Equipment .....	8.0
(H) Core Mission Equity Investments Under § 940.3(e) .....	8.0
(ii) Investments Downgraded to Below Investment Grade After Acquisition By Bank	
(A) Highest Below Investment Grade .....	12.0
(B) Second Highest Below Investment Grade .....	50.0
(C) All Other Below Investment Grade .....	100.0

(4) *Bank determination of specific credit risk percentage requirements.* (i) *General requirement.* Each Bank shall determine the credit risk capital requirement for each on-balance sheet asset and off-balance sheet item by determining the type of asset or item and its credit rating, if any (as provided in paragraph (d)(4)(ii) of this section) determining the applicable credit risk category for such asset or item as set forth in Table 1 of paragraph (d)(3) of this section, and applying the applicable credit risk percentage requirement for such credit risk category contained in Table 1.

(ii) *Bank determination of credit rating.* (A) For assets or items that are rated directly by an NRSRO, the credit rating that shall apply for purposes of determining the applicable credit risk category under Table 1 shall be the credit rating of the asset or item, respectively.

(B) For an asset or item, or relevant portion of an asset or item, that is not rated directly by an NRSRO, but for which an NRSRO rating has been assigned to any of the corresponding obligor counterparty, third party guarantor or underlying collateral, the credit rating that shall apply to the asset or item or portion of the asset or item corresponding to a particular rating, for purposes of determining the applicable

credit risk category under Table 1, shall be the highest of the credit ratings corresponding to such asset or item or portion or such asset or item.

(C) Where a credit rating has a modifier, e.g., A+ or A-, the credit rating is deemed to be the credit rating without the modifier, e.g., A+ or A = A.

(D) In determining the applicable credit risk category under Table 1 for a specific asset or item that has received more than one credit rating from a given NRSRO, the most recent credit rating shall be used.

(E) If a specific asset or item has received credit ratings from more than one NRSRO, the lowest credit rating shall be used in determining the applicable credit risk category for such asset or item under Table 1.

(F) If an asset or item, or relevant portion of an asset or item, does not meet the requirements of paragraphs (d)(4)(ii)(A) or (B) of this section, and does not fall within the credit risk categories of Cash, Government Securities, Advances, Premises, Plant, Equipment, or Core Mission Equity Investments, for purposes of determining the applicable credit risk category under Table 1, the Bank shall determine its own credit rating for the asset or item or relevant portion of the asset or item using credit rating standards available from an NRSRO or other similar standards.

(iii) *Recognition of collateral.* Assets or items shall be deemed to be backed by collateral for purposes of this paragraph (d)(4)(iii) if the collateral is:

(A) Actually held by the Bank or an independent, third-party custodian, or by the Bank's member or eligible nonmember borrower if permitted under the Bank's collateral agreement with such party;

(B) Legally available to absorb losses;

(C) Has a readily determinable value at which it can be liquidated by the Bank; and

(D) Is held in accordance with the provisions of the Bank's collateral management policy.

(iv) *Collateral haircut.* In recognizing collateral, appropriate allowance for haircuts (over collateralization) reflecting the market risk underlying the collateral must be made.

(5) *Specific credit risk capital requirements for on-balance sheet assets hedged with credit derivatives.*

(i) If a credit derivative is used to lower (hedge) the credit risk on an asset, the credit derivative and such underlying asset are of identical remaining maturity, and the asset being referenced in the credit derivative (reference asset) is identical to the underlying asset, the credit risk capital requirement for the underlying asset shall be zero.

(ii) If the underlying asset and the reference asset are identical, but their remaining maturities are different, the credit risk capital requirement for the underlying asset shall be zero, provided the remaining maturity of the credit derivative is two years or more.

(iii) If the remaining maturities of the underlying asset and the credit derivative are identical, but the underlying asset is different from the asset referenced in the credit derivative, the credit risk capital requirement for the underlying asset shall be zero, provided that the reference asset and the underlying asset have been issued by the same obligor, the reference asset ranks pari passu to or more junior than the underlying asset, and cross-default clauses apply.

(iv) If the credit risk capital requirement for the underlying asset is decreased in recognition of a credit derivative, the credit risk capital requirement for the derivative contract pursuant to paragraphs (f) and (g) of this section shall still apply.

(e) *Calculation of credit equivalent amount for off-balance sheet items other than derivative contracts.* The credit equivalent amount for an off-balance sheet item other than a derivative contract shall be determined by a Finance Board approved model or equal to the face amount of the instrument multiplied by the credit conversion factor assigned to such risk category of instruments provided in the following Table 2:

TABLE 2.—CREDIT CONVERSION FACTORS FOR OFF-BALANCE SHEET ITEMS OTHER THAN DERIVATIVE CONTRACTS

Instrument	Credit conversion factor (in percent)
(1) Standby letters of credit .....	100
(2) Asset sales with recourse where the credit risk remains with the Bank .....	100
(3) Sale and repurchase agreements .....	100
(4) Forward asset purchases ...	100
(5) Commitments to make advances, or other loans, with certain drawdown .....	100
(6) Other commitments with original maturity of over one year .....	150
(7) Other commitments with original maturity of one year or less .....	120

<sup>1</sup> The credit conversion factor would be zero for other commitments that are unconditionally cancelable, or that effectively provide for automatic cancellation, due to the deterioration in a borrower's creditworthiness, at any time by the Bank without prior notice.

(f) *Calculation of credit equivalent amount for single derivative contracts.* The credit equivalent amount for a derivative contract that is not subject to a qualifying bilateral netting contract (single derivative contract) shall be the sum of the current credit exposure (replacement cost) and the potential future credit exposure of the derivative contract.

(1) *Current credit exposure.* If the mark-to-market value of the contract is positive, the current credit exposure shall equal that mark-to-market value. If the mark-to-market value of the contract is zero or negative, the current credit exposure shall be zero.

(2) *Potential future credit exposure.* (i) The potential future credit exposure for a single derivative contract, including a derivative contract with a negative mark-to-market value, shall be calculated using an internal model approved by the Finance Board or, in the alternative, by multiplying the effective notional principal of the derivative contract by one of the assigned credit conversion factors for the appropriate category as provided in the following Table 3:

TABLE 3.—CREDIT CONVERSION FACTORS FOR POTENTIAL FUTURE CREDIT EXPOSURE DERIVATIVE CONTRACTS <sup>1</sup> (In percent)

Residual maturity <sup>2</sup>	Interest rate	Foreign exchange and gold	Equity	Precious metals except gold	Other commodities
(A) One year or less .....	0	1	6	7	10

TABLE 3.—CREDIT CONVERSION FACTORS FOR POTENTIAL FUTURE CREDIT EXPOSURE DERIVATIVE CONTRACTS<sup>1</sup>—  
Continued  
(In percent)

Residual maturity <sup>2</sup>	Interest rate	Foreign exchange and gold	Equity	Precious metals except gold	Other commodities
(B) Over 1 year to five years .....	.5	5	8	7	12
(C) Over five years .....	1.5	7.5	10	8	15

<sup>1</sup> For derivative contracts with multiple exchanges of principal, the conversion factors are multiplied by the number of remaining payments in the derivative contract.

<sup>2</sup> For derivative contracts that automatically reset to zero value following a payment, the residual maturity equals the time until the next payment. However, interest rate contracts with remaining maturities of greater than one year shall be subject to a minimum conversion factor of 0.5 percent.

(ii) If a Bank determines to use an internal model for a particular type of derivative contract, the Bank shall use the same model for all other similar types of contracts. However, the Bank may use an internal model for one type of derivative contract and Table 3 for another type of derivative contract.

(iii) Forwards, swaps, purchased options and similar derivative contracts not included in the Interest Rate, Foreign Exchange and Gold, Equity, or Precious Metals Except Gold categories shall be treated as Other Commodities contracts for purposes of Table 3.

(iv) If a Bank determines to use Table 3 for credit derivatives contracts, the credit conversion factors applicable to Interest Rate contracts under Table 3 shall apply to such credit derivative contracts.

(v) If a Bank determines not to use an internal model for single currency interest rate swaps in which payments are made based upon two floating indices (floating/floating or basis swaps), the potential future credit exposure for such swaps shall be zero.

(g) *Calculation of credit equivalent amount for multiple derivative contracts subject to a qualifying bilateral netting contract.*—(1) *Netting calculation.* The credit equivalent amount for multiple derivative contracts executed with a single counterparty and subject to a qualifying bilateral netting contract described in paragraph (g)(2) of this section, shall be calculated by adding the net current credit exposure and the adjusted sum of the potential future credit exposure for all derivative contracts subject to the qualifying bilateral netting contract.

(i) *Net current credit exposure.* The net current credit exposure shall be the net sum of all positive and negative mark-to-market values of the individual derivative contracts subject to a qualifying bilateral netting contract. If the net sum of the mark-to-market value is positive, then the net current credit exposure shall equal that net sum of the mark-to-market value. If the net sum of

the mark-to-market value is zero or negative, then the net current credit exposure shall be zero.

(ii) *Adjusted sum of the potential future credit exposure.* (A) The adjusted sum of the potential future credit exposure ( $A_{net}$ ) shall be calculated as follows:

$$A_{net} = 0.4 \times A_{gross} + (0.6 \times NGR \times A_{gross}).$$

(B)  $A_{gross}$  is the gross potential future credit exposure, *i.e.*, the sum of the potential future credit exposure for each individual derivative contract subject to the qualifying bilateral netting contract. NGR is the net to gross ratio, *i.e.*, the ratio of the net current credit exposure to the gross current credit exposure. The gross current credit exposure equals the sum of the positive current credit exposures of all individual derivative contracts subject to the qualifying bilateral netting contract.

(2) *Qualifying bilateral netting contract.* A bilateral netting contract shall be considered a qualifying bilateral netting contract if the following conditions are met:

(i) The netting contract is in writing;  
(ii) The netting contract is not subject to a “walkaway” clause;  
(iii) The netting contract provides that the Bank would have a single legal claim or obligation either to receive or to pay only the net amount of the sum of the positive and negative mark-to-market values on the individual derivative contracts covered by the netting contract in the event that a counterparty, or a counterparty to whom the netting contract has been assigned, fails to perform due to default, insolvency, bankruptcy, or other similar circumstance;

(iv) The Bank obtains a written and reasoned legal opinion that represents, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy, or similar circumstances, the relevant court and administrative authorities would find the Bank’s exposure to be the net amount under:

(A) The law of the jurisdiction by which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(B) The law of the jurisdiction that governs the individual derivative contracts covered by the netting contract; and

(C) The law of the jurisdiction that governs the netting contract;

(v) The Bank establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the netting contract continues to satisfy the requirements of this section; and

(vi) The Bank maintains in its files documentation adequate to support the netting of a derivative contract.

(h) *Exceptions.* The following derivative contracts are not included in the credit risk capital requirement:

(1) An exchange rate contract with an original maturity of 14 calendar days or less (gold contracts do not qualify for this exception); and

(2) A derivative contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract.

#### § 930.6 Market risk capital requirement.

(a) *General requirement.* A Bank’s market risk capital requirement shall equal the market value of the Bank’s portfolio at risk from movements in interest rates, foreign exchange rates, commodity prices and equity prices as could occur during periods of extreme market stress, as determined using the Bank’s internal market risk model approved by the Finance Board.

(b) *Measurement of market value at risk under Bank internal market risk model.* (1) Each Bank shall use an internal market risk model that measures the market value at risk, from all sources of the Bank’s market risks, of its holdings of on-balance sheet assets

and liabilities and of off-balance sheet items, including related options.

(2) The Bank's internal market risk model may use any generally accepted measurement technique, such as variance-covariance models, historical simulations, or Monte Carlo simulations, for estimating the market value of the Bank's portfolio at risk, provided that any measurement technique used must cover the Bank's material risks.

(3) The value at risk measures shall include the risks arising from the non-linear price characteristics of options and the sensitivity of the market value of options to changes in the volatility of the option's underlying rates or prices.

(4) The Bank's internal market risk model shall use interest rate and market price scenarios for estimating the market value of the Bank's portfolio at risk, but must at a minimum include the following:

(i) Monthly estimates of the market value of the Bank's portfolio at risk so that the probability of a loss greater than that estimated shall be no more than 1 percent;

(ii) Scenarios that reflect changes in rates and market prices equivalent to those that have been observed over 90-business day periods of extreme market stress. For interest rates, the relevant historical observation period is to start from the end of the previous month and go back to the beginning of 1978;

(iii) The value at risk measure may incorporate empirical correlations among interest rates, subject to a Finance Board determination that the model's system for measuring such correlations is sound; and

(iv) The two interest rate scenarios required to be used by OFHEO to determine the risk-based capital requirements for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, pursuant to 12 U.S.C. 4611(a)(2).

(5) If the Bank participates in consolidated obligations denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, and these instruments have been hedged for foreign exchange, equity and commodity risks:

(i) The Bank's internal market risk model must calculate the market value of its portfolio at risk due to these market risks and using the qualitative and quantitative requirements specified in this section, *i.e.*, the probability of a loss greater than that estimated must not exceed 1 percent and must include scenarios that reflect changes in rates and market prices that have been observed over 90-business day periods of extreme market stress.

(ii) The historical data from an appropriate period and satisfactory to the Finance Board must be used.

(iii) The value at risk measure may incorporate empirical correlations within foreign exchange rates, equity prices, and commodity prices, but not among the three risk categories, subject to a Finance Board determination that the model's system for measuring such correlations is sound.

(iv) If there is a default on the part of a counterparty to a derivative (hedging) contract linked to foreign exchange rates, equity prices or commodity prices, the Bank must enter into a replacement contract in a timely manner and as soon as market conditions permit.

(c) *Independent validation of Bank internal market risk model.* (1) Each Bank shall conduct an independent validation of its internal market risk model within the Bank that is carried out by personnel not reporting to the business line responsible for conducting business transactions for the Bank, or obtain independent validation by an outside party qualified to make such determinations, on an annual basis, or more frequently as required by the Finance Board.

(2) The results of such independent validations shall be reviewed by the Bank's board of directors and provided promptly to the Finance Board.

(d) *Finance Board approval of Bank internal market risk model.* (1) *General.* Each Bank shall obtain approval from the Finance Board of its internal market risk model, including subsequent material adjustments to the model made by the Bank prior to its use. A Bank shall make any subsequent adjustments to its model that may be directed by the Finance Board.

(2) *Transition provision.* Each Bank shall submit its initial internal market risk model required to be adopted under paragraph (d)(1) of this section to the Finance Board for approval within one calendar year of the effective date of this section.

#### **§ 930.7 Operations risk capital requirement.**

A Bank's operations risk capital requirement shall at any time equal 30 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement at such time.

#### **§ 930.8 Reporting requirements.**

Each Bank shall report to the Finance Board by the 15th day of each month its minimum total risk-based capital requirement by component amounts (credit risk capital, market risk capital, and operations risk capital), and its

actual total capital amount and risk-based capital amounts calculated as of the last day of the preceding month, or more frequently as may be required by the Finance Board.

#### **§ 930.9 Capital stock redemption requirements.**

(a) *Redemption with Finance Board approval.* A Bank may redeem that portion of a member's capital stock allocated by the Bank to the Bank's total risk-based capital pursuant to § 930.1 only if the Finance Board has approved such redemption.

(b) *Redemption without Finance Board approval.* (1) A Bank may at any time redeem any portion of a member's capital stock not included in or allocated by the Bank to the Bank's total risk-based capital pursuant to § 930.1, provided that the member's minimum capital stock purchase requirement under sections 6(b)(1) and 10(e)(3) of the Act (12 U.S.C. 1426(b)(1), 1430(e)(3)) is maintained.

(2) A Bank may subject redemptions under paragraph (b)(1) of this section to the six-month notice provision in section 6(e) of the Act (12 U.S.C. 1426(e)), or may shorten or waive such six-month notice provision.

(3) A Bank, after providing 15 calendar days advance written notice to a member, may require redemptions under paragraph (b)(1) of this section, provided the minimum capital stock requirement under sections 6(b)(1) and 10(e)(3) of the Act (12 U.S.C. sections 1426(b)(1), 1430(e)(3)) is maintained. The Bank's implementation of such unilateral redemption policy shall be consistent with the requirement of section 7(j) of the Act (12 U.S.C. 1427(j)) that the affairs of the Bank shall be administered fairly and impartially and without discrimination in favor of or against any member borrower.

(4) A Bank may not impose on or accept from a member a fee in lieu of redeeming the member's capital stock under paragraph (b)(3) of this section.

#### **§ 930.10 Minimum liquidity requirements.**

In addition to meeting the deposit liquidity requirements contained in § 965.3 of this chapter, each Bank shall hold contingency liquidity in an amount sufficient to enable the Bank to meet its liquidity needs, which shall, at a minimum, cover seven calendar days of inability to access the consolidated obligation debt markets. An asset that has been pledged under a repurchase agreement cannot be used to satisfy minimum liquidity requirements.



**§ 930.11 Limits on unsecured extensions of credit to one counterparty or affiliated counterparties; reporting requirements for total extensions of credit to one counterparty or affiliated counterparties.**

(a) *Maximum capital exposure limits*—(1) *Unsecured extensions of credit to a single counterparty*—(i) *General requirement.* Unsecured extensions of credit by a Bank to a single counterparty that arise from authorized Bank on- and off-balance sheet transactions shall be limited to the maximum capital exposure limit applicable to such counterparty, as set forth in Table 4 of this paragraph (a), multiplied by the lesser of:

- (A) The Bank's total capital; or
- (B) The counterparty's Tier 1 capital, or total capital if Tier 1 capital is not available.

(ii) *Bank determination of credit ratings and applicable maximum exposure limits.* (A) The applicable maximum capital exposure limits for specific counterparties are specific maximum percentage limits assigned to such counterparties based on the credit rating of the counterparty, as provided in the following Table 4:

TABLE 4.—MAXIMUM LIMITS ON UNSECURED EXTENSIONS OF CREDIT TO A SINGLE COUNTERPARTY BY COUNTERPARTY CREDIT RATING CATEGORY

Credit rating of counterparty category	Maximum capital exposure limit (in percent)
(1) Highest Investment Grade	15
(2) Second Highest Investment Grade	12
(3) Third Highest Investment Grade	6
(4) Fourth Highest Investment Grade	1.5
(5) Below Investment Grade or Other	1

(B) In determining the applicable credit rating category under Table 4 for a specific counterparty that has received more than one rating from a given NRSRO, the most recent credit rating shall be used.

(C) If a specific counterparty has received credit ratings from more than one NRSRO, the lowest credit rating shall be used in determining the applicable credit rating category for such counterparty under Table 4.

(D) In the event a counterparty has received different credit ratings for its transactions with short-term and long-term maturities:

(1) The higher credit rating shall apply for purposes of determining the

allowable maximum capital exposure limit under Table 4 applicable to the total amount of unsecured credit extended by the Bank to such counterparty;

(2) The lower credit rating shall apply for purposes of determining the allowable maximum capital exposure limit under Table 4 applicable to the amount of unsecured credit extended by the Bank to such counterparty for the transactions with maturities governed by that rating.

(E) If a counterparty is placed on a credit watch for a potential downgrade by an NRSRO, the Bank shall determine its remaining available credit line for unsecured credit concentration exposures under Table 4 by assuming a credit rating from that NRSRO at the next lower grade.

(2) *Unsecured extensions of credit to affiliated counterparties.* The total amount of unsecured extensions of credit by a Bank to all affiliated counterparties may not exceed:

- (i) The maximum capital exposure limit applicable under Table 4 based on the highest credit rating of the affiliated counterparties;
- (ii) Multiplied by the lesser of:
  - (A) The Bank's total capital; or
  - (B) The combined Tier 1 capital, or total capital if Tier 1 capital is not available, of all of the affiliated counterparties.

(b) *Reporting requirements*—(1) *Total unsecured extensions of credit.* Each Bank shall report monthly to the Finance Board the amount of the Bank's total unsecured extensions of credit to any single counterparty or group of affiliated counterparties that exceeds 5 percent of:

- (i) The Bank's total capital; or
- (ii) The counterparty's, or affiliated counterparties' combined, Tier 1 capital, or total capital if Tier 1 capital is not available.

(2) *Total secured and unsecured extensions of credit.* Each Bank shall report monthly to the Finance Board the amount of the Bank's total secured and unsecured extensions of credit to any single counterparty or group of affiliated counterparties that exceeds 5 percent of the Bank's total assets.

13. New part 940 is added to subchapter F to read as follows:

**PART 940—CORE MISSION ACTIVITIES REQUIREMENTS**

- Sec.
- 940.1 Definitions.
- 940.2 Mission of the Banks.
- 940.3 Core mission activities.
- 940.4 Core mission activities requirements.
- 940.5 Transfers of core mission activities to another Bank.

940.6 Safe harbor for anticipated noncompliance.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1430, 1430b, 1431.

**§ 940.1 Definitions.**

As used in this part:

*Certain drawdown* has the meaning set forth in § 930.1 of this chapter.

*Community lending* has the meaning set forth in § 952.3 of this chapter.

*Eligible nonmember borrower* has the meaning set forth in § 930.1 of this chapter.

*Financial Management Policy* has the meaning set forth in § 930.1 of this chapter.

*Housing-related whole loans* means all whole loans, or participation interests in whole loans (excluding mortgage-backed securities), secured by one-to-four family property, multifamily property, or manufactured housing, including loans for the construction, purchase, improvement, rehabilitation, or refinancing of housing.

*Member mortgage assets* means those mortgage-related assets that may be acquired by a Bank under part 954 of this chapter.

**§ 940.2 Mission of the Banks.**

The mission of the Banks is to provide to members and eligible nonmember borrowers financial products and services, including but not limited to advances, that assist and enhance such members' and eligible nonmember borrowers' financing of:

- (a) Housing in the broadest sense, including single-family and multi-family housing serving consumers at all income levels; and
- (b) Community lending.

**§ 940.3 Core mission activities.**

The following Bank activities qualify as core mission activities:

(a) *Advances and advance commitments.* (1) Advances, and commitments to make advances with certain drawdown, to members or eligible nonmember borrowers with assets of \$500 million or less; and

(2) Advances, and commitments to make advances with certain drawdown, to members or eligible nonmember borrowers with assets greater than \$500 million, up to the total book value of the following assets held by such member or eligible nonmember borrower:

- (i) Housing-related whole loans;
- (ii) Loans and investments that are generated by community lending; and
- (iii) Mortgage-backed securities that comprise the types of loans described in paragraphs (a)(2) (i) and (ii) of this section originated by the member or eligible nonmember borrower;

- (b) Standby letters of credit;
- (c) Intermediary derivative contracts;
- (d) Member mortgage assets;
- (e) *Certain equity investments*. Equity investments:

(1) That primarily benefit low- or moderate-income individuals or areas, or other areas targeted for redevelopment by local, state, tribal or Federal government (including Federal enterprise communities and Federal empowerment zones) by providing or supporting one or more of the following activities:

(i) Affordable housing, community services, or permanent jobs for low- or moderate-income individuals; or

(ii) Area revitalization or stabilization;

(2) In small business investment companies formed pursuant to 15 U.S.C. 681(d) (SBICs), but only to the extent that the equity investment is structured to be matched by an equity investment in the same activity by a member or eligible nonmember borrower of the Bank making the equity investment; or

(3) In governmentally-aided economic development entities comparable to SBICs where the investment primarily benefits low- or moderate-income individuals or areas;

(f) The short-term tranche of SBIC securities guaranteed by the Small

Business Administration, which guarantee is backed by the full faith and credit of the United States;

(g) Section 108 Interim Notes and Participation Certificates guaranteed by the Department of Housing and Urban Development pursuant to section 108 of the Housing and Community Development Act of 1974 (as amended);

(h) Investments and obligations for housing and community development issued or guaranteed under Title VI of the Native American Housing Assistance and Self-Determination Act of 1996; and

(i) *Certain assets acquired under the Financial Management Policy*. Assets acquired pursuant to:

(1) Section II.B.11 of the Financial Management Policy prior to the effective date of this section; or

(2) Section II.B.12 of the Financial Management Policy, up to the greater of:

(i) The amount authorized by resolution of the Finance Board; or

(ii) The amount acquired prior to the effective date of this section.

**§ 940.4 Core mission activities requirements.**

(a) *Core mission activities ratio*. Subject to the transition period set forth in paragraph (d) of this section, and

pursuant to the Bank's mission achievement policy required to be adopted under § 917.9(a) of this section, each Bank shall have and maintain total core mission activities, as defined in § 940.3, (*i.e.*, an average book value of core mission on-balance sheet assets and off-balance sheet items converted to an on-balance sheet asset value equivalent as prescribed in paragraph (c) of this section) equal to a minimum of 100 percent of the average book value of the Bank's total outstanding consolidated obligations. The Bank's core mission activities ratio shall be calculated based on a moving 12-month average.

(b) *Reporting requirement*. Each Bank shall report to the Finance Board as of the last day of each calendar quarter its actual core mission activities ratio for the previous 12 months.

(c) *On-balance sheet asset value equivalents for off-balance sheet items*. The on-balance sheet asset value equivalent for each core mission off-balance sheet item is the measure of value of the item multiplied by its percent conversion factor as provided in the following Table 1:

TABLE 1.—CONVERSION FACTORS FOR CORE MISSION OFF-BALANCE SHEET ITEMS

Core mission off-balance sheet item	Measure of value	Conversion factor (in percent)
(1) Standby Letters of Credit (during transition period) ...	Face amount .....	100 minus that year's core mission activities requirement (in percent)
(2) Standby Letters of Credit (after transition period) .....	Fee Charged to Members ..	100
(3) Intermediary Derivative Contracts .....	Fee Charged to Members ..	100
(4) Commitments to Make Advances with Certain Draw-down.	Contractual .....	100

(d) *Transition provision*. (1) Pursuant to paragraph (b)(1) of this section, by January 1, 2001, each Bank shall have a minimum core mission activities ratio of 80 percent.

(2) Thereafter, each Bank's required minimum core mission activities ratio shall increase annually, on January 1 of each year, by 5 percentage points, up to a required minimum core mission activities ratio of 100 percent.

**§ 940.5 Transfers of core mission activities to another Bank.**

A core mission activity of a Bank, if transferred to another Bank, retains its status as a core mission activity with respect to the transferee Bank.

**§ 940.6 Safe harbor for anticipated noncompliance.**

(a) *Safe harbor requirements*. If, after conducting the annual risk management policy review and risk assessment

required under § 917.3 of this chapter and the annual mission achievement policy review required under § 917.9 of this chapter, a Bank's board of directors determines that, for a certain time period, it will not be consistent with continued safe and sound operation for the Bank to meet the core mission activities requirements of § 940.4(a), the Bank shall not be deemed to be out of compliance with § 940.4(a) for the time period specified by the Bank's board of directors, provided that:

(1) The determination by the Bank's board of directors that compliance will not be consistent with continued safe and sound operation is based upon a finding that, if the Bank were to comply with the core mission activities requirements during such time period, the Bank:

(i) Would likely be unable to meet the liquidity requirement of § 930.10 of this chapter, or any other regulatory

requirement related to the safety and soundness of its financial operation; or

(ii) Would likely be unable to provide a return on equity sufficient to retain members intending to make use of such Bank's products and services;

(2) The Bank fully documents the process of review, consideration and decision-making leading to such determination, including the reasons for the establishment of a specific time period as the minimum period of anticipated noncompliance; and

(3) The Bank's board of directors adopts a plan to achieve compliance with the core mission activities requirement at the earliest feasible and prudent date.

(b) *Waivers*. Under other circumstances, a Bank may request a waiver of the requirements in this part 940, pursuant to part 907 of this chapter (12 CFR part 907).

**PART 950—ADVANCES**

14. The authority citation for part 950 continues to read as follows:

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a)(1), 1426, 1429, 1430, 1430b and 1431.

15. Amend § 950.1 by revising the definition of "long-term advance" to read as follows:

**§ 950.1 Definitions.**

\* \* \* \* \*

*Long-term advance* means an advance with an original term to maturity greater than one year.

\* \* \* \* \*

16. Remove § 950.2.

17. Amend § 950.15 by:

a. Removing paragraphs (b)(1) and (b)(2); and

b. Redesignating paragraphs (a)(1) and (a)(2) as paragraphs (a) and (b), respectively.

18. New parts 954, 955 and 958 are added to subchapter G to read as follows:

**PART 954—MEMBER MORTGAGE ASSETS**

Sec.

954.1 Definitions.

954.2 Authorization to hold member mortgage assets.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1430, 1430b, 1431.

**§ 954.1 Definitions.**

As used in this section:

*Eligible nonmember borrower* has the meaning set forth in § 940.1 of this chapter.

*Residential real property* has the meaning set forth in § 950.1 of this chapter.

**§ 954.2 Authorization to hold member mortgage assets.**

Each Bank may hold assets or pools of assets acquired from or through its members or eligible nonmember borrowers, by means of either a purchase or a funding transaction involving the Bank and such member or eligible nonmember borrower, that meet each of the following requirements:

(a) The assets or pools of assets are either:

(1) Mortgages, or interests in mortgages, excluding one-to-four family mortgages where the loan amounts exceed the limits established pursuant to 12 U.S.C. 1717(b)(2);

(2) Loans, or interests in loans, secured by manufactured housing, regardless of whether such housing qualifies as residential real property; or

(3) State and local housing finance agency bonds; and

(b) The assets or pools of assets are either:

(1) Originated or issued by or through the member or eligible nonmember borrower; or

(2) Held for a valid business purpose by the member or eligible nonmember borrower prior to acquisition by the Bank; and

(c) The transactions through which the Bank acquires the assets or pools of assets are structured such that:

(1) The member or eligible nonmember borrower bears the amount of credit risk necessary to raise the assets or pools of assets to the fourth highest credit rating category;

(2) To the extent that the Bank requires, either at the time of acquisition or subsequently, that the assets or pools of assets have a higher credit rating, the member or eligible nonmember borrower bears at least 50 percent of any credit risk necessary to raise the assets or pools of assets from the fourth highest credit rating category to such higher credit rating category, up to the second highest credit rating category;

(3) If the credit risk-sharing requirements of paragraphs (c)(1) or (c)(2) of this section do not result in the member or eligible nonmember borrower bearing a material portion of the credit risk, the member or eligible nonmember borrower bears a material portion of the credit risk, up to the second highest credit rating; and

(4) To the extent that the U.S. government has insured or guaranteed the credit risk of the asset or pool of assets, the member or eligible nonmember borrower may rely upon that insurance or guarantee to meet all or part of the risk-bearing requirements of paragraphs (c)(1) and (c)(2) of this section; however, to the extent that the U. S. government insurance or guarantee is insufficient or incomplete, the portion of the risk-bearing requirements not met by the government insurance or guarantee must be borne by the member or eligible nonmember borrower.

**PART 955—FEDERAL HOME LOAN BANK INVESTMENTS**

Sec.

955.1 Definitions.

955.2 Authorized investments.

955.3 Prohibited investments and prudential rules.

955.4 Use of hedging instruments.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1431, 1436.

**§ 955.1 Definitions.**

As used in this part:

*Deposits in banks or trust companies* has the meaning set forth in § 965.1 of this chapter.

*Financial Management Policy* has the meaning set forth in § 930.1 of this chapter.

*GAAP* means Generally Accepted Accounting Principles.

*Investment grade* has the meaning set forth in § 930.1 of this chapter.

*Member mortgage assets* means those mortgage-related assets that may be acquired by a Bank under part 954 of this chapter.

**§ 955.2 Authorized investments.**

Except as provided in § 955.3, and subject to the applicable limitations set forth in this part and in part 954, each Bank may invest in:

(a) Obligations of the United States;

(b) Deposits in banks or trust companies;

(c) Obligations, participations or other instruments of, or issued by, the Federal National Mortgage Association or the Government National Mortgage Association;

(d) Mortgages, obligations, or other securities that are, or ever have been, sold by the Federal Home Loan Mortgage Corporation pursuant to 12 U.S.C. 1454 or 1455;

(e) Stock, obligations, or other securities of any small business investment company formed pursuant to 15 U.S.C. 681(d), to the extent such investment is made for purposes of aiding members of such Bank; and

(f) Instruments that the Bank has determined are permissible investments for fiduciary or trust funds under the laws of the state in which the Bank is located.

**§ 955.3 Prohibited investments and prudential rules.**

(a) *Prohibited investments.* A Bank may not invest in:

(1) Instruments that provide an ownership interest in an entity and that do not qualify as a core mission activity under § 940.3 of this chapter;

(2) Instruments issued by non-United States entities, except United States branches and agency offices of foreign commercial banks;

(3) Debt instruments that are not rated as investment grade, except for debt instruments that were downgraded to a below investment grade rating after purchase by the Bank; or

(4) Whole mortgages or other whole loans, or interests in mortgages or loans, except:

(i) Member mortgage assets;

(ii) Mortgage-backed securities that meet the definition of the term "securities" under 15 U.S.C. 77b(a)(1); and

(iii) Loans held or acquired pursuant to section 12(b) of the Act (12 U.S.C. 1432(b)).

(b) *Foreign currency or commodity positions prohibited.* A Bank may not take a position in any commodity or foreign currency. If a Bank participates in consolidated obligations denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, the currency, commodity and equity risks must be hedged.

(c) *Transition provision.* A Bank may not make any investments that were not permitted under the Finance Board's Financial Management Policy in effect prior to the effective date as to such Bank of this part 955 until:

(1) The Bank has received Finance Board approval of the Bank's initial internal market risk model;

(2) The Bank demonstrates to the Finance Board that it has sufficient risk-based capital to meet the minimum total risk-based capital requirement under § 930.4(b) of this chapter for its then-current portfolio; and

(3) The Bank demonstrates to the Finance Board adequate credit risk assessment and procedures and controls sufficient to show control over credit, market and operations risks.

#### § 955.4 Use of hedging instruments.

(a) *Speculative use prohibited.* A Bank shall not make speculative use of hedging instruments.

(b) *Applicability of GAAP.* All transactions entered into by a Bank for hedging purposes shall meet the requirements for a hedge under GAAP.

(c) *Documentation requirements.* (1) A Bank's hedging strategies must be explicitly stated at the time of execution of the hedge, and adequate documentation of the hedge must be maintained during the life of the hedge.

(2) Transactions with a single counterparty shall be governed by a single master agreement when practicable.

(3) A Bank's agreement with the counterparty for over-the-counter derivative contracts shall include:

(i) A requirement that market value determinations and subsequent adjustments of collateral be made at least on a monthly basis;

(ii) A statement that failure of a counterparty to meet a collateral call will result in an early termination event;

(iii) A description of early termination pricing and methodology, with the methodology reflecting a reasonable estimate of the market value of the over-the-counter derivative contract at termination (Standard International Swaps and Derivatives Association, Inc. language relative to early termination pricing and methodology may be used to satisfy this requirement); and

(iv) A requirement that the Bank's consent be obtained prior to the transfer of an agreement or contract by a counterparty.

#### PART 958—OFF-BALANCE SHEET ITEMS

Sec.

958.1 Definitions.

958.2 Authorized off-balance sheet items.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1429, 1430, 1430b, 1431.

##### § 958.1 Definitions.

As used in this part:

*Derivative contracts* has the meaning set forth in § 930.1 of this chapter.

*Repurchase agreement* has the meaning set forth in § 930.1 of this chapter.

##### § 958.2 Authorized off-balance sheet items.

(a) *Authorization.* A Bank may enter into the following types of off-balance sheet transactions:

(1) Standby letters of credit, pursuant to the requirements of 12 CFR part 959;

(2) Derivative contracts;

(3) Forward asset purchases and sales; and

(4) Commitments to make advances or other loans.

(b) *Speculative use prohibited.* A Bank shall not make speculative use of derivative contracts.

19. New part 965 is added to subchapter H to read as follows:

#### PART 965—SOURCES OF FUNDS

Sec.

965.1 Definitions.

965.2 Authorized liabilities.

965.3 Liquidity reserves for deposits.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1431.

##### § 965.1 Definitions.

As used in this part:

*Deposits in banks or trust companies* means:

(1) A deposit in another Bank;

(2) A demand account in a Federal Reserve Bank;

(3) A deposit in, or a sale of federal funds to:

(i) An insured depository institution, as defined in section 2(12)(A) of the Act (12 U.S.C. 1422(12)(A)), that is designated by a Bank's board of directors;

(ii) A trust company that is a member of the Federal Reserve System or insured by the Federal Deposit Insurance Corporation, and is designated by a Bank's board of directors; or

(iii) A U.S. branch or agency of a foreign bank, as defined in the

International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*), that is subject to the supervision of the Board of Governors of the Federal Reserve System, and is designated by a Bank's board of directors.

*Repurchase agreement* has the meaning set forth in § 930.1 of this chapter.

##### § 965.2 Authorized liabilities.

(a) As a source of funds for business operations, each Bank is authorized to incur liabilities by:

(1) Acting as joint and several obligor with other Banks on consolidated obligations, as authorized under part 966 of this chapter;

(2) Accepting time or demand deposits from members, other Banks and instrumentalities of the United States, so long as the deposit transaction is not conducted in such a way as to result in the offer or sale of a security in a public offering as those terms are used in 15 U.S.C. 77b(3); or

(3) Solely in order to satisfy the Bank's short-term liquidity needs:

(i) Purchasing federal funds; and

(ii) Entering into repurchase agreements.

(b) Consolidated obligations shall not be directly placed with any Bank.

##### § 965.3 Liquidity reserves for deposits.

Each Bank shall at all times have at least an amount equal to the current deposits received from its members invested in:

(a) Obligations of the United States;

(b) Deposits in banks or trust companies; or

(c) Advances with a maturity of not to exceed five years that are made to members in conformity with part 950 of this chapter.

#### PART 966—CONSOLIDATED OBLIGATIONS

20. The authority citation for part 966 continues to read as follows:

**Authority:** 12 U.S.C. 1422b, 1431.

21. Amend § 966.2 by:

a. Removing paragraph (b);

b. Redesignating paragraph (c) as paragraph (b); and

c. Revising the reference to "paragraphs (c)(1) through (6)" in the last sentence of § 966.2 to read "paragraphs (b)(1) through (6)."

22. Amend § 966.7 by revising paragraph (b) to read as follows:

##### § 966.7 Reservation of right to revoke or amend; limitations thereon.

\* \* \* \* \*

(b) *Limitation on amendment of negative pledge requirement.* No

revocation or relaxation of any of the restrictions or requirements contained in or imposed by § 966.2(b) shall be effected except if there are no senior bonds then outstanding or the principal of and interest to date of maturity or to such date designated for redemption and any redemption premium on all senior bonds the holders of which have not consented to such revocation or relaxation has been fully defeased.

23. New part 980 is added to subchapter J to read as follows:

#### **PART 980—NEW BUSINESS ACTIVITIES**

Sec.

980.1 Definitions.

980.2 Prior notice to Finance Board.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1431(a), 1432(a).

#### **§ 980.1 Definitions.**

As used in this part:

*New business activity means*, with respect to a particular Bank's activities:

(1) An activity that was not previously undertaken by that Bank, or was undertaken under materially different terms and conditions;

(2) An activity that entails risks not previously and regularly managed by that Bank or its members; or

(3) An activity that introduces operations not substantially equivalent to operations currently managed by that Bank.

#### **§ 980.2 Prior notice to Finance Board.**

A Bank may undertake a new business activity after providing 30 days notice of such new business activity to the Finance Board, unless otherwise directed by the Finance Board.

Dated: September 1, 1999.

By the Board of Directors of the Federal Housing Finance Board.

**Bruce A. Morrison,**

*Chairman.*

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