



Federal Register

**Thursday,
July 13, 2000**

Part II

Federal Housing Finance Board

12 CFR Part 917, et al.

**Capital Requirements for Federal Home
Loan Banks; Proposed Rule**

FEDERAL HOUSING FINANCE BOARD**12 CFR Parts 917, 925, 930, 931, 932, 933, 956, and 960****[No. 2000-23]****RIN 3069-AB01****Capital Requirements for Federal Home Loan Banks****AGENCY:** Federal Housing Finance Board.**ACTION:** Proposed rule.

SUMMARY: The Federal Housing Finance Board (Finance Board) proposes to amend its regulations to implement a new capital structure for the Federal Home Loan Banks (Banks), as is required by the Gramm-Leach-Bliley Act. The proposed rule would establish risk-based, leverage, and operations capital requirements for the Banks. It also addresses the different classes of stock that a Bank may issue, the rights and preferences that may be associated with each class of stock, and the capital plans that each Bank must submit for Finance Board approval.

DATES: The Finance Board will accept written comments on the proposed rule that are received on or before October 11, 2000.

ADDRESSES: Send comments to: Elaine L. Baker, Secretary to the Board, at the Federal Housing Finance Board, 1777 F Street, N.W., Washington, D.C. 20006. Comments will be available for 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; Ellen Hancock, Senior Financial Analyst, (202) 408-2906; or Christina Muradian, Senior Financial Analyst, (202) 408-2584; or Julie Paller, Senior Financial Analyst, (202) 408-2842, Office of Policy, Research and Analysis; or Deborah F. Silberman, General Counsel, (202) 408-2570; Neil R. Crowley, Deputy General Counsel, (202) 408-2990; or Thomas E. Joseph, Attorney-Advisor, (202) 408-2512, Office of General Counsel, Federal Housing Finance Board, 1777 F Street, N.W., Washington, D.C. 20006.

SUPPLEMENTARY INFORMATION:**I. Statutory and Regulatory Background***A. The Bank System*

The twelve Banks are instrumentalities of the United States organized under the authority of the Federal Home Loan Bank Act (Bank Act). 12 U.S.C. 1423, 1432(a), *as amended*. The Banks are a "government

sponsored enterprise" (GSE), *i.e.*, a federally chartered but privately owned institution created by Congress to serve a public purpose. The purpose of the Bank System is to support the financing of housing and community lending. *See* 12 U.S.C. 1422a(a)(3)(B)(ii), 1430(i), (j)(10) (1994). As with other GSEs, Congress has granted the Banks certain benefits, including an exemption from registration of their securities under federal securities laws, an exemption from state and local corporate taxation, and an ability to sell debt obligations (at the discretion of the Secretary of the Treasury) to the United States Treasury, that enable them to borrow in the capital markets on favorable terms. Typically, the Banks are able to borrow at a spread that is over the rates on U.S. Treasury securities of comparable maturity but which is less than the rates available to comparably situated private corporate borrowers. The Banks pass along that funding advantage to their members—and ultimately to consumers—by providing advances (secured loans) and other financial services at rates that their members generally could not obtain on their own.

The Banks also are cooperatives, meaning that only their members may own the capital stock and share in the profits of the Banks and only their members, and certain eligible associates (such as state housing finance agencies), may borrow from or use the other products and services provided by the Banks. 12 U.S.C. 1426, 1430(a), 1430b, *as amended*. Each Bank is managed by a board of directors, a majority of whom are elected by its members and the remainder of whom are appointed by the Finance Board. 12 U.S.C. 1427, *as amended*. An institution that is eligible (typically, an insured depository institution) may become a member of a Bank if it satisfies certain statutory criteria and purchases a specified amount of the Bank's capital stock. 12 U.S.C. 1424, 1426 (1994). 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 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) (1994).

B. Federal Home Loan Capital Structure

Since its enactment in 1932, the Bank Act has provided for a "subscription" structure for the capital of the Banks. Under that structure, the amount of capital stock each Bank issued was determined as a percentage of either the total mortgage assets of each member of the Bank or the dollar amount of advances outstanding to each member, whichever was greater. The subscription capital structure was deficient in certain respects, most notably in that the amount of capital each Bank was required to hold bore no relationship to the risks posed by its activities. Moreover, the subscription capital structure caused the Banks to become substantially overcapitalized in relation to the risks they face. The amount of excess capital contributed to an increase in the amount of arbitrage investments made by the Banks, *i.e.*, investments in assets such as money market instruments or mortgage-backed securities that do not advance the housing finance and community lending mission of the Banks. The substantial amount of the non-mission investments held by the Banks collectively, though diminishing in recent years as a percentage of their assets, has been the subject of much criticism from the Administration and the Congress, and was one issue that the Congress intended to address by reforming the capital structure and other aspects of the Bank System. The Congress recognized that if it were to eliminate mandatory membership for federal savings associations, and thus remove the only permanent capital from the Bank System, it also would have to create a new capital structure that would include capital elements with more permanence than one based solely on 6-month redeemable stock.

C. The Gramm-Leach-Bliley Act

On November 12, 1999, the President signed the Gramm-Leach-Bliley Act, Pub. Law No. 106-102, 133 Stat. 1338 (Nov. 12, 1999) (GLB Act), which, among other things, substantially amended the provisions of the Bank Act that relate to the capital structure of the Banks. 12 U.S.C. 1426, *as amended*. As a result of those amendments, the existing subscription capital structure will be replaced over a period of several years by a more modern capital structure, with risk-based and leverage capital requirements that are similar to those applicable to depository institutions and to the other housing GSEs. The GLB Act provides for a transition period to the new capital structure of up to approximately five

years from the date of enactment, during which time the prior capital provisions are to remain in effect. The GLB Act requires the Finance Board to promulgate uniform capital regulations for the Banks no later than November 12, 2000. Under the new structure, each Bank will be required to maintain amounts of total capital and permanent capital that are sufficient to comply with the minimum leverage and risk-based capital requirements, respectively, established by the GLB Act.

The GLB Act requires each Bank to maintain a ratio of total capital to total assets of at least 4 percent. Total capital is defined to include a Bank's permanent capital (defined below), plus the amounts paid-in by members for Class A stock (which is redeemable on 6 months written notice), any general loss allowance (if consistent with generally accepted accounting principles (GAAP) and not established for specific assets), and other amounts from sources determined by the Finance Board as available to absorb losses. Permanent capital is defined as the amounts paid-in by members for the Class B stock (which is redeemable on 5 years written notice), plus the amount of a Bank's retained earnings, as determined in accordance with GAAP. In addition to requiring total capital of 4 percent, the GLB Act requires the Banks to maintain a leverage ratio of 5 percent. In calculating the leverage ratio, the amount paid-in for Class B stock and the amount of retained earnings are multiplied by 1.5, while other capital items are counted at face value. The risk-based capital provision requires each Bank to maintain permanent capital in an amount sufficient to meet the credit and market risks to which the Bank is subject, with the market risk being based on a stress test established by the Finance Board that tests for changes in certain specified market variables.

The GLB Act further requires the capital regulations to address a number of other matters, such as the classes of stock that a Bank may issue, the rights, terms, and preferences that may be established for each class, the issuance, transfer, and redemption of Bank stock, and the liquidation of claims against a withdrawing member. The rules must permit each Bank to issue Class A or Class B stock, or both, with the board of directors of each Bank to determine the rights, terms, and preferences for each class. Both Class A and Class B stock may be issued only to and held only by members of the Bank, and the regulations are to provide the manner in which the stock may be sold,

transferred, redeemed, or repurchased. The rules also must address the manner in which a Bank is to liquidate any claims against its members.

The GLB Act separately establishes a number of other capital-related requirements, which pertain to matters such as the termination of an institution's Bank membership, the ability of a Bank to redeem excess stock held by a member (*i.e.*, stock that is in excess of the amount each member is required to hold), restrictions on the ability of a Bank to redeem stock when its capital is impaired, restrictions on readmission to membership after withdrawing, and the ownership of the retained earnings by the Class B stockholders.

Within 270 days after the publication of the final capital rule, the board of directors of each Bank must submit for Finance Board approval a capital plan that the board determines is best-suited for the Bank and its members. Any amendments to the plan also must be approved in advance by the Finance Board. The law does not specify a period of time within which the Finance Board must approve the plans, which allows for the possibility that a Bank may be required to revise its plan before obtaining Finance Board approval. The GLB Act requires the plan to include certain provisions, requires that it be consistent with the regulations adopted by the Finance Board, and that when implemented it must provide the Bank with sufficient capital to meet both the leverage and risk-based capital requirements. Each plan also must include certain provisions specified by the GLB Act. Those provisions relate to the minimum investment required of each member in order for the Bank to meet its regulatory capital requirements, the effective date of the plan and the length of its transition period (which may be up to 3 years from the effective date of the plan), the classes of stock to be offered by the Bank and the rights, terms, and preferences associated with each class, the transferability of the Bank stock, the disposition of Bank stock held by institutions that withdraw from membership, and review of the plan by an independent accountant and a credit ratings agency. Those provisions are only the minimum contents required by the GLB Act; the Finance Board may require that other provisions be included in each plan, and the Banks as well may include other provisions in their plans, provided they are consistent with the Bank Act and the regulations of the Finance Board.

D. Federal Home Loan Bank Stock

Section 6 of the Bank Act, as in effect prior to the GLB Act, authorized the Banks to issue stock, specified the characteristics of the stock, and addressed the manner in which the stock may be issued, transferred, and redeemed. 12 U.S.C. 1426 (1994). Since the establishment of the Bank System in 1932, each of the Banks has been authorized to issue a single class of stock, which could be issued and redeemed only at its statutory par value of \$100 per share. An institution becoming a Bank member was required to subscribe for a certain minimum amount of the Bank's stock, for which it was required to pay in full and in cash at the time of its application.¹

The amount of the initial stock subscription required for membership was the greater of \$500, 1.0 percent of the member's mortgage assets, or 0.3 percent of the member's total assets.² 12 U.S.C. 1426(b), 1430(e) (1994). If a member were to borrow from its Bank, the amount of Bank stock it was required to own could not be less than 5.0 percent of the amount of Bank advances outstanding to the member. Each Bank was required to adjust the minimum stock investment required of each member, as of December 31st of each year, so that each member would own at least the required minimum amount of Bank stock, based on a percentage of either its assets or advances, whichever amount was higher. Each Bank had the discretion to retire any "excess" stock held by a member, *i.e.*, stock in excess of the

¹ A member also was allowed to purchase the stock in installments, under which it would pay one-quarter of the full amount at the time of application, and the remainder in three installments over the following 12 months. 12 U.S.C. 1426(c) (1994).

² The Bank Act referred to a member's "aggregate unpaid loan principal", which the Finance Board has defined to include a variety of mortgage assets, such as home mortgage loans, combination loans, and mortgage pass-through securities. 12 U.S.C. 1426(b)(1) (1994); 65 Fed. Reg. 8253 (Feb. 18, 2000), to be codified at 12 CFR 925.1. For purposes of applying the 1.0 percent of mortgage assets test, the Bank Act also established a statutory presumption that each member had at least 30 percent of its assets in mortgage related instruments. 12 U.S.C. 1430(e)(3) (1994). The effect of the presumption was that commercial banks (which typically have a lower percentage of their assets in mortgage related instruments than do savings associations) were required to maintain a minimum investment equal to the greater of 1.0 percent of mortgage assets, 0.3 percent of total assets, or 5.0 percent of outstanding advances. Separately, a member that was not a "qualified thrift lender" (QTL), *i.e.*, an institution with less than 65 percent of its assets in certain mortgage related instruments, was subject to a higher "percentage of advances" requirement, which would vary inversely with its QTL ratio.

minimum required for that member, upon the application of the member.

Once issued, the stock of a Bank could be transferred only between the member and the Bank or, with the approval of the Finance Board, from one member to another member or to an institution in the process of becoming a member. The Bank Act also required that all stock issued by a Bank share in dividends equally and without preference. The Bank Act also allowed any member, other than a federal savings and loan association, to withdraw from membership by providing six months written notice to the Finance Board. At the end of the six-month notice period, and provided that all indebtedness owed by the withdrawing member to the Bank had been liquidated, a Bank could redeem the stock of the withdrawing member, paying cash to the member equal to the par value of the stock. Any such withdrawing member could not rejoin the Bank system for 10 years, with only limited exceptions.

The Bank stock currently outstanding carries only limited voting rights. The members of each Bank have the right to elect a majority of its directors, typically eight of fourteen directorships, but do not vote on any other matters. The number of votes each member may cast in an election of directors is tied to the amount of Bank stock it is "required to hold" under the subscription capital provisions. Section 7 of the Bank Act provides that the number of votes each member may cast is equal to the number of shares of Bank stock "required [by Section 6 of the Bank Act] to be held by [each] member at the end of the calendar year next preceding the election" of directors. 12 U.S.C. 1427(b) (1994). As noted above, at the end of each year each member was required to hold Bank stock equal to the greater of \$500, 1.0 percent of its mortgage assets, 0.3 percent of its total assets, or 5.0 percent of its outstanding advances. For voting purposes, however, Section 7 limits the number of votes that any member may cast at the average number of shares of Bank stock "required to be held" by the members located in the same state at the end of the prior calendar year. Thus, for any members that hold stock in excess of the average for their state, those excess shares are divested of their voting rights.³ As

amended by the GLB Act, all of Section 6 of the Bank Act has been revised and no longer requires a member to hold a particular amount of Bank stock as of the end of the calendar year. Similarly, the Bank Act no longer establishes a required investment for each member. Instead, Section 6 of the Bank Act now authorizes each Bank to determine the amount and nature of any investment each member must maintain in the capital stock of the Bank, and requires each Bank to address the voting rights for each class of stock in its capital structure plan, subject to the approval of the Finance Board.

E. The Financial Management and Mission Achievement Proposal

In 1999 the Finance Board proposed to adopt a risk-based capital requirement as part of its "Financial Management and Mission Achievement" (FMMA) rulemaking, 64 FR 52163 (Sept. 27, 1999). The capital provisions of the FMMA would have established a "minimum total capital requirement" and a "minimum total risk-based capital requirement" for each Bank. Under the total risk-based capital requirement a Bank would have been required to maintain "total risk-based capital" in an amount sufficient to meet the sum of its credit risk, market risk, and operations risk capital requirements, each of which would have been established by the proposed rule. The credit risk aspect of the FMMA would have addressed the credit risks to which each Bank is exposed with respect to both its on- and off-balance sheet items, using data from Nationally Recognized Statistical Rating Organizations (NRSRO) to estimate the credit losses likely to be associated with particular classes of items during periods of extreme credit stress. The FMMA would have established the market risk capital requirement based on the market value of a Bank's portfolio at risk from movements in market prices, such as interest rates, foreign exchange rates, commodity prices, or equities prices, that might occur during periods of extreme market stress. The proposal would have allowed for the use of a Bank's internal market risk model, which was to have been approved by the Finance Board. The FMMA would have required each Bank to maintain capital in an amount equal to 30 percent of the sum of its credit risk capital and market risk capital

requirements in order to support the operations risks to which the Bank is exposed. The FMMA also would have required the Banks to maintain both a System-wide and individual Bank credit ratings, at levels specified by the proposed rule, and would have required each Bank to maintain "contingency liquidity" in an amount sufficient to enable the Bank to meet its obligations if it were unable to borrow in the capital markets for seven consecutive days. The proposal included provisions limiting the amount of unsecured credit that a Bank could have outstanding to any single counterparty (or to affiliated counterparties) and would have addressed the extent to which the Banks may use hedging instruments. The Finance Board withdrew the FMMA proposal following the enactment of the GLB Act. Board Resolution No. 99-56 (Nov. 15, 1999); 64 FR 66115 (Nov. 24, 1999).

With the enactment of the GLB Act, certain aspects of the proposed FMMA capital rule, such as those pertaining to the types of capital required for the leverage and risk-based capital requirements, no longer would be consistent with Section 6 of the Bank Act, as amended. Other aspects of the capital rules proposed as a part of FMMA, however, remain generally consistent with the amended statute, particularly as it relates to the capital required to be held against credit risk and market risk. The GLB Act requires the Finance Board to adopt a risk-based capital regulation that requires the Banks to maintain sufficient permanent capital to meet the credit risks to which they are subject, but does not otherwise provide how the credit risk is to be measured. Similarly, the GLB Act provides that the market risk element of the risk-based capital requirement must be based on a stress test developed by the Finance Board that "rigorously tests for changes in market variables, including changes in interest rates, rate volatility, and changes in the shape of the yield curve." The GLB Act does not further specify the provisions of the stress test, other than to require that the Finance Board give "due consideration" to any risk-based capital rules promulgated by the Office of Federal Housing Enterprises Oversight (OFHEO) with respect to Fannie Mae and Freddie Mac. Moreover, the GLB Act does not preclude the Finance Board from incorporating other elements into the risk-based capital rules, such as a requirement to hold some amount of capital to cover the operations risks to which the Banks are subject. In considering the requirements of the GLB

³ The Bank Act provides generally that each Bank is to have a board of fourteen directors, eight of whom are elected by the members and six of whom are appointed by the Finance Board. 12 U.S.C. 1427(a) (1994). The elected directorships for each Bank are allocated among the states in each Bank district, based on the amount of stock held by members in the respective states, subject to certain

"grandfather" provisions that reserve a specified number of directorships to particular states (based on relative stock ownership in 1960) and certain discretionary authority conferred on the Finance Board to establish a limited number of additional seats in certain Bank districts.

Act for the credit and market risk elements of the capital rules, the Finance Board has determined that in many respects the underlying methodology of the credit and market risk provisions of the capital rules that were proposed as part of the FMMA are consistent with the requirements of the GLB Act. Accordingly, the proposed rule builds on those provisions, as well as on the provisions of the FMMA relating to operating risk.

II. The Proposed Rule

A. Issuance of Bank Stock.

In General. The GLB Act provides that the capital regulations are to permit each Bank to issue "any one or more" of Class A or Class B stock. Class A stock is to be redeemable at par on six months written notice to the Bank; Class B stock is to be redeemable at par on five years written notice to the Bank. The board of directors of each Bank is to determine the "rights, terms, and preferences" for each class of stock, consistent with Section 6 of the Bank Act, with the regulations of the Finance Board, and with market requirements. The regulations are required to prescribe the manner in which Bank stock may be "sold, transferred, redeemed, or repurchased." The regulations also are required to restrict the issuance and ownership of Bank stock to the members of the Bank, to prohibit the issuance of other classes of stock, and to provide for the liquidation of claims and the redemption of stock upon an institution's withdrawal from membership in its Bank.

Apart from authorizing the issuance of two classes of Bank stock, the GLB Act eliminated certain key characteristics of the single class of Bank stock that had been established under prior law. For example, the Bank Act no longer mandates a statutory par value for all Bank stock of \$100 per share and no longer requires all Bank stock to be issued at par value.⁴ As a result, the Bank Act now authorizes a Bank to establish the par value for its Class A and Class B stock (which may differ), and permits the issuance of stock at a price other than par value. The proposed rule includes provisions that implement those changes in the law, as described below.

Classes of Stock. In authorizing the new capital structure for the Banks, the GLB Act provides that the regulations

promulgated by the Finance Board "shall * * * permit each Federal home loan bank to issue * * * any 1 or more of * * * Class A stock * * * and * * * Class B stock." 12 U.S.C. 1426(a)(4)(A), *as amended*. The GLB Act also provides that the capital structure plan for each Bank "shall afford each member * * * the option of maintaining its required investment in the bank through the purchase of any combination of classes of stock authorized by the board of directors of the bank and approved by the Finance Board." *Id.*, 1426(c)(4)(A), *as amended*. Although the GLB Act gives the members the option to decide how to allocate their required investment if a Bank issues both Class A and Class B stock, that option applies only to whatever "classes of stock [are] authorized by the board of directors of the bank" and must be read in light of the other provisions that permit each Bank to issue "any 1 or more" classes of stock. The directive that the regulations must allow a Bank to issue "any 1 or more" class of stock clearly contemplates that a Bank may issue only a single class of stock. Provided that a Bank's board of directors were to determine that a single class structure would be in the best interest of the Bank and its members, such a stock structure would be legally permissible.

Accordingly, the proposed rule would permit each Bank to issue either Class A stock or Class B stock, or to issue both Class A and Class B stock. Whatever classes the board of directors of a Bank authorizes, the capital plan must demonstrate that the classes of stock to be issued will result in the Bank having sufficient amounts of permanent capital (*i.e.*, the amounts paid-in for the Class B stock, plus retained earnings) to meet the regulatory risk-based capital requirement and sufficient amounts of total capital (*i.e.*, permanent capital plus the amounts paid-in for Class A stock, certain loss allowances, and other items capable of absorbing losses) to meet the regulatory total capital requirement. For example, if a Bank were to increase its retained earnings to an amount that would provide sufficient permanent capital to comply with the regulatory risk-based capital requirement it may not need to issue any Class B stock. Alternatively, if a Bank were to have only a minimal amount of retained earnings it may need to issue only Class B stock in order to have sufficient permanent capital to meet the regulatory risk-based capital requirement.

The proposed rule would define the essential characteristics of both Class A and Class B stock. As required by the GLB Act, Class A stock would be

redeemable in cash at its par value on six-months written notice to the Bank. The Finance Board is proposing to require that the Class A stock have a par value of \$100 per share and that it be issued at par value. Because the current capital stock of the Banks has a par value of \$100 per share and is issued and redeemed at par, the Finance Board believes that establishing the same characteristics for the Class A stock would facilitate the transition to the new capital structure. The proposed rule also would require each Bank to specify in its capital plan a stated dividend for the Class A stock, which would have a priority over the payment of any dividends paid on Class B stock. The Finance Board anticipates that the stated dividend would be commensurate with the risks of holding an instrument that is puttable to the issuer on six months notice. By definition, the Class B stock entails a greater risk to the member because its investment is committed to the Bank for at least five years. The Finance Board believes (and has been so advised by a financial consultant retained by the Banks) that members will demand some form of control over the affairs of the Bank in return for putting their capital at risk for five years. In that event, the members holding Class B stock likely would control the board of directors of the Bank, and thus would be in a position to determine the dividend to be paid on the Class A stock. The Finance Board has included the requirement that the Class A stock pay a stated dividend as a means of ensuring that the Class B stockholders would not be able to reduce or eliminate the dividend for the Class A stock, should they control the board of directors.

Certain of the essential characteristics of Class B stock would differ from those established for the Class A stock. As with the Class A stock (and as required by the GLB Act) the proposed rule would provide that the Class B stock must be redeemable in cash and at par value on five-years written notice to the Bank. The Class B stock would differ from the Class A stock with regard to its par value and its issuance price, which could be different from its par value. Allowing the Banks to set an issuance price above the par value of the Class B stock should result in a greater degree of permanence for the Class B stock that would be more in the nature of common stock. The proposed rule would not require a Bank to issue the Class B stock above par value, but simply would allow a Bank that option. A Bank could issue Class B at par if it wished to do so. The proposed rule also would

⁴ 12 U.S.C. 1426(a) (1994). The minimum amount of Bank stock that each member was required to purchase had to be issued at par value. Any subsequent issuance could be at a price in excess of par value, but not less than par value. As a matter of practice, the stock of the Banks has been issued at par value.

provide that a fundamental characteristic of the Class B stock is that it would confer on the member an ownership interest in the retained earnings of the Bank upon acquisition of the stock. The GLB Act provides that the holders of the Class B stock shall own the retained earnings of each Bank, which is consistent with the attributes of permanent equity capital in a corporate setting.

Subclasses of Stock. The GLB Act requires the capital regulations to provide that a Bank may not issue stock other than as authorized by Section 6 of the Bank Act, and that the stock is to have “such rights, terms, and preferences * * * as the board of directors of that Bank may approve.” Separately, the GLB Act requires the capital plan for each Bank to establish the “terms, rights, and preferences, including minimum investment, dividends, voting, and liquidation preferences for each class of stock issued by the bank.” 12 U.S.C. 1426(a)(4)(A), (c)(4)(B), *as amended*. The Finance Board construes this language as authorizing a Bank to establish rights, terms, and preferences for Class A stock that differ from those established for the Class B stock. The Finance Board also believes that the authority to establish different rights, terms, or preferences for the stock should apply within a particular class of stock as well as between the two different classes. For example, the repeal of the requirement that all stock must be issued at par would allow a Bank to issue two types of Class B stock—one type that was issued at par and another that was issued above par. Although both types of stock would possess the minimum characteristics required for Class B stock, *i.e.*, they would be redeemable on five years written notice to the Bank, they would have been issued on materially different terms. The same rationale would apply if a Bank were to issue one type of Class B stock for which the dividend is to be determined based on the performance of a specific category of Bank assets and other Class B stock for which the dividend would be determined on the general profitability of the Bank. Because the board of directors of a Bank clearly has the authority to establish different rights, terms, and preferences for the Bank stock, the Finance Board believes it would be appropriate to allow a Bank to designate stock of the same class that possesses different rights as separate subclasses of that class.

Issuance of Capital Stock. The proposed rule would allow each Bank to determine whether to issue either Class A or Class B stock, or both Class A and

Class B stock, and whether to issue any subclasses of stock. In accordance with the GLB Act, the proposed rule also would provide that a Bank may issue its capital stock only to its members, and may not issue any other types or classes of capital stock. The proposal would require a Bank to act as its own transfer agent, and to issue its capital stock only in book-entry form, which is consistent with the current practice at each of the Banks, and is intended to ensure that the stock is held only by members. The Finance Board is not aware of any business necessity that would require the Banks to issue stock certificates, especially given the limited universe of potential stockholders, and believes that certificates would only increase the possibility that third parties might acquire the stock. The Finance Board requests comments on whether there are any sound reasons why the Banks should be permitted to issue stock certificates to their members, and if so what safeguards would be appropriate.

In order to allow each Bank to determine the method of distribution that is best suited to its business requirements and to the needs of its members, the Finance Board is not proposing to prescribe the manner in which the Banks must conduct the initial issuance of the Class A and Class B stock. Instead, the proposed rule would require each Bank to determine the manner in which to issue its stock, and would require only that the method of distribution be fair and equitable to all eligible purchasers. The proposal would expressly allow the Banks to conduct the initial issuance through an exchange or conversion, but would not mandate either approach. Whatever method a Bank adopts for the initial stock issuance must be included in the Bank’s capital plan, as set forth in § 933.2. Additionally, because a fundamental characteristic of Class B stock is that it confers on the member an ownership interest in the retained earnings of the Bank, the Finance Board is proposing to allow a Bank to distribute its then-existing unrestricted retained earnings as shares of Class B capital stock.

The Finance Board is further proposing to establish concentration limits that would preclude any one member, or group of affiliated members, from controlling the Bank. Thus, the proposed rule would provide that a Bank shall not issue stock to a member or group of affiliated members if it were to result in such member or group of affiliated members owning more than 40 percent of any class or subclass of its outstanding capital stock. Other provisions of the rule would bar a Bank

from approving a transfer of stock that would result in a member or group of affiliated members owning more than 40 percent of any class or subclass of its stock. The proposed rule also would allow a Bank to include in its capital plan an ownership cap lower than 40 percent.

The investment by one Bank in the assets of another Bank, such as Acquired Member Assets, has been increasing in recent years. As these “joint assets” increase, capital issues under the new structure will exist. One such issue would be whether two or more Banks jointly managing assets through a participation agreement could jointly issue stock. Another issue would be whether two or more Banks jointly managing assets could pool their capital stock in order to meet the regulatory capital requirements. The Finance Board specifically requests comments on whether the Banks should be allowed to issue stock jointly or to pool stock to meet regulatory capital requirements for assets that are being jointly managed by two or more Banks.

B. Voting rights. Section 7 of the Bank Act addresses, among other things, the manner in which the members of each Bank elect directors and the manner in which the Finance Board allocates directorships among the states in each Bank district. The GLB Act did not expressly amend Section 7 as it relates to those issues, but it did include certain amendments to Section 6 that conflict with those provisions of Section 7. In the proposed rule, the Finance Board has attempted to strike a balance between the conflicting provisions of Sections 6 and 7, respectively, by giving full effect to the more recent amendments to Section 6, while preserving as much as possible the provisions of Section 7. The approach taken in the proposed rule represents one means of reconciling the competing provisions of Section 6 and Section 7. The Finance Board recognizes that there may be other approaches to balancing the requirements of these provisions and specifically requests public comment on how else the provisions might be harmonized, and how the proposed rule may affect the cooperative structure of the Bank System. The Finance Board also would like to know whether there are any other restrictions on voting rights or allocation of directorships that should be incorporated into the rule as mandatory requirements, or whether there are other restrictions or requirements that the Finance Board should encourage the Banks to include as part of their capital plans.

Since 1932, the Banks have been authorized to issue only one class of stock. Ownership of Bank stock has conferred on a member the right to participate in the election of directors. In 1961, Congress amended Section 7 of the Bank Act to provide that the number of votes each member may cast in an election of directors, and the manner in which the elected directorships are to be allocated among the states, would be determined on the basis of the subscription capital provisions of Section 6. Specifically, Section 7 was amended to provide that "each such member may cast * * * a number of votes equal to the number of shares of stock in [the Bank] required by this Act to be held by such member at the end of the calendar year next preceding the election".⁵ At that time, Congress also amended Section 7 to require that the allocation of elected directorships, like the method for determining the number of votes, be determined based on the proportionate amounts of Bank stock "required to be held" by the members in each state as of the end of the preceding calendar year, subject to a "grandfather" provision that reflected the allocation of directorships as of December 31, 1960. See 12 U.S.C. 1427 (a)-(c) (1994).

The language in Section 7 regarding the amount of Bank stock "required to be held" by the members as of the preceding December 31st refers to the subscription capital provisions of Section 6, as in effect prior to the GLB Act. As described previously, the subscription capital provisions required each member to purchase an amount of Bank stock based on a statutory formula (*i.e.*, the greater of \$500, 1.0 percent of mortgage assets, 0.3 percent of total assets, or 5.0 percent of advances) that was to be applied to each member as of December 31st of each year. By incorporating into Section 7 a principal component of Section 6—*i.e.*, the amount of Bank stock "required to be held" by each member as of the end of each year—the Congress in 1961 effectively linked the process of electing Bank directors to the subscription capital structure. In the GLB Act the Congress removed the subscription capital provisions from Section 6, but made no conforming amendments to

⁵ Act of September 8, 1961, Pub. Law No. 87-211; see, 12 U.S.C. 1427(b) (1994). Although each share of Bank stock carried one vote, the Bank Act also limited the number of votes any one member could cast to the average number of shares of Bank stock "required to be held" by each member in that state as of the end of the preceding calendar year. That provision had the effect of partially disenfranchising any members that owned Bank stock in excess of the average stockholdings within that state.

Section 7. As a result, Section 7 of the Bank Act continues to require that the allocation of directorships and the determination of member votes be based solely on the subscription capital provisions, which will no longer exist when the new capital plans take effect. The Congress has provided no guidance on how, if at all, it intended the references to the subscription capital provisions within Section 7 to be applied in conjunction with the new risk-based capital provisions of Section 6.

The most apparent conflict between Section 7 and Section 6 (as amended) pertains to the number of votes each member may cast in an election of directors. Though Section 7 provides that the number of votes each member may cast shall equal the number of shares of Bank stock that the member is required to own, Section 6 expressly authorizes each Bank to establish voting preferences for its capital stock. As amended, Section 6 would authorize a Bank to assign voting rights exclusively to either its Class A or Class B stock, or to the Class A and Class B stock equally, or to both Class A and Class B but with a disproportionate weighting. The Finance Board believes that it is not possible to reconcile these provisions, as a Bank cannot establish a system of voting preferences (which, by definition, results in disparate voting rights for each class) while at the same time adhering to a requirement that all shares of its stock are to have uniform voting rights (subject only to the cap on members with large stockholdings).⁶ In order to give effect to the GLB Act capital amendments that have authorized each Bank to establish voting preferences, the Finance Board is of the opinion that the provisions of Section 7(b) of the Bank Act that establish a "one share, one vote" structure must be considered to have been impliedly repealed by Section 6(c)(4)(B), as amended by the GLB Act.

In a similar fashion, there are conflicts between provisions of Section 7(b), (c), and (e), regarding the designation of directorships among the states, and Section 6, as amended by the GLB Act. The former provisions are premised on the assumption that the Banks are to be capitalized in accordance with a statutory formula, whereas the latter provisions require the Banks to be capitalized in relation to their risks. As described previously, Section 7 continues to require the Finance Board

⁶ As a technical matter, members with large amounts of Bank stock cannot vote all of their shares of stock due to the cap based on the average holdings within each state. For those shares that can be voted, however, all votes count equally.

to designate the elected directorships of each Bank among the states in the approximate ratio of the Bank stock required to be held by the members in each state to the total stock outstanding, as of the end of the calendar year. The Finance Board cannot determine those ratios in the manner required by the literal language of Section 7, however, because under the new capital structure the members will no longer be required to maintain an investment in Bank stock in accordance with the statutory formula and as of December 31st of each year. The Finance Board has considered whether it would be feasible to calculate the Section 7 ratios for the allocation of directorships on the basis of Section 6, as it has been amended, but believes that doing so likely would create a host of uncertainties that are not addressed by the Bank Act and which the Finance Board would be required to resolve.

As amended by the GLB Act, Section 6 does refer to a "minimum investment" that each member must maintain in the stock of the Bank, but it does not specify what that term means, other than indicating that it may be based on a percentage of a member's assets or a percentage of its advances, or any other provision approved by the Finance Board. The Finance Board could define the term, but there likely are several ways in which to do so, none of which would be compelled by statute. However the term is to be defined, it would have to be correlated in some fashion to the risks to which the Bank is exposed, *i.e.*, it should not result in a Bank having too little or too much capital in relation to its risks. Thus, a bare formulaic definition of the term (as formerly included in the subscription capital provisions) likely would not be appropriate because it would have no relation to the risks to which the Banks are exposed.

As one possibility, the Finance Board could define "minimum investment" to mean an amount of Bank stock required to be held as a condition of membership in the Bank. That approach, however, would be complicated by the issuance of the two classes of Bank stock authorized by the GLB Act. The existence of two classes of stock means that for every state within a Bank district each member located in that state would hold a certain percentage of the Bank's Class A stock and a certain percentage of the Bank's Class B stock. Because the GLB Act gives each member the option of determining which class of stock to buy, it is likely that if a Bank issues both Class A and Class B stock there will be some members that purchase only one class of Bank stock and other members that purchase both

classes of stock but in varying combinations. As a result, for each state in a Bank district it is unlikely that the percentage of Class A stock held by the members located in that state will be identical to the percentage of Class B stock held by the members in that state. Indeed, it appears probable that the relative percentages of Class A and Class B stock held by the members in a particular state will differ, and may well differ substantially. Thus, it would be possible, and perhaps probable, that the Class A stock of a Bank may be concentrated in certain states while the Class B stock would be concentrated in other states within the Bank district. In that event, the Finance Board should be able to determine the ratio of Class A stock held by members in a given state, and separately should be able to determine the ratio of Class B stock held by the members in that state. It is not at all clear, however, how the Finance Board could apply those ratios to allocate the elected directorships in the manner required by Section 7, especially if there are material differences among the ratios for the various states in the Bank district. The possibility of having two different ratios would be further complicated by the provisions of the GLB Act that allow a Bank to set a lower minimum investment for the B stock than for the Class A stock. Thus, even if the Finance Board could readily calculate the ratios for the Class A and Class B stock, respectively, for each state, the ratio for the Class B stock most likely would have to be adjusted in some fashion.

As an alternative to viewing the term "minimum investment" as an investment required as a condition of membership, it could be defined in terms of the amount of Bank stock required to support the credit, market, and operations risks created for the Bank as a result of entering into business transactions (such as making advances, acquiring mortgage assets, or issuing letters of credit) with a member. Because all Bank assets entail some degree of risk, a member could be required to purchase Class A and Class B stock in whatever amounts are necessary to provide the total capital and permanent capital required to cover the risks associated with the assets created by its business transaction with the Bank. If the Finance Board were to define "minimum investment" on the basis of the risk placed on the balance sheet, such an approach would result in most members investing in both Class A and Class B stock. The relative amounts of each class of stock held by a member under such an approach would vary

with the degree of risk associated with the underlying assets. Thus, one would expect that a member placing somewhat more risky assets on the balance sheet of the Bank would be required to purchase a correspondingly greater amount of Class B stock than a member creating the same amount of a less risky asset. Because the leverage requirement applies independently of risk, however, an equal amount of assets with different risk characteristics should require the same amount of Class A stock for leverage purposes. Thus, defining "minimum investment" in this manner also would be likely to result in the ratio of Class A stock held by the members in a particular state differing from the ratio of Class B stock held by the members in that state, which would present the same difficulties in calculating the individual state ratio described previously. Moreover, it is likely that the term "minimum investment" could not be defined solely on the basis of a member's transactions with the Bank because not all members will at all times be engaged in a business transaction with the Bank. For that reason, it is likely that a definition of "minimum investment" would have to incorporate both membership and risk aspects. If so, the Finance Board then would be faced with using as many as four different stock ratios for each state if it were to determine the allocation of directorships in accordance with the literal language of Section 7.

Apart from those definitional concerns, the Finance Board has a more general concern that requiring the allocation of elected directorships among the states, regardless of how it is done, could impair the ability of the Banks to sell Class B stock in amounts sufficient to comply with their risk-based capital requirements. If that were to occur, the adherence to the state-based allocation formula clearly would frustrate the intent of Congress in establishing a risk-based capital structure for the Banks. In requiring the Banks to have sufficient permanent capital to meet their risk-based capital requirements, the GLB Act has effectively mandated that the Banks, through sale or conversion, issue a significant amount of Class B stock.⁷ In

⁷ Although a Bank may include its retained earnings as permanent capital, no Bank has sufficient retained earnings to comply with the risk based capital requirements at present or is likely to have sufficient retained earnings in the near future. Since the enactment of FIRREA in 1989, the Banks have maintained only nominal amounts of retained earnings. Moreover, in the six months since the enactment of the GLB Act, some Banks have paid out significant portions of their retained earnings to their members. As of March 31, 2000, the retained

tension with this requirement is another provision of the GLB Act, which requires that each Bank's capital plan allow each member the option of determining what combination of classes of authorized Bank stock to purchase. In effect, the GLB Act requires the Banks to issue Class B stock but does not compel the members to purchase the Class B stock. The GLB Act does provide that each Bank is to establish the terms, rights, and preferences for each class of stock that are "consistent with Finance Board regulations and market requirements." That provision recognizes that if the purchase of Class B stock is to be voluntary, then the Banks must be authorized to establish terms for the Class B stock, such as voting and dividend preferences, that provide economic incentives for the members to purchase the Class B stock.

The paramount intent of Congress in revising the capital structure for the Banks was to ensure that the risks to which each Bank are exposed are supported by permanent capital, *i.e.*, Class B stock and retained earnings. Because Class B stock is the only practical source of permanent capital for the immediate future, the intent of the Congress cannot be implemented unless the Banks are able to sell Class B stock. To the extent that other provisions of the Bank Act might impair the ability of the Banks to do so, the application of those provisions would frustrate the intent of Congress in creating the new risk-based permanent capital structure. The Finance Board believes that requiring the allocation of the elected directorships of each Bank exclusively on a state-based formula would make the Class B stock a less attractive economic option for the members because there would be no assurance that the Class B stock would be distributed in the same proportion that the directorships would be allocated among the states.

Because of the difficulties in using a "minimum investment" as a proxy for the amount of stock "required to be held" as of each December 31st, and the likelihood that a state-based allocation of directorships would make the sale of Class B stock more difficult, the Finance Board has preliminarily determined that it cannot apply the provisions of Section 7 regarding the allocation of directorships without frustrating the intent of Congress to create a workable risk-based permanent capital structure

earnings of the Bank System were equal to 0.11 percent of the total assets of the Banks, and the amounts at the individual Banks ranged from 0.03 percent to 0.20 percent of total assets.

for the Banks. The Finance Board believes that there is no practical way to give simultaneous effect to one provision of law that would require the preservation of the subscription capital structure for the purpose of allocating directorships and voting rights and another provision of law that would repeal the subscription capital structure in its entirety. The Finance Board is proposing to resolve that conflict by giving precedence to the provisions of Section 6 of the Bank Act, as amended by the GLB Act, over those provisions of Section 7(b), (c), and (e) relating to voting and the allocation of directorships.⁸ The Finance Board does not believe that any other provisions of Section 7 are inconsistent with Section 6, as amended. Thus, the other provisions of Section 7, such as those regarding the size of the board of directors (including both elected and appointed directors), the requirements applicable to individual directors, the terms of office, term limits, vacancies, compensation, duties, and indemnification, would not be affected by the application of Section 6, as amended.

In cases of conflicting statutory provisions, it is an ordinary rule of statutory construction that later-enacted provisions take precedence over older provisions, to the extent that the older provision is inconsistent with the later-enacted provision. See *Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Comm'n*, 626, F.2d 1020, 1022 (D.C. Cir. 1980); *Estate of Flanigan v. Commissioner of Internal Revenue*, 743 F.2d 1526, 1532 (11th Cir. 1984). The Finance Board believes, as described above, that the provisions of Section 6 must take precedence over the

provisions of Section 7 that relate to the allocation of directorships and voting. The U.S. Supreme Court has made clear, however, that it is also a "cardinal rule" of statutory construction that judicial findings of such implied repeals of statutory provisions are not favored. *Morton v. Mancari*, 417 U.S. 535, 549 (1974); *Posadas v. National City Bank*, 296 U.S. 497, 503 (1936). The Court has explained that effect should be given to both provisions wherever possible and that absent a "clear and manifest" intention on the part of Congress to repeal a statutory provision, the only permissible justification for a repeal by implication is when the earlier and later statutes are "irreconcilable." *Morton*, 417 U.S. at 550-51; see *Georgia v. Pennsylvania RR Co.*, 324 U.S. 439, 456-57; *FAIC Securities v. United States*, 768 F.2d 352, 362 (D.C. Cir. 1985); *United Ass'n of Journeymen and Apprentices v. Thornburgh*, 768 F. Supp. 375, 379-80 (D.D.C. 1991).

In determining whether an "irreconcilable" conflict exists between statutory provisions, a court will first look to the plain language of the statutes. See *Flanigan*, 743 F.2d at 1532 (finding that two provisions of the Internal Revenue Code were, on their face, plainly irreconcilable). Only when the language of two provisions leaves the court in doubt as to whether they represent truly irreconcilable intentions will a court resort to any legislative history that may be pertinent to the issue. See *Demby v. Schweiker*, 671 F.2d 507, 510 (D.C. Cir. 1981) (wherein the court resorted to the legislative history of the newer act in finding that the provisions in question were not irreconcilable).

An administrative agency charged with the implementation of a particular statute may implement an administrative resolution of two conflicting provisions in that statute through a proper APA notice-and-comment rulemaking. *Citizens to Save Spencer County v. Environmental Protection Agency*, 600 F.2d 844, 875-78 (D.C. Cir. 1979). In undertaking such a rulemaking, an agency should determine, based on the plain language of the provisions and, if necessary, on the legislative history of the statutes, that the provisions are irreconcilable. *Id.* at 863-68. The agency should then consider the statute as a whole and the purposes of the provisions in question in order to fashion a solution that avoids unnecessary hardship or surprise to affected parties and remains within the general bounds of the statute in question. *Id.* at 870-71. The Finance Board believes that the provisions of Sections 6 and 7 of the Bank Act

described above are in conflict and is proposing through this rulemaking to give precedence to the capital provisions of Section 6. The legislative history of the GLB Act does not address the interrelationship between Section 6 and Section 7, though the language of the statute and the legislative history do suggest strongly that the creation of a sound system of permanent capital was of paramount concern to the Congress in amending Section 6. The proposed rule has been structured to give effect to Section 7 to the greatest degree possible, and would not preclude a Bank from establishing a state-based structure if it believed that approach would be consistent with capitalizing the Bank in the manner required by the GLB Act.

The proposed rule would require that the capital plan for each Bank specify the manner in which the members are to elect directors and the other corporate matters, if any, on which the members will be entitled to vote. The capital plan also must describe the voting preferences, if any, to be assigned to any particular class or subclass of stock, and whether the Bank will permit cumulative voting by its members and, if so, the matters on which members may vote cumulatively.

If a Bank were to issue any Class B stock, the proposed rule would require that the Bank assign some voting rights to the Class B stock. The proposed rule would not specify what voting rights should be assigned to the Class B stock, and thus would allow each Bank to determine whether the Class B stock would have exclusive voting power or shared voting power. If a Bank were to issue Class B stock, the proposed rule would allow the Bank, in its discretion, also to assign some voting rights to the Class A stock, and would allow some voting rights to be assigned to the members generally, *i.e.*, without regard to the amount or class of Bank stock that each member owns. Within each class or subclass of stock, however, the proposed rule would require that all shares have equal voting rights, although a Bank could give preferences to one or more classes. Thus, all Class B stock would vote equally, although a Bank could authorize the Class B members to elect a majority of the elected directors by giving Class B a preference over the Class A stock. As suggested to the Finance Board by an independent consultant retained by the Banks to study the GLB Act capital issues, a Bank may find that such preferences are necessary in order to sell the Class B stock because it bears more of the risks than does the Class A stock.

As a means of preventing undue concentration of voting power within a

⁸ Puerto Rico presents a unique situation of a prior Finance Board establishment of a directorship, which has been made permanent by statute. In 1962, Congress amended Section 7(e) to authorize the Finance Board to establish an additional elected directorship for the Bank in which the Commonwealth of Puerto Rico was located, which directorship was required to be designated to Puerto Rico. The Finance Board exercised that authority, creating an additional elected directorship for the New York Bank, which it designated as representing the members located in Puerto Rico. Although the designation of that seat to Puerto Rico is inconsistent with the risk-based capital amendments to Section 6, for the same reasons that the other state-based designations are inconsistent with Section 6, the preservation of the additional directorship can be reconciled with Section 6, as amended. Accordingly, the New York Bank would continue to have an additional elected directorship pursuant to Section 7(e), and the proposed rule would allow the Bank to accommodate the representation of members located in Puerto Rico as part of its capital plan. As provided in Section 7(e), if the Finance Board ever were to relocate the Commonwealth of Puerto Rico to another Bank district, the additional elected directorship created by Section 7(e) would cease to exist.

small number of members, the proposed rule would cap the number of votes any member (including affiliated members) may cast in an election at 20 percent of the votes eligible to be cast in that election. The Finance Board recognizes that in some Bank districts a member with less than 20 percent of the vote may be able to control the Bank and therefore is proposing to allow any Bank to establish a lower percentage as part of its capital plan.

As noted above, in order to ensure that the new capital structure is workable and the Banks are able to sell the Class B stock, the proposed rule would state expressly that the elected directorships for a Bank need not be allocated among the states on the basis of the amount of stock required to be held under the now-repealed subscription capital requirements, and that the number of votes for each member also need not be based on the amount of stock each member was required to hold as of the end of the prior year. Notwithstanding that provision the proposed rule would not preclude a Bank from allocating voting rights among its members on a state-by-state basis, provided such an allocation were approved as part of the Bank's capital plan. A Bank also could adopt any other reasonable method of electing directors, such as authorizing each class of stock to elect a specified number of directors, or allocating the directors among the members based on the asset size of the members. The proposed rule also would require that each Bank include in its capital plan, to the extent feasible, a provision for the representation of small members that own Class B stock, particularly members that are community financial institutions (CFI), as that term is defined by the GLB Act.

Although the proposed rule includes provisions addressing concentration of stock ownership, limits on voting rights, and representation of CFIs on the boards of directors, the Finance Board is especially interested in receiving comments on these issues and whether there may be other ways to address each of them. The approach taken in the proposed rule regarding voting would allow each Bank to determine the manner in which the members are to elect directors, which recognizes that the board of each Bank may be best suited to determining how to balance the interests of its members against the need to raise the capital required by the GLB Act. Notwithstanding the approach embodied in the proposed rule, the Finance Board requests public comments on whether there might be a need to include some limitations in the

rule such that it does not have any untoward consequences for the cooperative structure of the Bank System.

On the issue of board composition, the Finance Board would like to receive comments on whether the rule should include a provision requiring certain types of members, such as CFIs, to be represented on the boards of the Banks. As proposed, the rule would require the Banks to ensure that small members, specifically including CFIs, that own Class B stock be represented on the board, to the extent it is feasible to do so. The Finance Board would like to know whether this type of requirement should be made mandatory on the Banks, such that some number of the elected directorships should be assigned permanently to the CFIs within that district. The Finance Board also would like to receive comments on whether the rule should mandate some form of state-based representation on the boards of the Banks. With the removal of barriers to interstate banking, it is less clear what purpose is served by retaining a state-based board of directors, especially when there is no requirement that the members within a particular state hold any Class B stock. The Finance Board requests that any comments advocating a requirement for state-based representation address the details of how that should be accomplished, especially in light of the varying number of states in each Bank district, which range from two to eight, and the cooperative structure of the Bank System. The Finance Board also would like to know whether it would be advantageous to increase the size of the boards of directors to accommodate the representation of small members, which the Finance Board can do in the five Bank districts that include five or more states, and if so, what actions might be appropriate in the other seven Bank districts, for which the Finance Board cannot increase the number of directors on the boards.

One issue on which the Finance Board would like to receive comment is whether the rule should allow a Bank to include advisory directors on its board, *i.e.*, directors who are not elected by the members and who do not vote on board matters, but who may participate in the deliberations of the full board of directors. Advisory directors are neither expressly authorized nor expressly prohibited by the Bank Act, but the Finance Board believes that it could authorize such directors, provided that the management of the Bank (*i.e.*, the ability to vote) remained vested exclusively in the elected and appointed directors. Although an advisory director

could not vote on matters before the board of the Bank, the Finance Board believes that there may be some value to the Bank in having such individuals on the board, as they could present the views of members who might not otherwise have a voice at the meetings of the boards of directors. For example, if the members were to elect directors predominantly from certain states or from certain sized institutions, the board could appoint advisory directors from states or classes of members that were not otherwise represented. The proposed rule does not include any provisions regarding advisory directors, but the Finance Board would appreciate comments on whether such directorships, or other advisory panels, might be appropriate to address in the final rule.

The proposed rule would bar any member or affiliated members from owning more than 40 percent of any class of Bank stock and would bar any member or affiliated members from casting more than 20 percent of the eligible votes in any election. Although the proposed rule would allow each Bank to establish lower limits as part of its capital plan, the Finance Board requests comments on whether the percentages used in the proposal are appropriate or whether the Finance Board should adopt some other percentages as a means of preserving the cooperative structure of the Bank System.

With regard to voting rights, the proposed rule would require that the Class B stockholders be assigned some voting rights, but would leave to each individual Bank the responsibility to decide exactly what voting rights the Class B stock shall be assigned. The rule expressly allows a Bank to assign voting rights as well to the Class A stockholders and further allows a Bank to assign voting rights on the basis of membership, *i.e.*, without regard to what class or how much stock a particular member owns. The Finance Board would like to receive comments on whether those matters that are at present left to the discretion of the Banks should be included in the rule as a mandatory requirement, *i.e.*, whether the Banks should be required to assign some portion of the voting rights on a one-member one-vote basis, or should otherwise require that the members generally be allowed to elect some number of directors. Similarly, the Finance Board requests comments on whether some number of directorships or some proportion of the vote should be assigned by regulation to the Class A stockholders.

With regard to all such issues, the Finance Board requests that commenters elaborate on how any alternative voting arrangements recommended by the commenters would work in conjunction with Section 6 and how they would facilitate, or at least not impair, the ability of the Banks to raise the permanent and total capital required by the GLB Act. If the Finance Board ultimately adopts a final rule addressing the voting rights and directorship structure generally as proposed, the final rule also would include conforming amendments to certain provisions of the current election rules, 12 CFR Part 915. Those rules address matters such as the allocation of directorships, the annual capital stock report, the determination of member votes, and the election process. If the final rule authorizes each Bank to determine the manner of electing directors, several of the existing regulations in Part 915 would have to be rescinded or revised, to the extent that they are based on the subscription capital provisions incorporated in Section 7. Assuming that the final rule were to address voting rights and the allocation of directorships in the manner proposed, the Finance Board requests comment on what conforming amendments to the existing elections regulations would be appropriate.

C. Dividends. Under the proposed rule, any member, including those withdrawing from the Bank System, that owns Class A or Class B stock, or both, would be entitled to receive dividends declared on its stock for as long as it owned the stock. The Class A stock would be required to pay a stated dividend, and the capital plan would specify the basis on which the stated dividend would be calculated. Any Bank wishing to change the basis on which the stated Class A dividend is calculated would be required to amend its capital plan and submit the amendment to the Finance Board for approval. Payment of the stated dividend on the Class A stock would have priority over the payment of dividends on Class B stock. By providing Class A stockholders a dividend priority, the Finance Board intends to preclude the possible manipulation of the Class A dividend by and for the benefit of Class B shareholders, who are likely to have greater influence on the Bank's dividend policies than Class A stockholders. After a Bank pays its stated Class A dividend, the board of directors of a Bank may augment the stated dividend. This additional payment may be paid, at the discretion of the Bank's board of

directors, before, concurrently with, or after payment of dividends on paid-in Class B stock. Along with specifying the basis on which the stated dividend would be calculated, a Bank's board of directors would have to determine, prior to issuance of the stock, whether such dividends are to be cumulative or non-cumulative.

Under the proposed rule, the Bank's board of directors could authorize the payment of a dividend to Class B stockholders and would determine the amount of the dividend to be paid. The board of directors would also be able to establish different dividend rates or preferences for different subclasses of Class B stock. A dividend established for a different subclass could, for example, track the performance of specific Bank assets, such as Acquired Member Assets or advances. Any dividend that tracks the performance of a Bank asset, however, must be proportionately appropriate for the level of risk and profitability associated with the underlying asset. For example, the lower the risk and profitability of an asset, the lower the dividend payment should be.

The payment of any Class B dividends would only be permitted after the payment of the stated Class A dividend. Any dividends to Class B stockholders must be payable from GAAP net earnings of the Bank plus the GAAP retained earnings of the Bank (after the payment of Class A dividends). GAAP net earnings are the net earnings of the Bank after the payment of the Resolution Funding Corporation (RefCorp) and Affordable Housing Program obligations. Any dividends on Class B stock would be non-cumulative. Cumulative dividends on Class B stock would not be necessary because the board of directors would set the dividend rate anew each year and could, therefore, effectively treat dividends as cumulative, but only if there were sufficient earnings to do so.

D. Preferences on Liquidation, Merger, or Consolidation. Under the proposed rule, in the event of a liquidation, merger, or other consolidation of a Bank, Class A stockholders would be entitled to receive the par value of their stock, plus any accumulated dividends. Class A stockholders would be paid before the Bank (or its successor) could redeem any Class B stock or pay dividends on the outstanding Class B stock that had been issued by the Bank that had been liquidated, merged, or consolidated. The preference given to Class A stockholders in such cases is consistent with the priority given to the payment of the stated dividend to Class

A stockholders and with the role of Class B stock as bearing the greater risk.

E. Transfer of Capital Stock. As required by the GLB Act, the proposed rule would allow a member to transfer capital stock only to another member of the Bank or to an institution that is in the process of becoming a member. The Finance Board considers the transfer of stock to an institution in the process of becoming a member as an opportunity to minimize the likelihood of a Bank becoming overcapitalized. Any such transfer of stock would be at a price agreed to by the parties, and could be below, at, or above the par value of the stock.

Additionally, the proposed rule would prohibit a Bank from allowing the transfer of Bank stock to a member or group of affiliated members if, after the transfer, the member or group of affiliated members would own more than 40 percent of any class or subclass of capital stock. The proposed rule also would allow a Bank, through its capital plan, to establish an ownership cap lower than 40 percent. The ownership cap is intended to preclude the possibility that a single member or group of affiliated members could control a Bank. If a merger, acquisition, or other consolidation of two or more members of a Bank were to result in the surviving member holding more than 40 percent of any class of stock, or any lower cap set by the Bank, the Bank and member(s) would be required to agree to a plan for the member to divest any stock in excess of the ownership cap in an orderly manner. The Finance Board requests comments on how else the concentration limits might be applied in the case of a merger of members, as well as on how to apply such limits if a member were to exceed the limits as a result of actions taken by a third party, such as the withdrawal of a large member that causes the percentages of all other members to increase.

F. Membership Investment in Capital Stock. The GLB Act requires each member to maintain an investment in its Bank. Under the proposed rule, a Bank may require an institution to invest in Class A stock as a condition to becoming and remaining a member of the Bank, or a Bank may establish a membership fee to be assessed in lieu of mandatory stock investment. As noted below, after a Bank reaches its operating capital ratios it could no longer continue to require any additional membership investments, though it would be able to continue to assess annual membership fees. If a Bank were to require a membership investment in Class A stock, the Bank also must provide the member the option of

investing in a lesser proportional amount of Class B stock, which amount would be as determined by the Bank. For example, a lesser proportional amount of Class B stock could be calculated by multiplying the amount of Class A stock otherwise required for membership by a Bank-determined percentage.

If a Bank were at or above its operating total capital ratio and its operating risk-based capital ratio, the proposed rule would provide that the Bank could not require a member to purchase capital stock, but it still could require a member to pay an annual membership fee in lieu of the mandatory stock purchase. Because the amounts paid as membership fees do not constitute total capital or permanent capital under the GLB Act, the proposed rule would not preclude a Bank from assessing an annual membership fee after it has reached or exceeded its operating capital ratios. Both of these provisions have been included in the proposed rule in an effort to avoid a Bank becoming over-capitalized. The Finance Board believes that allowing a Bank to accumulate excessive amounts of capital, *i.e.*, amounts of capital beyond what is required to support the risks inherent in the business of the Bank, plus the marginal amount of additional capital carried as a result of the Bank's operating total capital and risk-based capital ratios, would lead to increased arbitrage investments, which the Congress clearly intended to address as part of the GLB Act capital restructuring. The Finance Board would allow the Banks to operate at higher capital ratios than are required by the GLB Act and this regulation, *i.e.*, higher percentages of total and permanent capital, which the Finance Board does not believe would lead to increased arbitrage investments. Also, by providing the Bank with various options to offer its members, the Finance Board believes members would have the flexibility necessary to accommodate the membership investment requirement that is required by the GLB Act.

G. Activity-Based Stock Purchase Requirement. The proposed rule provides that a Bank may require a member to purchase either or both Class A or Class B stock as a condition to entering into a specific business transaction with the Bank. Such an activity-based stock purchase requirement would not be inconsistent with other provisions of the GLB Act, which provide generally that a member shall have the option of purchasing either Class A or Class B stock. Any business transaction between a Bank

and a member, such as an advance, is a voluntary transaction initiated by the member that results in an asset being placed on the books of the Bank. Under the risk-based capital provisions of the GLB Act and the proposed rule, every on-balance sheet asset and off-balance sheet item of a Bank must be supported by some amount of permanent capital to cover the credit, market, and operations risks associated with the asset or item. Ultimately, whatever amount of permanent capital is required by each Bank to meet its regulatory risk-based capital ratio and its operating risk-based capital ratio must be provided by the members; if a Bank lacks sufficient capital to engage in a particular transaction, it cannot enter into the transaction. If the provision of the GLB Act allowing each member the option of purchasing either Class A or Class B stock were read to allow each member to decline to purchase any Class B stock, the Banks would be unable to engage in any transactions with their members beyond the amount that could be supported by their retained earnings, the only other source of permanent capital. There is nothing in the GLB Act or its legislative history that suggests that the provision allowing members the option of purchasing Class A or Class B stock was intended to override the other provisions of the GLB Act that require every asset and off-balance sheet item to be supported, at least in part, by some amount of permanent capital. As noted above, the provisions of this proposed rule regarding each member to maintain some investment in the Bank preserves for the members the option of maintaining that investment in either Class A or Class B stock. To ensure that the Banks have sufficient permanent and total capital to cover the risks of their business, the proposed rule would authorize a Bank to require a member, as a condition to doing business with the Bank, to purchase whatever amount of Class A and Class B stock is necessary for the Bank to comply with the regulatory capital requirements (and operating capital ratios) that would be associated with the Bank asset (or off-balance sheet item) to be generated by the transaction with the member. If a member would prefer not to purchase any Class B stock, it would not be required to do so, but the Bank would not be required to make an advance or enter into any other transaction with a member that declined to provide the capital needed for the business it wished to conduct with the Bank.

The activity-based stock purchase requirement also should provide the Banks with some additional flexibility

in managing their capital accounts, such that the levels of capital correspond more closely to the risks generated by the business of the Bank. The proposed rule would impose certain limitations on activity-based stock purchases. First, the amount of Class B stock that a member may be required to purchase in order to engage in a certain transaction must be based on the risk characteristics of the asset being acquired by the Bank. Second, a Bank could not require a member entering into a transaction to purchase Class B stock if the amount of the purchase would cause the Bank to exceed its operating total capital ratio and operating risk-based capital ratio, as established in the Bank's capital plan. Although a Bank could not impose an activity-based stock purchase requirement if doing so would cause it to exceed its operating capital ratios, the proposed rule would allow a Bank to enter into a written agreement with a member under which the member would commit to purchase a specific number of shares of Class A or Class B stock at a specified price, but with the purchase to be completed and all payments made at a future date to be determined by the Bank. Any such arrangement would have to be included in the Bank's approved capital plan. Under such an arrangement, if a Bank were to fall below its operating capital ratios it could require the members to honor their commitment to provide the capital that otherwise would have been required at the time they entered into the commitments. These provisions are intended to prevent the Banks from building excessive amounts of capital, which the Finance Board believes would lead to arbitrage investments. Additionally, the proposed rule would bar a Bank from prohibiting a member that had purchased capital stock in compliance with an activity-based purchase requirement from selling the stock to another member. The members would remain subject to the other provisions of the rule, under which no member may redeem any capital stock if doing so would cause the Bank to fail to comply with any regulatory capital requirement.

H. Concentration limits. Under the proposed rule, no member, or group of affiliated members, of a Bank would be permitted to own more than 40 percent of any class or subclass of the outstanding capital stock of the Bank. A Bank would be able, through its capital plan, to establish an ownership cap lower than 40 percent. If at a given time, a member, or group of affiliated members, of a Bank were to acquire stock such that they owned more than 40 percent of any class or subclass of

stock (or any lower amount as established by the Bank) the Bank and member (including any affiliated members) would be required to agree to a plan under which the member would divest sufficient shares of such stock as necessary to comply with the limit. The Finance Board requests comment on the need to include concentration limits in the rule and what percentage limits might be most appropriate to ensure that the Bank cannot be dominated by a small number of members.

I. *Redemption and Purchase of Capital Stock.* As required by the GLB Act, a member may redeem its Class A stock with six-months written notice to the Bank. Class B stock may be redeemed with five-years written notice to the Bank. At the end of the notice periods, a member would be entitled to receive the par value of the stock in cash. The proposed rule would bar a member from having pending at any one time more than one notice of redemption for any class of Bank stock. For example, a member may have pending a notice to redeem 50 shares of Class A stock, as well as a notice to redeem 50 shares of Class B stock. A member, however, could not have two separate notices to redeem only Class B (or only Class A) stock. A Bank would be permitted to impose a fee, as specified in its capital plan, on a member that cancels a pending notice of redemption. The imposition of a fee would be at the discretion of a Bank, as specified in its capital plan. The Finance Board is proposing the option of establishing a fee in order to minimize a Bank's cost associated with canceling a notice of redemption.

J. *Capital Impairment.* Under the proposed rule, the Bank would not be permitted to redeem or purchase any capital stock without prior written approval from the Finance Board if the Bank were not in compliance with any of its regulatory capital requirements. The Bank would also not be permitted to redeem or purchase any capital stock without prior written approval from the Finance Board if such a redemption or purchase of stock would cause the Bank to fail to comply with any of its regulatory capital requirements. These provisions reflect the requirement of the GLB Act that the Bank shall maintain both total and permanent capital that is sufficient to meet its regulatory capital requirements.

K. *Part 932—Federal Home Loan Bank Capital Requirements.*

Overview. As discussed previously, the Banks' current capital requirements have been determined according to a statutory formula, which has used either the assets held by a member or the

amount of the member's borrowings from a Bank to determine the amount of Bank stock that the member must hold. 12 U.S.C. 1426(b)(1), (b)(2), and (b)(4); 1430(c), (e)(1), and (e)(3) (1994). The capital provisions of the GLB Act replace this approach with a modern risk-based capital system for the Banks and mandate a capital structure that is more in line with the risk-based capital standards developed under the Basle Accord and with the practices of other bank regulatory agencies.⁹ Under the GLB Act amendments, 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 choose to accept. The Finance Board is proposing to implement the capital provisions of the GLB Act by adopting a modern approach to overseeing the Banks, which would require the Banks to implement regulatory capital requirements as part of a comprehensive risk management system. In developing the proposed regulations, the Finance Board has reviewed the Basle Accord, the regulations of other banking regulators, the OFHEO proposed capital regulations,¹⁰ and other papers drafted by the BCBS and other bodies.

The capital requirements of proposed Part 932 also would replace the risk management provisions of the Finance Board's Financial Management Policy (FMP) under which the Banks currently operate. The FMP imposes specific restrictions and limitations on the Banks' investment practices and includes a leverage limit to regulate the risk management practices of the Banks. 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), Finance Board Res. No. 97-86 (Dec. 17,

⁹The risk-based capital standards of the other federal bank regulatory agencies are based on the 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.

¹⁰On April 13, 1999, OFHEO published a notice of proposed rule-making with respect to the required risk-based capital standards. See 64 FR 18083 (Apr. 13, 1999). The original deadline for comments on this proposal was August 11, 1999, but that deadline was extended. The comment period ultimately closed on March 10, 2000. See 64 FR 56274 (Oct. 19, 1999). On March 13, 2000, OFHEO solicited reply comments in response to the comments received on the proposed rule. See 65 FR 13251 (Mar. 13, 2000). The deadline for these reply comments was April 14, 2000.

1997) and 65 FR 36305 (June 7, 2000). Although the FMP has served the purpose of ensuring the safety and soundness of the Bank System, it lacks sufficient flexibility to enable the Banks to fulfill their mission to the maximum extent possible.

The Basle Accord forms the basis for risk-based capital standards for banks in the world's industrialized countries. Its approach principally involves 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 U.S. 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.*, 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.

The Finance Board, and other commentators, believe that the Basle Accord has a number of shortcomings. For example, the risk weight categories are so broad that instruments with markedly different credit risks may be subject to the same risk weighting. The Basle Accord also does not take into consideration how differences in the maturities between two instruments within the same category 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.

The January 1996 amendment to the Basle Accord (the Amendment) remedies some of these shortcomings, especially with respect to debt instruments held in the trading portfolios of large banks.¹¹ The Amendment offers large banks the

¹¹The Amendment, entitled "Amendment to the Capital Accord to Incorporate Market Risks," 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).

alternative either to use internal credit risk models to calculate value at risk due to credit risk on debt instruments held in its trading portfolio, or, if the bank lacks satisfactory internal models, to use standardized credit risk capital percentage requirements specified in the Amendment.

In order to address some shortcomings of the Basle Accord with respect to the non-trading portfolio, *i.e.*, the banking book, the BCBS published in June 1999 a consultative paper entitled "A New Capital Adequacy Framework" (the Framework), which proposed a system to better correlate regulatory solvency with the economic-capital needs of a bank and with the risks and returns of a bank's lending activities.¹² The Framework would calibrate a bank's risk-based capital requirements more closely with its underlying credit risks, and would recognize the improvements in risk measurement and control that have occurred in recent years. The Framework would also 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.

General Capital Requirements. Section 6(a)(1) of the Bank Act, 12 U.S.C. 1426(a), *as amended*, requires that each Bank maintain a minimum ratio of total capital to total assets and that each Bank maintain permanent capital in an amount that is sufficient, as determined in accordance with the regulations of the Finance Board, to cover the credit risk and market risk to which a Bank is subject. 12 U.S.C. 1426(a)(1), (3), *as amended*.

The GLB Act defines "permanent capital" as the amounts paid for a Bank's Class B stock, plus the Bank's retained earnings (as determined in accordance with GAAP). 12 U.S.C. 1426(a)(5)(A), *as amended*. The term "total capital" includes permanent capital, the amounts paid for Class A stock, any general allowance for losses that are not held against specific assets (determined in accordance with GAAP and Finance Board regulations), and any other amounts available to absorb losses that the Finance Board determines by regulation to be appropriate to be included in total capital. 12 U.S.C. 1426(a)(5)(B), *as amended*.

The definitions for "permanent capital" and "total capital" proposed in § 930.1 conform with the statutory definitions. Proposed § 930.1 also defines the term "general allowance for

losses" to require that such allowances be consistent with GAAP and not include any amounts held against specific assets of the Bank. The restrictions would be the same as the statutory restrictions placed on loan loss reserves.

Capital requirement transition provisions. The proposed rule would require that by a date not later than three years from the effective date of the its capital plan, each Bank shall have sufficient total capital to meet the total capital requirement in proposed § 932.2 and sufficient permanent capital to meet the risk-based capital requirement in proposed § 932.3. Before the new total capital and risk-based capital requirements could be implemented, however, each Bank must first obtain Finance Board approval for its internal risk model or its cash flow model, which would be used to calculate the market risk component of its risk-based capital requirement, and for the risk assessment procedures and controls that would be used to manage the Bank's credit, market, and operations risks.

The capital rule would not supercede the risk management provisions of the FMP until after the Finance Board has approved the models and procedures, discussed above, for each Bank and the Bank has met its regulatory capital requirements. Thus, each Bank would continue to be governed by the Hedging Transaction Guidelines and the Interest Rate Risk guidelines of the FMP until those conditions are met. *See* FMP Sections V and VII. The provisions of the FMP that limit the purchase of mortgage-backed securities (MBS), collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and eligible asset-backed securities to 300 percent of capital, Section II.C.2, also would remain in effect until the Bank had met the proposed regulatory capital requirements.

The proposed rule also would mandate that the minimum stock purchase and stock retention requirements of the Bank Act in effect immediately prior to the GLB amendments would remain in effect until the Bank has issued capital stock in accordance with its approved capital plan. (See discussion of proposed Part 933.) This provision is consistent with the GLB Act requirement that the pre-GLB Act stock purchase and stock retention requirements shall continue in effect until the capital plan of a Bank has been approved and implemented. 12 U.S.C. 1426(a)(6), *as amended*. Under the proposed rule, the new capital structure for each Bank would take effect (subject to any transition

provision) once a Bank has issued its Class A or Class B capital stock. Any other Finance Board regulations that may affect stock purchase or retention would also apply.¹³

Total capital requirement. The GLB Act requires each Bank to maintain a ratio of total capital to total assets of no less than four percent. 12 U.S.C. 1426(a)(2), *as amended*. The statute also requires each Bank to maintain a leverage ratio of total capital to total assets of five percent, where in calculating this ratio, the amounts paid in for the class B stock and the amounts of retained earnings are multiplied by 1.5 and all other items of total capital are included at face value. *Id.* Section 932.2 of the proposed rule would implement these statutory provisions.

Risk-based capital requirement. The GLB Act requires each Bank to maintain permanent capital in an amount that is sufficient, as determined in accordance with the regulations of the Finance Board, to cover the credit risk and market risk to which a Bank is subject. 12 U.S.C. 1426(a)(1), (3), *as amended*. Section 932.3 of the proposed rule would require each Bank to maintain sufficient permanent capital to meet the combined credit, market, and operations risks to which it is subject, as determined under proposed § 932.4, § 932.5, and § 932.6, respectively.

Although the GLB Act does not address operations risk, the Finance Board is proposing to adopt an operations risk component to the risk-based capital requirements in order to assure that the Banks "operate in a financially safe and sound manner" and "remain adequately capitalized." 12 U.S.C. 1422a(a)(3)(A), (B), *as amended*. The Finance Board believes that the risk of loss from business operations exists with regard to the Banks and that it is necessary to require the Banks to maintain capital against that risk. Under the new credit and market risk capital provisions in the GLB Act, the amount

¹³The Finance Board recently approved a final rule that, among other things, established an asset-based leverage limit under which the aggregate amount of assets of any Bank shall not exceed 21 times the total of paid-in capital stock, retained earnings and reserves (or a capital to assets ratio of at least 4.76 percent). The rule also extended and made permanent the additional leverage authority originally permitted to the Banks for Year 2000 liquidity, *i.e.*, a Bank may have asset-based leverage of up to 25 to 1 (or a capital to assets ratio of at least 4.0 percent) if that Bank's ratio of non-mortgage assets does not exceed 11 percent of the Bank's total assets minus deposits and capital. *See* 65 FR 36290, 36299 (June 7, 2000). Non-mortgage assets equal total assets after deduction of core mission activity assets, as defined in proposed § 940.3, and assets described in sections II.B.8 through II.B.11 of the FMP. *See* 65 FR 25676, 25688 (May 3, 2000). This 25 to 1 limit is in line with the requirements of the GLB Act.

¹²*New Basle Committee Proposals Have Positive Bank Credit Implications*, Moody's Credit Perspectives, June 21, 1999, at 1, 18.

of capital held by the Banks will be closely aligned to the expected losses associated with those risks, and is not meant to cover the unexpected losses that may result from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems or other operations risks. Without an operations risk requirement, the proposed rule would be deficient and the Banks could be exposed to losses arising from these operational failures. Thus, the Finance Board considers the operations risk requirement necessary to ensuring the continued safe and sound operation of the Bank system.

Credit Risk Capital Requirement. The GLB Act mandates that each Bank maintain sufficient permanent capital, as determined in accordance with Finance Board regulations, to meet the credit risk to which the Bank is subject. 12 U.S.C. § 6(a)(3)(A)(i), *as amended*. The GLB Act, however, does not specify the elements that make up credit risk or the charges that must be applied to cover such risk, leaving to the Finance Board the responsibility to define the elements of credit risk.

Proposed § 932.4 would implement the credit risk requirements of the GLB Act. In developing these requirements, the Finance Board has reviewed the Basle Accord, the regulations of other banking regulators, OFHEO's proposed capital regulations, and other information prepared by the BCBS and other relevant bodies. As already discussed, the Finance Board has revised the credit risk provisions contained in the proposed FMMA both to meet the GLB requirements and to further enhance the accuracy of the provisions.

The credit risk component of the risk-based capital requirement proposed by the Finance Board would encompass the credit risks associated with both on-balance sheet assets and off-balance sheet items of each Bank. The objective of this credit risk capital standard 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) be responsive to 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.

Finance Board determination of specific credit risk percentage requirements. The credit risk capital requirement would be equal to the sum of a Bank's credit risk capital charges for all on-balance sheet assets and off-

balance sheet items. For an on-balance sheet asset, the credit risk capital charge would equal the book value of the asset multiplied by the "credit risk percentage requirement" assigned to the asset. For off-balance sheet items, the credit risk capital charge would be the "credit equivalent amount" of the item, multiplied by the credit risk percentage requirement assigned to the item.

The proposed rule would include credit risk percentage requirements for various categories of on-balance sheet assets and the credit equivalent amount of off-balance sheet items based on the type of asset or item, its credit rating and, if appropriate, its remaining maturity. The Finance Board has used data from NRSROs and other relevant sources to calculate estimates of credit losses associated with the particular categories. The estimates of credit risk percentage requirements represent the expected credit losses for the particular categories of instruments during periods of credit stress, based on historical data that reflect the longer-term nature of credit cycles, and span multiple credit cycles. The credit losses are estimated after identifying time periods with the highest losses stemming from downgrades and defaults. The loss in market value from a downgrade is estimated for each maturity category of the investment using credit spreads from 1992 to the present that were available to the Finance Board. For defaults, assumptions for loss severity are based on exposure type and maturity as indicated by available data. Periodic updates to the initial credit risk percentage requirements will be implemented by the Finance Board as amendments to the credit risk capital requirement.

In the proposed FMMA, the credit risk percentage requirements did not consider the term structure of credit risk. This limitation mirrored the initial failure of the Basle Accord to consider the term structure of credit risk, such that an overnight exposure on a particular instrument would receive the same capital charge as a two- or a ten-year exposure on another instrument from the same issuer. Recently, however, the BCBS as well as other financial regulators have begun to address this failure. 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 problem 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 its risk-based capital requirements for the farm credit banks. In the proposed rule, the Finance Board would give recognition to the term structure of credit risk.

While consideration of term structure is not necessary for all credit risk categories, the Finance Board incorporated term structure in the percentage requirements for advances and "rated assets or items other than advances or residential mortgage assets." The Finance Board also has incorporated specific credit risk percentage requirements for residential mortgage assets, which include MBS, by investment grade. As a result, four tables are included in proposed § 932.4(d)(2)(i): Table 1.1—Requirement for Advances; Table 1.2—Requirement for Residential Mortgage Assets; Table 1.3—Requirement for Rated Assets or Items Other Than Advances or Residential Mortgage Assets; and Table 1.4—Requirement for Unrated Assets. These tables set forth 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. The Finance Board seeks comment on its proposed recognition of asset maturity in its calculation of credit risk percentage requirement for certain types of assets or items. The Finance Board also generally requests comment on any aspect of the tables included in the proposed rule.

Table 1.1. The proposed FMMA assigned advances to a triple-A credit risk category 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), and a statutory stock purchase requirement that required a member to maintain an investment in the Bank at least equal to 5 percent of its outstanding advances. 12 U.S.C. 1430(e) (1994).

In developing the FMMA, the Finance Board considered treating advances in the same manner as cash or as securities that are backed by the full faith and credit of the U.S. government, both of which are assigned zero credit risk. Two credit rating agencies, however, have

expressed their opinion to the Finance Board that such treatment would not be appropriate for advances, *i.e.*, that advances should not be treated as equivalent to assets that have no credit risk. The two rating agencies recommended that advances be treated as triple-A rated assets. They noted, in particular, that legislative authority for the Banks to accept new types of collateral from certain members as one reason why advances should not be rated higher than triple-A. Based on the historical experience of zero credit losses for advances over the past 60 years, however, compared to the experience with triple-A rated corporate securities, some of which have had rating downgrades that have led to eventual credit losses, it would appear that advances are a better credit than are triple-A rated corporate securities. Accordingly, the proposed rule would treat advances as having somewhat greater credit risk than securities that are backed by the full faith and credit of the U.S. government, but somewhat less than triple-A rated corporate securities. The proposed rule, in Table 1.1, provides unique credit risk percentage requirements for advances by their maturity.

The determination of credit risk percentage requirements or credit losses for advances under stress conditions would require estimates of the default rate and the loss severity rate under such stress conditions. Because the Banks have incurred no credit losses on their advances, the Finance Board has assumed, for purposes of establishing a default rate for advances, that advances would exhibit the same default patterns as the highest investment grade corporate bonds in Moody's Default Risk Service database, and that advances would have a recovery rate of 90 percent (*i.e.*, a loss severity rate of 10 percent). A recovery rate of 90 percent is consistent with the conservative lending and collateral management policies and the historical credit loss record of the Banks with respect to advances. Thus, the credit risk percentage requirements in Table 1.1 for advances are based on the maximum default rates for the highest investment grade exposures from Moody's Default Risk Service database and a recovery of 90 percent.¹⁴ The Finance Board seeks comment on the methodology used for setting the credit risk percentage

requirements for advances and whether a more satisfactory analytical framework exists that could be used to determine more appropriate credit risk percentage requirements for advances.

Table 1.2 and Table 1.3. Table 1.2 includes the credit risk percentage requirements for residential mortgage assets, which category includes both mortgages and MBS, while Table 1.3 sets forth credit risk percentage requirements for rated assets or items other than advances or residential mortgage assets. The credit risk percentage requirements in Table 1.3 were developed for instruments without embedded options. As explained in more detail following the discussion of Table 1.3, residential mortgage assets have prepayment options, and, therefore, require a separate set of credit risk percentage requirements.

The proposed credit risk percentage requirements in Table 1.3 for credit exposures of rated assets or items other than advances and residential mortgages are calculated by examining data from Moody's which includes the rating and default history for rated assets over the time period 1970–1999. In calculating the values in Table 1.3, the worst time period for credit losses is found for each rating category, where credit losses are estimated as the sum of defaults, assuming a 100 percent loss severity, and losses in market value from rating downgrades during a specified period or credit risk horizon.¹⁵ See "Historical Default Rates of Corporate Bond Issuers, 1920–1998," Moody's Investor Service, January 1999.

A maximum of a two year credit risk horizon has been used for calculating the default and downgrade probabilities, because this is the expected period of time, based on experience, needed to resolve asset-quality problems at troubled commercial banks. Furthermore, both the default and downgrade probabilities increase as the horizon is increased from six months to two years. For credit exposures longer than two years, the default and downgrade probabilities remain constant at the two year maximum horizon. The loss in market value from a downgrade is estimated from calculations of market values of corporate bonds at initial credit ratings and market values subsequent to the

downgrade. These losses tend to increase with the maturity of the asset.

The probability of a rating downgrade (of one or more categories), and the probability of default, are taken from the worst historical period as defined above. These probabilities, and available credit spread data, are used to estimate the possible loss in value from defaults and downgrades in future stressful environments. Assets with longer maturities will generally have higher credit risk percentage requirements to reflect higher credit risk associated with longer maturities. Even though the default and downgrade probabilities are constant for maturities above two years, the downgrades will have a greater impact on the market value of longer lived assets.

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, no triple-A rated security has ever defaulted while it was rated triple-A. Given a sufficiently long period of time, however, even triple-A rated corporate credits may default following rating downgrades.¹⁶ 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 ratings.¹⁷ 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 capital to be maintained for triple-A rated credit exposures.

For Bank assets that are downgraded to below investment grade after being acquired by the Bank, the proposed rule would assign increasingly higher credit risk percentage requirements. The percentage requirements would range from 5.0 percent to 20.0 percent for assets or items that are downgraded to the highest rating below investment grade. For assets or items that are downgraded to the second highest rating below investment grade, the percentages would range from 22.0 percent to 37.0 percent. The proposed rule would assign a percentage requirement of 100 percent for all other assets or items that

¹⁴ The credit risk percentage requirement for advances with maturities above 10 years has been capped at the maximum credit risk percentage requirement for the highest investment grade residential mortgage exposures as historical loss rates for advances have been below the loss rates for residential mortgages.

¹⁵ Based on Moody's data from 1977–98, historical defaulted-bond prices display a great deal of volatility and are zero at two standard deviations below the mean. Unless more data is examined and a positive recovery rate under credit stress conditions can be established with confidence, the Finance Board would adopt a recovery rate of zero for estimation of credit losses that are to be used for credit risk capital requirements.

¹⁶ According to Moody's data from 1970 to 1998, over a 4-year default horizon, the worst historical probability of default for assets initially rated triple-A is 1.21 percent.

¹⁷ This applies equally to triple-A rated securities issued by GSEs.

are downgraded below investment grade. Table 1.3 includes U.S. government securities that are backed by the full faith and credit of the U.S. government. These securities, which would include Government National Mortgage Association (GNMA) MBS, are assigned to the zero percentage category regardless of their maturity, because they are deemed not to present any credit risk to the Bank.

Credit risk capital requirements in Table 1.3 were developed for instruments without embedded prepayment options.¹⁸ Instruments with prepayment options, such as residential mortgage assets, would require a separate set of capital charges. Therefore, credit risk percentage requirements for residential mortgage related exposures are presented in Table 1.2.¹⁹ Due to prepayment features, the expected or weighted average maturity for 30-year, fixed-rate mortgages is significantly less than 30 years. Therefore, the credit risk percentage requirements in Table 1.3 would be too high for residential mortgage exposures. In addition, the pattern or timing of defaults between corporate bonds and residential mortgages significantly differ. The default rates for corporate bonds generally increase with the time horizon, whereas, mortgage defaults tend to be concentrated between years three and eight. See "Moody's Approach to Rating Residential Mortgage Pass-Through Securities," Moody's Investor Service, November 1996 (hereinafter Moody's). Based on Moody's analysis of the lifetime default curve for 30-year residential mortgages, the default rate becomes very small after 14 years and is zero after 22 years. Due to the build up of borrower equity in residential assets, the loss severity rates generally decline after the first few years of a residential mortgage's life. The Fitch IBCA Residential Mortgage-Backed

Securities model utilizes a 14 year credit loss horizon. See "Fitch IBCA Residential Mortgage-Backed Securities Criteria" Fitch IBCA, December 1998 (hereinafter Fitch IBCA). Somewhat similar default and loss patterns are found in Duff & Phelps model. See "The Rating of Residential Mortgage-Backed Securities" Duff & Phelps Credit Rating Co.

As required by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Housing Enterprises Act), OFHEO has identified a "benchmark loss experience" for fixed rate mortgages (defined as conventional, 30-year, fixed-rate loans secured by first liens) on single-family properties (defined as single unit, owner occupied, detached properties) that were originated from 1979 to 1993 by the secondary market housing enterprises. OFHEO proposed to base its benchmark credit loss estimates on a 10 year credit loss horizon See 61 FR 29616. (June 11, 1996).

In the proposed rule, residential mortgage assets, including MBS, held by Banks that are not rated directly for credit quality by rating agencies (NRSROs) must be rated for credit quality internally by Banks based on NRSRO criteria for rated MBS. The determination of credit risk percentage requirements or credit losses for residential mortgages under stress conditions would require estimates of the lifetime default rate corresponding to each rating category and the loss severity rate under stress conditions. In grading the relative credit risk of MBS, rating agencies employ the same symbol system as used for corporate bonds and counterparty obligations. As stated by Moody's, "The overall expected loss for a security of any rating should be the same, whether applied to an unsecured corporate instrument, a senior class of an MBS transaction (where losses would be of small magnitude), or a subordinate tranche." Moody's at 2. To determine the appropriate thresholds on the distribution of mortgage default rates to be associated with each rating level, Fitch IBCA calibrated the lifetime mortgage default rate curve to the default rate curves for corporate bonds. Fitch IBCA at 4. This means that the corporate bond default rate data could provide a means of determining default rates comparable to mortgage default rates at each credit rating level. Based on the above analysis and conversations with rating agencies, it appears that a credit loss horizon of 15 years would be sufficient to capture the credit risk from residential mortgages. Therefore, the maximum default rate for a 15 year horizon from Moody's Default Risk

Service is utilized for calculation of credit risk percentage requirements for residential mortgage assets with prepayment features.

The loss severity rates for residential mortgages can be significantly different from the loss severity rates for corporate exposures. Private label mortgage issues rated single-B have had loss severity rates of 100 percent even though the private label market has yet to cope with a period of serious stress or a prolonged recession. In addition, the actual loss rates for some of the single-B rated issues have been 100 percent. Conversations with credit rating agencies indicate that the loss severity rates for mortgages are associated with credit ratings. Mortgage issues rated triple-A would be expected to have relatively small losses even under a severe recession, and loss severity rates increase with a decline in credit rating. Thus, a loss severity rate of 100 percent is assumed for residential mortgage assets rated single-B or below. Loss severity rates for investment grade mortgage assets are derived by calibrating them to the pattern of loss rates for long corporate bonds.

Credit risk percentage requirements in Table 1.2 for residential mortgage assets are based on 15-year maximum default rate from Moody's Default Risk Service database and the rating specific loss severity rate. Unless separate credit risk percentage requirements are determined by the Finance Board for other classes of mortgages, such as multifamily and commercial properties, the percentages in Table 1.3 would apply to such rated credit exposures. The Finance Board seeks comment on the methodology used for setting credit risk percentage requirements, as well as alternative approaches for setting such percentages, that are linked to specific credit ratings from NRSROs.

Table 1.4. To the extent possible, credit risk percentage requirements are derived from actual loss experience during periods of financial stress. For several asset categories, however, there is no relevant loss experience from which to calculate the credit risk percentage. The credit risk percentage requirements for certain unrated assets are set forth in Table 1.4, and are the same as previously proposed in the FMMA. Cash would be assigned to the zero percent category, as it is deemed not to present any credit risk to the Bank. All of a Bank's tangible assets, "Premises, Plant and Equipment," as well as any unrated targeted debt or equity investments made by the Banks

¹⁸The proposed credit risk percentage requirements in Table 1.3 are based on the credit risk from typical bonds that carry normal coupons. Zero or low coupon exposures would require credit risk percentage requirements higher than those being proposed. The Banks' holdings of such exposures and other complex credit-related instruments would be monitored and assigned appropriate credit risk percentage requirements on a case-by-case basis.

¹⁹Conceptually, the data in Table 1.2 should be based on historical mortgage default data. Because sufficient data on historical mortgage default rates was not available, however, the percentages in the table are derived from corporate bond default rates and mortgage loss recovery rates, adjusted to approximate mortgage default rates. The Finance Board believes that the use of corporate bond data is less than ideal and intends to seek better sources of historical mortgage default data for purposes of the final rule. The Finance Board requests comment on any other methods of obtaining accurate data on historical mortgage loan defaults.

pursuant to proposed § 940.3(a)(5),²⁰ would be assigned an 8.0 percent requirement. The targeted investments included in this category would be certain non-securitized debt or equity investments that advance certain specific public welfare goals. The 8 percent credit risk percentage requirement for these categories is consistent with the Basle Accord (with regard to tangible assets) and with the capital requirements applicable to national banks (with regard to public welfare investments).

Bank determination of specific credit risk percentage requirements. The proposed rule would require each Bank to determine the credit risk capital requirement for each asset and item, first by identifying its type, its credit rating, and, its remaining maturity (as appropriate), then by identifying its appropriate risk category and applying the applicable credit risk percentage for that risk category under Tables 1.1 through 1.4. The proposal includes guidance for the Banks on how to determine the credit rating for a particular asset or item.

The proposed rule would require the Banks to apply certain criteria when determining the credit rating to be used in finding the applicable credit risk percentage requirement from Tables 1.2 and 1.3. 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 rated or the asset or item is backed by collateral that is 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, and the portion of the asset or item that is not 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 with a maturity of less than one year 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 maturity equal to or less than one year, which would carry a credit risk percentage requirement from Table 1.3 of 0.15 percent, and the remaining 75 percent of the value of the asset will be assigned to the fourth highest investment grade category with a maturity equal to or less

than one year, which would carry a credit risk percentage requirement of 1.30 percent.

The proposal further provides that the Banks must 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, or third highest investment grade, for credit risk-based capital charge 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 more difficult to calculate credit risk percentage 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 Tables 1.1 or 1.4 (which do not need to be rated), 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 percentage requirement for the particular asset or item. 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 collateral other than marketable securities, 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 credit risk 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 and have a superior priority to all other parties with competing claims to the asset), must have a readily determinable value at which it can be liquidated, and must be held in conformance with the Bank's member product policy. See 12 CFR § 917.4. 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 percentage requirement, a bank must make appropriate allowance for discounts, such as haircuts or overcollateralization, to reflect the price risk underlying the collateral.

Credit equivalent amounts 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. The proposed rule would require the Banks to convert all off-balance sheet credit exposures into equivalent on-balance-sheet credit exposures or credit equivalent amounts, determine the type of the item, and then apply the appropriate credit risk percentage requirement from the tables to estimate the instrument's credit risk capital charge. 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 on-balance-sheet credit equivalents. 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. Table 2 in proposed § 932.4(e)(1), which

²⁰ See 65 FR 25676, 25688 (May 3, 2000).

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 used to calculate the credit equivalent amount of an off-balance sheet instrument other than a derivative contract. The conversion factors are given in percentage form so that a conversion factor of 50 results in the face value of the off-balance sheet instrument being multiplied by 0.50 to calculate the credit equivalent amount.

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 it is not one that can be ignored. The proposed rule would assign a credit conversion factor of zero percent for other commitments that are unconditionally cancelable by the Bank without prior notice, or that effectively provide for automatic cancellation, due to deterioration in a borrower's creditworthiness. The proposed rule also would allow the Banks to use Finance Board approved internal models to calculate credit conversion factors instead of those specified in Table 2.

Under the proposed FMMA, a standby letter of credit (SLOC) would have been assigned a 100 percent conversion. Because a SLOC issued by a Bank is rarely drawn down, and if drawn down it converts to an advance, the Finance Board believes that it would be more appropriate to assign a Bank SLOC a 50-percent conversion factor, and has done so in the proposed rule. The Finance Board intends to undertake further research on the magnitude and appropriateness of the credit conversion factors set forth in proposed Table 2 and may make revisions in the final rule based on this research. The Finance Board requests comment on the credit conversion factors generally, and what issues might be appropriate to address as part of the anticipated research on this issue.

Credit equivalent amounts for derivative contracts. The proposed rule provides that for market driven instruments such as over-the-counter derivative contracts, *i.e.*, swaps, forwards, and options, subject to

counterparty default, the credit risk percentage requirement will be based on both current and potential future credit exposures (PFEs). 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 PFE (sometimes referred to as the potential future replacement cost) of the contract.

The proposed rule provides that the current credit exposure is equal to the maximum of the mark-to-market value of the contract, if that value is positive. A current credit exposure of zero is applied for contracts with a zero or negative mark-to-market value because such contracts do not create any current credit exposure for a Bank.

The proposed rule provides that the 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.²¹ Under this approach, the PFE of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional amount of the contract by a credit conversion factor for the underlying market risk, as specified in proposed Table 3 of proposed § 932.4(f)(3)(i). The credit conversion factors are given in percentage terms such that a conversion factor of 7 would require the notional amount of a derivative contract to be multiplied by 0.07 to calculate the PFE for the contract.

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 must be treated as Other Commodities for purposes of applying proposed Table 3. If a Bank determines to use proposed Table 3 for credit derivative contracts, the credit conversion factors applicable to Interest Rate Contracts under proposed Table 3 would apply.²²

²¹ 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.

²² 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. Within each category of market risks, a Bank would not be allowed to arbitrage between capital requirements based on proposed Table 3 and internal models.²³ If a Bank were to use an internal model for a particular type of derivative contract, the Bank would be required to use the same model for all other similar types of contracts. The Bank, however, could use an internal model for one type of derivative contract and proposed Table 3 for another type of derivative contract. Adjustments to the credit conversion factors provided in Table 3 are specified in the proposed rule for contracts with multiple payment dates or that automatically reset to zero following a payment.

The proposed rule does not include 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, even where the credit risk of one is significantly more concentrated than that of the other. As noted by the BCBS, however, this limitation may be effectively addressed in a portfolio-based internal credit risk model 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 their counterparties are financial institutions. The remaining unrated exposures are insignificant and may be dealt with outside a credit risk model. The Finance Board requests comment on whether the rule should take into account the diversification of a Bank's portfolio, and if so, how that should be done.

The proposed rule sets forth specific requirements for calculation of credit equivalent amounts for multiple derivative contracts subject to a

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.

²³ 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 would 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.

qualifying bilateral netting contract, as defined in the proposed rule. The provisions in the proposal are consistent with the requirements set forth in the risk-based capital guidelines of the federal bank regulatory agencies.

Zero credit risk charge for assets and items. The proposed rule would allow on-balance sheet assets that are hedged with credit derivatives to be assigned a zero credit risk capital charge under three specified scenarios. Even if the credit risk capital requirement for the on-balance sheet asset were decreased through the use of a credit derivative, the applicable credit risk capital required for the derivative contract still would be applied.

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 and value at risk models for trading portfolios. Under the proposed rule, only some of the offsets would 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 charge for the on-balance sheet asset to zero. For example, if a Bank purchases a triple-B rated corporate bond with a maturity of five years and at the same time enters into a five-year credit default option contract based on the same bond, the credit risk capital charge for the underlying asset will be zero. The net credit risk capital charge for the pair will equal the credit risk capital charge for the credit exposure on the derivative contract.

If the on-balance sheet asset and the asset referenced in a credit derivative are identical, but the remaining maturities for the asset and the credit derivative are different, the capital relief in the proposed rule would depend on a maturity comparison between the two. For example, if the same triple-B rated five-year corporate bond was hedged with a credit derivative referenced to the same five-year corporate bond with a remaining maturity of two years or longer, there would be no credit risk associated with the underlying asset given the Finance Board's proposed default horizon of two years. Therefore, such a hedge would be fully recognized and the credit risk capital charge on the underlying asset would be zero. If the credit derivative maturity were less than two years, however, no capital relief would be granted because the credit derivative would not off-set the exposure associated with the asset for the complete term of the proposed

default horizon. In all cases, there will be a credit risk capital charge for the credit exposure on the derivative contract.

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

Where the on-balance sheet asset and the asset referenced in the credit derivative 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. The Finance Board also more generally requests comment on how it should account for credit derivatives in calculating credit risk capital charges.

The proposed rule also would allow foreign exchange rate contracts with an original maturity of 14 calendar days or less to be assigned a zero credit risk capital charge. Gold contracts would not be considered exchange rate contracts. Derivative contracts that are traded on regulated exchanges that require daily collection of variation margin for the contract also would be assigned a zero credit risk capital charge.

The credit risk capital charge calculations required by the proposed rule, unless otherwise directed by the Finance Board, must be performed based on a Bank's on-balance sheet assets and off-balance sheet items as of the close of business on the last business day of the month for which the

credit risk capital requirement is being calculated. Where applicable, calculations of credit risk capital charges must use the most current NRSRO credit risk ratings available as of the last business day of the month for which the credit risk capital requirement is being calculated.

Market Risk Capital Requirement. The GLB Act requires each Bank to maintain sufficient permanent capital, as determined in accordance with Finance Board regulations, to cover the market risk to which the Bank is subject. 12 U.S.C. 1426(a)(3)(A)(ii), *as amended*. It further specifies that each Bank's market risk be determined:

based on a stress test established by the Finance Board that rigorously tests for changes in market variables, including changes in interest rates, rate volatility, and changes in the shape of the yield curve.

Id. Beyond requiring that the stress test include the effects of changes in the interest rates, rate volatility and changes in the shape of the yield curve, neither the elements of market risk nor specific elements of the stress test are further defined in the statute, leaving the Finance Board with a degree of discretion to determine the terms and elements of the market risk stress test.

The GLB Act also directs the Finance Board, in developing the market risk stress test, to "take due consideration" of any risk-based capital test established by OFHEO for Fannie Mae and Freddie Mac, with such modifications as are appropriate to reflect differences in operations between the Banks and Fannie Mae and Freddie Mac. 12 U.S.C. 1426(a)(3)(B), *as amended*. This provision requires the Finance Board to take "due consideration" of the OFHEO capital rule only as it may relate to market risk. It does not require consideration of other aspects of the OFHEO rule, such as those relating to credit risk, nor does it mandate deference to OFHEO in any respect. The Finance Board has included the proposed OFHEO market risk test among the factors it has considered in developing the proposed market risk provisions of its capital rules. The Finance Board has modeled a hypothetical \$100 billion asset Bank with a portfolio composition similar to the portfolio composition of Freddie Mac and Fannie Mae. The results of this simulation show that the Finance Board's risk-based capital requirement is consistent with what OFHEO has proposed to require for Freddie Mac and Fannie Mae. Given this consideration, the Finance Board believes that it has complied with its legal obligations under the GLB Act. Further, although

OFHEO has not yet adopted a risk-based capital test, the Finance Board intends to consider the substance of the final rule once it is adopted by OFHEO.

Market risk may be defined as the risk that the market value, or estimated fair value if market value is not available, of a Bank's portfolio will decline as a result of changes in interest rates, foreign exchange rates, equity prices and commodity prices. The Banks engage in activities that carry complex on-and off-balance sheet market risks. For example, outstanding consolidated obligations (COs), for which the Banks are jointly and severally liable, include bonds having embedded options, callable and index amortizing bonds, bonds denominated in foreign currencies, and bonds linked to equity prices. To hedge the market risk on such instruments, the Banks typically enter into off-balance sheet derivative contracts that convert the bonds to simple fixed-rate or floating rate bonds or convert the exposure to U.S. dollars. The Banks also make advances on a simple fixed-or floating-rate basis, as well as callable, putable/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 needed to address market risks should be similar to the market risk capital requirements established or recommended by the BCBS and other financial institution regulatory agencies, but broader in scope. The Finance Board further believes that the general approach to market risk developed by the BCBS, as modified in this proposed rule, is consistent with the statutory requirements of the GLB Act.

As previously discussed, the BCBS has led the drive to institute a risk-based capital system for general market risk. 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 to incorporate a measure for market risk, effective as of January 1, 1998 (Joint Rule). 61 FR 47358 (Sept. 6, 1996). 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, including mortgages or other similar types of instruments.

Financial institutions regulated by the Office of Thrift Supervision (OTS) and by the Farm Credit Administration (FCA) currently are subject to credit risk capital requirements that contain no market risk capital components (consistent with the small bank regulatory capital framework). See 12 CFR 567.5 (OTS), 615.5205, 615.5210 (FCA). OFHEO, however, has published a Notice of Proposed Rulemaking including its regulatory model for calculating risk-based capital for Fannie Mae and Freddie Mac, which model does account for both interest rate risk and credit risk. See 64 FR 18083 (Apr. 3, 1999). The OFHEO interest rate risk based capital rule is mandated by the 1992 Housing Enterprises Act, which requires that capital requirements account for market risks. Under the proposed OFHEO test, the market risk capital requirement would be determined by a stress test, which examines the effects of two specified interest rate shocks. See 12 U.S.C. 4611(a)(2). The 1992 Housing Enterprises Act establishes parameters that OFHEO must meet in developing the model used to implement its stress test such that many aspects of OFHEO's stress test are dictated by legislation. This legislative approach is in contrast to the greater flexibility afforded the Finance Board in developing its stress test under the GLB Act. While the 1992 Housing Enterprises Act reflected the state of the art in risk measurement at the time it was drafted, the Finance Board's proposed regulation seeks to incorporate improvements in risk measurement that have been made since then. Furthermore, the statutory

constraints imposed on OFHEO have rendered it difficult for OFHEO to develop and implement its capital requirements in a timely manner. The Finance Board believes that its proposed approach would reach the same goal as OFHEO's proposal—that of providing sound capital requirements based on the economic risks undertaken by the regulated entities—albeit with inevitable differences in the underlying methodology. Nonetheless, the Finance Board also notes that its proposed market risk rule would provide Banks with the opportunity to develop a cash flow model, similar to that proposed by OFHEO, as long as the cash flow model is consistent with the requirements of the GLB Act and the Finance Board's proposed requirements governing internal market risk models, and is approved by the Finance Board.

Currently, the FMP limits the Banks' interest rate risk based on a methodology that uses interest rate shocks similar to those proposed but never adopted by the four federal bank regulatory agencies (the OCC, the FRB, the FDIC, and the OTS). Specifically, the FMP requires the Banks to maintain the duration of their equity to within ± 5 years and to maintain the duration of their equity to ± 7 years under an assumed change in interest rates of ± 200 basis points. See FMP Section VII.

In the view of the Finance Board, the methodology underlying the FMP is not sufficiently flexible to capture the Banks' market risks as they currently exist, or as they are likely to evolve given the recent proposal to expand their investment authority. See 65 FR 25676 (May 3, 2000). Additionally, the risk management approach of the FMP is not consistent with a risk-based capital structure, nor would it allow the Finance Board to establish a market risk capital requirement based on a stress test that "rigorously tests for changes in market variables" and captures the risks to which a Bank is subject, as required by the GLB Act. Accordingly, the proposed rule sets forth an approach to measuring market risk that is based on the value at risk (VAR) framework adopted by the BCBS and other financial institution regulators. This approach can be implemented with commercially available models, is practical, and is sufficiently rigorous to comply with the requirements of the GLB Act. In particular, the proposed rule would require each Bank's internal market risk model to capture the effects of various shifts in the interest rate yield curve beyond parallel shocks, and to account for other financial and market shocks that could be experienced by the Banks given historic experience.

Components of the market risk capital requirement. The proposed market risk capital requirement is the sum of two separate components. One component is the amount by which the current market value of a Bank's total capital is less than 95 percent of the book value of the Bank's total capital. The current market value of a Bank's total capital would be estimated by using the Bank's internal risk model to calculate the market value of the Bank's on-balance sheet assets, liabilities and off-balance sheet items. In essence, these values would be the base line values for the Bank's portfolio prior to running any stress tests required by the proposed rule. The "book value" of total capital would equal the Bank's total capital where all on-balance sheet assets, liabilities and off-balance sheet items are accounted for under GAAP. The second component of the proposed market risk requirement would be the market value of the Bank's portfolio at risk, as estimated by the Bank's approved internal risk model. This value would equal the maximum loss in the market value of a Bank's portfolio under various stress scenarios, where the Bank's portfolio would be comprised of all its on-balance sheet assets and liabilities, and all off-balance sheet items.

The 95 percent test. The Finance Board believes that significant impairment in a Bank's market value of capital, to the extent that it is not reflected in the book value of capital, must be taken into account in developing an adequate market risk capital requirement. To address this issue, the Finance Board proposes to increase the market risk capital requirement by the amount, if any, that a Bank's market value of total capital is less than 95 percent of its book value of its total capital. Thus, given the proposed test, if the current value of a Bank's total capital were significantly diminished by adverse market changes, a Bank's ability to take on risk would be restrained even if the impact of such adverse market events were not reflected in the book value of a Bank's total capital.

Generally, the proposed rule requires a Bank to measure and report its capital adequacy based upon the book value of total or permanent capital, calculated in accordance with GAAP. Because the Banks have large portfolios of long-term on- and off-balance sheet positions that are held-to-maturity, however, a Bank's financial strength, expressed by its market value, can decline significantly without that decline being reflected in

the Bank's book value of capital.²⁴ This is because under GAAP, held-to-maturity positions would generally be valued at historic cost. Without the proposed 95 percent market value test, a Bank could incur a significant loss in financial strength due to adverse market changes, but not alter its market risk profile in response to that loss. The Finance Board is proposing this 95 percent test as a safeguard measure and believes that it will have little effect on Bank operations because most Banks have a market value of capital above 95 percent of book value. The charge associated with the 95 percent test would only limit a Bank's risk taking activities if its market value of capital were to fall below the 95 percent benchmark, and the Bank had otherwise fully leveraged its permanent capital.

Measurement of market value at risk under a Bank's internal market risk model. The proposed rule requires each Bank to estimate the current market value of its portfolio and measure the market value of the portfolio at risk using an internal VAR model, subject to the parameters in the proposed rule. Each Bank's internal model must calculate the value of a Bank's portfolio at risk during periods of market stress, given the interest rate, foreign exchange rate, equity price, and commodity price risks undertaken by the Bank, including risks of related options positions.

The Finance Board notes that even where foreign exchange, equity or commodity price exposures are hedged, the market valuations may differ from valuations for hedging instruments 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 would generally remain. Under the proposed rule, however, a Bank is not required to determine the market value of its portfolio at risk from its exposure to interest rate, foreign exchange rate, equity price, and commodity price risk if those risks are not material. For example, such risks may be effectively eliminated through matching hedges such as "mirror swaps" arranged in conjunction with the issuance of consolidated obligations denominated in foreign currencies or linked to equity or commodity prices, which typically reduce a Bank's market risk exposure to foreign exchange, equity or commodity price risk to an immaterial amount.

²⁴ The held-to-maturity items in a Bank's portfolio would typically include 15 and 30 year fixed-rate mortgage loans and fixed-rate pass-through MBS.

The proposed rule would require the Banks to calculate the market value of their portfolios at risk associated with these risks except, as discussed below, in the narrow circumstances where such risks may be immaterial. The proposed rule would allow the value at risk measure to incorporate empirical correlations within and among foreign exchange rates, equity prices, and commodity prices, subject to a Finance Board determination that the model's system for measuring such correlations is sound. The Finance Board is requesting comment on whether the final rule should require the Banks to account for basis risk by incorporating the correlations across risk categories in the market risk model.

The Finance Board believes that it is appropriate to exempt a Bank's exposure to certain hedged risks from the market value at risk calculation. The Finance Board emphasizes that this proposed exception is a narrow one, and the Banks would be expected consistently to estimate a market value at risk measurement for instruments linked to foreign exchange rates, equity prices, and commodity prices unless the hedging of those risks in each instrument results in those risks being immaterial. Given the Banks' portfolios, however, the Finance Board does not expect that the Banks' overall exposure to interest rate risk could ever be considered immaterial.²⁵ If the proposed "immateriality" exception is adopted, the Finance Board intends to direct its staff to monitor the Banks' implementation of the exception to assure that it is applied strictly in accordance with its underlying purpose.

As proposed, the rule would allow each Bank to develop an internal market risk model that uses any generally accepted measurement technique, such as variance-covariance models, historical simulations, or Monte Carlo simulations, provided that the measurement technique covers the Bank's material risks. In this respect, the proposed rule specifically 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. Thus, for example, while

²⁵ 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. As a result market risks associated with foreign exchange rates, equity prices, and commodity prices are currently small relative to interest rate risk. Therefore, the bulk of the proposed market risk capital requirement will reflect interest rate and related options risks.

a variance-covariance methodology may be sufficient for estimating the market value at risk associated with instruments that contain no optionality, it would be essential to use a simulation technique for instruments with options characteristics.

The proposed rule also provides that a Bank's internal market risk model must use interest rate and market price scenarios of the Bank's choosing for estimating the market value of the Bank's portfolio at risk, subject to certain minimum requirements. These requirements are that the internal risk model must incorporate: (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 one percent; and (ii) scenarios that reflect changes in interest rates, interest rate volatility and the shape of the yield curve equivalent to those that have been observed over 120-business day periods of market stress. The proposed rule specifies that for interest rates, the relevant historical observation period would start at the end of the month prior to the month for which the market risk capital requirement is being calculated and go back to the beginning of 1978. This time frame represents a modern period with a relatively liquid debt market that also includes periods of market stress. The rule would also allow the market value at risk measure to incorporate empirical correlations among interest rates, subject to a Finance Board determination that the model's system for measuring such correlations is sound. These required scenarios assure that the stress tests performed using the Bank's models will be rigorous and fulfill the statutory requirements of the GLB Act.

The proposed rule provides that if a Bank participates in COs denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, 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 such that the probability of a loss greater than that estimated must not exceed one percent and must include scenarios that reflect changes in rates and market prices that have been observed over 120-business day periods of market stress. For foreign exchange, equity and commodity prices, the relevant historic observation period can be chosen by the Banks, but such period must be acceptable to the Finance Board. The chosen time periods generally must reflect periods of stress, which given the risk exposures of a Bank, could have resulted in a strong negative impact on the Bank's financial

position. Although 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, this requirement reflects the conservative approach adopted by the Finance Board with respect to the Banks' safety and soundness.

The proposed rule also makes clear that Banks are required to hedge risk arising from consolidated obligations that are denominated in foreign currencies or otherwise linked to foreign exchange, equity or commodity prices, and to enter into a replacement contract if there is a default by a counterparty on an existing hedging contract. Besides strengthening safety and soundness, the proposed requirement formalizes the long standing practice at the Banks under which the Banks do not assume unhedged foreign exchange, equity or commodity positions and is consistent with the requirement in proposed § 956.3(b). See 65 FR 25676, 25692 (May 3, 2000).

Independent validation of Bank internal market risk model. The proposed rule provides that each Bank annually 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. The Finance Board would be able, however, to require such reviews to occur more frequently. In order for validations conducted within the Bank to be considered independent, the validation would have to be carried out by personnel not reporting to persons responsible for conducting or overseeing business transactions for the Bank. As contemplated by the Finance Board, the required validation could include periodic comparisons, such as on a quarterly basis or annual basis, of model-generated mark-to-market values with values obtained from dealers/markets or of model-generated market value at risk measurements obtained from an independent third-party source. An integral part of this process, however, is the necessity to validate key assumptions and associated parameters underlying the Bank's market risk models. For example, the Finance Board would expect a Bank to determine periodically the impact on its market value at risk measurements from shifts in key parameters such as correlations or regime shifts in volatility parameters. The results of such validations would be reviewed by the Bank's board of directors and provided to the Finance Board.

Under the proposed rule, 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 initial use or to implementing the subsequent adjustments. A Bank would be required to make any adjustments to its model that may be directed by the Finance Board. In addition, the calculations required by the proposed rule, unless otherwise directed by the Finance Board, must be performed based on the Bank's portfolio as of the close of business on the last business day of the month for which the market risk capital requirement is being calculated.

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.²⁶ While certain modeling techniques may capture the effects of basis risk on a Bank's portfolio, the proposed rule does not require a Bank's model to capture basis risk. At this time, the Finance Board is requesting comment on how best to treat basis risk in the final rule.

Operations Risk Capital Requirement. Operations risk is 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 statutory requirement imposed on Fannie Mae and Freddie Mac, 12 U.S.C. 4611(c)(2), but will allow the Banks the option of demonstrating to the Finance Board that a lower requirement should apply.

As proposed, § 932.6 provides that each Bank's operations risk capital requirement shall equal 30 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement. The proposed provision, however, allows a Bank to substitute an alternative methodology for calculating the operations risk capital requirement if such methodology is approved by the Finance Board. In addition, a Bank may obtain insurance to cover it for operations risk and, with Finance Board approval, proportionately reduce the

²⁶ See *Principles for the Management of Interest Rate Risk* (Jan. 1997).

operations risk capital requirement. Any insurance obtained must be from an insurer that has at least the second highest investment grade credit rating by an NSRSO. As proposed, however, the rule specifies that in no case may a Bank's operations risk requirement be reduced to less than 10 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement.

Reporting Requirements. Proposed § 932.7 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 permanent capital calculated as of the last day of the preceding month, or more frequently as may be required by the Finance Board.

L. Minimum Liquidity Requirements. Liquidity risk is the risk that a Bank would be unable to meet its obligations as they come due or to meet the credit needs of its members and associates in a timely and cost-efficient manner. See 65 FR 25267, 25274 (May 1, 2000), *to be codified* at 12 CFR 917.1. 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. Neither, however, 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 obligations of the United States, deposits in banks or trusts, or advances to members that mature in 5 years or less. 12 U.S.C. 1431(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.²⁷ The Finance Board requests comment on whether the rule should address the issue of operational liquidity, and if so, how it should do so. The proposed rule provides that the Banks not only must meet the statutory liquidity requirements, 12 U.S.C. 1431(g), but also must hold contingency liquidity in an amount sufficient to enable the Bank to cover its liquidity risk, assuming a period of not less than five business days of inability to borrow in the capital markets. Contingency liquidity may be provided, for example, by 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; (3) assets that are generally accepted as collateral in the repurchase agreement market; and (4) irrevocable lines of credit from financial institutions rated not lower than the second highest credit rating by a NRSRO. The proposed rule specifically states that an asset that has been pledged under a repurchase agreement cannot be used to satisfy the contingency liquidity requirement, because such an asset will not be available to provide liquidity should a contingency arise.

The proposed five business 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 determined from calculations using daily data on CO redemptions during 1998. The Finance Board found that the 99th percentile of the five-business day CO redemption distribution resulted in liquidity requirements that ranged from

about 5 percent to 17 percent of each Bank's total assets.

Other regulators recognize the importance of adequate levels of liquidity but, for the most part, have not always 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. For example, each institution regulated by the Farm Credit Administration is required to maintain a minimum liquidity reserve. 12 CFR 615.5134. 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. The importance of liquidity is also 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. OFHEO has not published any regulation concerning liquidity requirements for Fannie Mae and Freddie Mac.

Liquidity problems may arise from concerns about the creditworthiness of the Banks or from events that may temporarily disrupt the Banks' access to the credit markets. 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 GSE in question received assistance from the federal government.²⁸ 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

²⁷ Recently adopted 12 CFR § 917.3(b)(3)(iii) requires 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. See 65 FR 25267, 25275 (May 1, 2000).

²⁸ See Federal Reserve Bank of Richmond, *Instruments of the Money Market* 153 (1993).

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 case, the proposed contingency requirement is not meant to address such an event. The five business day contingency liquidity requirement could, however, provide 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.

The proposed requirement is meant to address principally events that may temporarily disrupt a Bank's access to credit markets. It 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.

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.²⁹ Thus, the Finance Board believes that the proposed liquidity requirement is important to maintaining a sound credit rating for the Banks and assuring continued safe and sound operation of the Bank System and access to the capital markets.

M. Limits on Unsecured Extensions of Credit. The proposed rule also would establish maximum capital exposure limits for unsecured extensions of credit by a Bank to a single counterparty or to affiliated counterparties. As proposed, the rule also establishes reporting requirements for total unsecured credit exposures and total secured and unsecured credit exposures 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 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 the counterparty because of concerns about the counterparty's ability to repay a loan. The Bank's concentration of credit in such a counterparty may indicate that the Bank's extensions of credit are 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 the value of the Bank's remaining loans to the counterparty. Further, a Bank may even be tempted to lend additional funds to the counterparty to keep the counterparty in business, in order to protect its existing 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 credit exposures 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 requirement in the proposed rule does not take into account the increase in credit risk associated with concentrations of credit exposures. Therefore, the Finance Board believes that it is necessary, for safety and soundness reasons, to impose separate limits on unsecured credit exposures of 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 U.S.C. 84; 12 CFR Part 32 (the lending limit for a national bank is generally 15 percent of its capital and surplus).

Currently, the FMP limits Bank unsecured credit exposures 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 exposure 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, § 932.9(a)(1) of the proposed rule provides that unsecured credit exposure by a Bank to a single counterparty that arises 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 information on Tier 1 capital is not available.³⁰ 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 one percent for counterparties with a below

³⁰ For the purposes of the proposed requirements related to limits on and reporting of credit concentrations, the term "total capital" when used in reference to capital held by a Bank's counterparty (or an affiliate of such counterparty) would have the same meaning as in regulations issued by the counterparty's (or the affiliate's) principal regulator and not as defined in proposed § 930.1. The proposed rule makes clear in the affected sections when the meaning of "total capital" differs from that in proposed § 930.1.

²⁹ Moody's Investor Service, Global Credit Research, *Moody's Credit Opinions—Financial Institutions*, (June 1999).

investment grade rating. These limits are consistent with those established internally by large lenders. Section 932.9(a)(3)(iii) 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 § 932.9(a)(3)(iii)(A).

The proposed rule also provides that if a counterparty is placed on a credit watch for a potential downgrade by an NRSRO, the Bank would determine the maximum capital exposure under Table 4 by first assuming that an NRSRO had already downgraded the rating to the next lower grade and then choosing the exposure limit that corresponds to that next lower rating. Section 932.9(b) 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 information on Tier 1 capital is not available, of all of the affiliated counterparties.

Reporting requirement for total unsecured credit concentrations. Currently, there is no Finance Board requirement establishing a centralized mechanism for maintaining and measuring specific data on the aggregate unsecured credit concentration exposure 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.

Accordingly, 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 information on Tier 1 capital is not available), or in the case of affiliated counterparties, the combined Tier 1 capital (or total capital if information on 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.

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 U.S.C. 84; 12 CFR Part 32. 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, the proposed rule requires each Bank to report monthly to the Finance Board the amount of the Bank's total secured and unsecured credit exposures 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.

N. Part 933—Capital Plans.

Approval of Plans. The GLB Act requires the board of directors of each Bank to submit to the Finance Board a

capital plan within 270 days after the date of publication of the final capital rule. Each capital plan must establish the details for the new capital structure, which must provide sufficient capital for the Bank to comply with its regulatory total capital and regulatory risk-based capital requirements. The proposed rule would allow the Finance Board to approve a reasonable extension of the 270-day period upon a demonstration of good cause as to why the Bank does not expect to meet the statutory deadline. The Finance Board would determine what constitutes "good cause" on a case-by-case basis. As required by the GLB Act, a Bank must receive approval from the Finance Board prior to implementing its capital plan, or any amendment to the plan. As part of that approval process, the Finance Board would reserve the right to determine the effective date for each capital plan.

If a Bank, for any reason, were to fail to submit a capital plan to the Finance Board within the 270-day period, including any Finance Board approved extension, the proposed rule would authorize the Finance Board to establish a capital plan for that Bank, and the Finance Board also would have the discretion to take any enforcement action against the Bank, its directors, or its executive officers authorized by Section 2B(a)(5) of the Bank Act, or to merge the Bank in accordance with Section 26 of the Bank Act into another Bank that has submitted an acceptable capital plan.

Contents of Plan. The GLB Act sets forth requirements regarding the contents of each Bank's capital plan. The proposed rule would follow the statutory requirements and require that each Bank's capital plan address, at a minimum, the classes of capital stock, capital stock issuance, membership investment or fee structure, transfer of capital stock, termination of membership, independent review of the capital plan, and implementation of the plan. In addressing the classes of stock, the Finance Board is proposing that the capital plan shall, at a minimum, describe each class or subclass of capital stock to be issued to the members; establish the terms, rights, and preferences for each class and subclass of capital stock to be issued; establish the voting rights and preferences; and provide the basis on which the stated Class A dividends are to be calculated and whether such dividends are to be cumulative. In general, the Finance Board believes the inclusion of each of these items in the Banks' capital plans is necessary for the Bank to transition

smoothly to the new capital structure mandated by the GLB Act.

The proposed rule also would require each Bank to include in its capital plan a description of the manner in which the Bank intends to solicit its members for voluntary purchases of its capital stock. By requiring that the Banks address the issue of solicitations of voluntary purchases in its capital plan, the Finance Board would have the opportunity to ensure that the methods used are fair and equitable. The proposed rule also would require each Bank's capital structure plan to specify "operating capital ratios," *i.e.*, an "operating total capital ratio" and an "operating risk-based capital ratio," each of which would be set at a higher percentage than the regulatory total capital and the regulatory risk-based capital requirements, respectively, as established by the Finance Board. Because it is necessary that each Bank manage its risk portfolio such that it complies with its regulatory capital requirements, the Finance Board believes each Bank must establish target ratios at which to operate that are sufficiently higher than the minimum regulatory capital requirements. Doing so would allow each Bank to manage its capital accounts in a manner that affords a capital "cushion" within which to conduct its operations while ensuring its compliance with the regulatory capital requirements.

The GLB Act requires that each Bank's capital plan specify the minimum investment required of the members. The proposed rule requires that each Bank's capital plan allow for the fulfillment of this requirement through either the purchase of Class A stock or the payment of an annual membership fee, as set forth in § 931.7. The Finance Board is proposing that a Bank's capital plan must allow a member to substitute the purchase of Class B stock for its membership investment of Class A stock. The capital plans also would be required to specify the methodology used by the Bank to determine the level of the membership investment or the annual membership fee. The Finance Board is proposing to allow the Banks to offer the option of a membership fee in order to provide additional flexibility to both the Banks and its members. By providing an option, the Banks would have more flexibility in controlling their capital accounts while meeting the needs of their members.

If, to fulfill its membership investment requirement, a member were to elect to invest in the capital stock of the Bank, the Finance Board is proposing that the member be provided

the option of investing in Class B stock, if authorized by the Bank, at a proportionately lesser amount than would be required if the member purchased Class A stock. The terms of Class A and Class B stock, as specified in the Bank's capital plan, will dictate an appropriate rate of substitution of Class B stock for Class A stock to fulfill the membership investment requirement. For example, one term imposed by the GLB Act is to weight Class B stock at 1.5 times of Class A stock for purposes of determining compliance with the five percent leverage requirement, which, taken alone, suggests that one share of Class B stock should substitute for more than one share of Class A stock. In proposing that this provision be included in the Banks' capital plans, the Finance Board is providing the Banks the opportunity to offer members different membership investment options.

Additionally, the proposed rule requires that each Bank's capital plans specify that the board of directors of the Bank review and adjust the membership investment periodically to ensure that the Bank complies with the regulatory capital requirements and, further requires members to comply promptly with any adjusted membership investment.

The Finance Board is also proposing that a Bank's capital plan may specify a fee to be imposed on a member that cancels a notice of withdrawal or a notice of redemption. The decision to impose a fee structure would be at a Bank's discretion, but the methodology used to calculate such fees would need to be specified in the capital plan. The conditions under which a Bank may impose a fee also must be specified in its capital plan to ensure the fair and equitable imposition of fees among members. The Finance Board is proposing the option of establishing a fee in order to minimize the Bank's costs associated with canceling a notice of withdrawal or redemption.

As required in the GLB Act, the capital plan must establish the criteria for the issuance, redemption, retirement, or purchase of Bank stock by the Bank, and for the transfer of Bank stock between members of the Bank. The capital plan must also specify that the stock of the Bank may only be issued to or held by the members of the Bank, and that no entities other than the Bank may trade the stock of the Bank.

Under the proposed rule, as required in the GLB Act, the plan must address the manner in which the Bank will provide for the disposition of its capital stock that is held by institutions that terminate their membership, and the

manner in which the Bank will liquidate claims against its members, including claims resulting from prepayment of advances prior to their stated maturity. Also as required in the GLB Act, the plan must include a report from an independent certified public accountant regarding the extent to which the implementation of the plan would affect the redeemable stock issued by the Bank and a report from an NRSRO regarding the extent to which the implementation of the plan would affect the credit rating of the Bank. The plan must also demonstrate that the Bank has made a good faith determination that the Bank will be able to implement the plan as submitted and that the Bank will be in compliance with its regulatory total capital requirement and regulatory risk-based capital requirement.

Implementation of Plan. The Finance Board is proposing that each Bank's capital plan must specify the manner in which the members of the Bank may convert or exchange their existing Bank capital stock into either, or both, Class A and Class B capital stock. The plans should address how the conversion or exchange will take place and the likely outcome in terms of total Class A and Class B stock, as demonstrated by prior commitments of members, surveys, or other quantifiable means. The proposed rule also requires that the capital plan specify what will happen to existing Bank stock owned by a member that does not affirmatively elect to convert or exchange its existing Bank stock into either Class A or Class B stock or some combination of both.

As required by the GLB Act, each Bank's plan must include a transition provision that specifies the date on which the plan is to take effect, as well as the date, not to exceed three years from the effective date of the plan, on which the Bank must be in full compliance with its regulatory total capital requirement and regulatory risk-based capital requirement. The GLB Act further requires that the capital plan for each Bank may include a provision allowing any institution that was a member of the Bank on November 12, 1999, a period of up to three years from the effective date of the plan in which to comply with the membership investment requirements of the capital structure plan. Any institution that was approved for membership after November 12, 1999, will be required to comply with the membership investment requirements as soon as the Bank's capital structure plan becomes effective. The Finance Board also requests comment on whether it would be appropriate for the final rule to allow

institutions becoming members after November 12, 1999 to be provided with a similar transition period.

O. Part 925 Membership Amendments.

The proposed rule would revise several provisions of the Finance Board's membership regulations to reflect changes made by the GLB Act. The existing membership regulations include provisions regarding the amount of Bank stock an institution must purchase upon becoming a member. Because that issue would be addressed by the capital regulations and the capital plan for each Bank, the proposed rule would remove all stock purchase requirements from the membership regulations.

The proposed rule also would revise the existing provisions that pertain to the effect of a merger or other consolidation of a member into another member of the same Bank, a member of another Bank, or a nonmember. Generally speaking, the Bank membership of an institution terminates when its charter is cancelled in connection with its merger or consolidation into another institution. The proposed rule would retain that concept, but would consolidate the substance of the two sections that deal separately with the consolidation into another member and into a nonmember, respectively. The proposed rule also would remove from the membership regulation provisions that address the treatment of the member's Bank stock, dividends, and advances, each of which is to be covered by other provisions of the regulations. For example, § 950.19 of the advances regulations provides that upon an institution's termination of membership, the Bank shall determine an orderly schedule for the liquidation of any indebtedness owed by the member to the Bank, and may allow the debt to run until its maturity. The Finance Board believes that the general requirement in § 950.19 for an orderly liquidation of indebtedness is sufficient and is proposing to remove the existing references to such liquidation from the provisions dealing with consolidation of members as being duplicative.

The proposed rule also would implement the provisions of the GLB Act that address the withdrawal of a member from a Bank. Section 6(d) of the Bank Act, 12 U.S.C. 1426(d), *as amended*, provides that any member may withdraw from its Bank by providing written notice of its intent to do so, provided that on the date of the withdrawal there is in effect a certification from the Finance Board (RefCorp certification) that the withdrawal will not cause the Bank

System to fail to meet its obligations to contribute to the debt service for the obligations issued by RefCorp, in accordance with Section 21B(f)(2)(C) of the Bank Act, 12 U.S.C. 1441b(f)(2)(C), *as amended*. The GLB Act further provides that the receipt of the notice by the Bank commences the applicable stock redemption periods for the stock owned by that member, *i.e.*, the 6-month and 5-year notice periods for Class A and Class B stock, respectively, and allows the member to receive the par value of its stock in cash at the end of the redemption period. During the notice period, the member may continue to receive dividends on its stock.

The proposed rule would require a member to specify in its notice of withdrawal the date on which it intends its termination of membership to become effective, which date may be no later than the date on which the last of its stock redemption periods end. If the notice does not indicate a withdrawal date, the proposed rule would provide that the withdrawal is deemed to take effect on the date that the last applicable stock redemption period ends. Because the Bank Act no longer links the withdrawal from membership to the redemption of stock, the proposed rule would allow an institution to terminate its membership in a Bank as early as upon the Bank's receipt of the member's notice of withdrawal, if the member so chose. The effect of an immediate withdrawal would be that an institution would cease to be eligible to obtain any further services from the Bank and would be at risk that the Bank would call due any advances outstanding to the member. Such an institution, however, could not redeem its Bank stock until the end of the applicable stock redemption period, notwithstanding its earlier termination of membership, but would be entitled to continue to receive dividends on its Bank stock for as long as it were to hold the stock. The proposed rule would allow a member to cancel a notice of withdrawal at any time before its effective date, by providing a written cancellation notice to the Bank. The proposed rule also would permit a Bank to impose a fee, which would be specified in its capital plan, on any member that withdraws a notice of termination.

As amended by the GLB Act, the obligation of the Banks to contribute to the annual RefCorp debt service was changed from a fixed dollar amount of \$300 million per year to a percentage amount, 20 percent of the net earnings of each Bank. In effect, the RefCorp certification requires the Finance Board to certify that the withdrawal of a

member would not cause the Bank System to fail to pay 20 percent of its annual earnings (on an aggregate basis) to discharge its RefCorp obligation. Because the GLB Act has changed the method of calculating the RefCorp obligation to a percentage formula, there are no circumstances in which the Bank System could ever fail to meet its RefCorp obligations, *i.e.*, if the obligation is to pay 20 percent of annual net earnings, and the net earnings for a given year were to be zero or negative, the obligation for that year would be zero. Moreover, if one or more Banks were to have zero or negative earnings, and zero contributions, for a particular year, the RefCorp obligation, as amended by the GLB Act, would be extended for some additional number of years, based on a present value calculation. The Finance Board anticipates addressing this matter by issuing a certification that the withdrawal of any member will not cause the Bank System to fail to meet its RefCorp obligation. That certification would remain in effect, thus allowing members to withdraw from membership without requesting individual certifications, until rescinded by the Finance Board.

The GLB Act also provides grounds on which the Bank may terminate the membership of an institution, such as in the case of violating the Bank Act or Finance Board regulations, or insolvency. The proposed rule would provide that the stock redemption periods commence on the date that a Bank removes an institution from membership, during which time the institution could continue to receive dividends on its stock, but not any other membership benefits.

If a member withdraws from membership, the proposed rule would require the Bank to determine an orderly manner for liquidating all indebtedness owed to the Bank and for unwinding other transactions with the member, and would provide that the Bank's lien on any stock held by the member would remain in effect until the debts are paid, the effect of which could be to delay the redemption of stock until the member has satisfied its indebtedness to the Bank. Once an institution terminates its membership, it may not again become a member of any Bank for five years, as required by the GLB Act amendments.

P. Part 956—Hedging Provisions and Part 960 Off Balance Sheet Items.

Use of hedging Instruments—§ 956.6: Section 956.6 of the proposed rule addresses the Banks' use of hedging instruments, such as interest rate swaps, options, and futures contracts. Hedging

instruments are derivative contracts or securities used to offset the risks associated with asset-liability management by financial institutions and others, typically relating to interest rate risk. Proposed § 956.6(a) would require that derivatives instruments that do not qualify as hedging instruments pursuant to GAAP may be used only if a non-speculative use is documented by the Bank. Because GAAP prescribes extensive rules for hedging transactions that are required to be followed by most market participants, the Finance Board finds it prudent that the Banks also should be subject to these same requirements. The Banks, however, enter into derivatives contracts with members in order to assist those members with their asset-liability management. In addition, certain derivatives that currently are used by the Banks for hedging purposes, would not meet the requirements of FAS 133.³¹ The Finance Board recognizes that allowing the Banks to serve as intermediaries in derivatives contracts with members is a benefit that is valued by members, and that the Banks may benefit from the ability to use certain instruments to hedge actual balance sheet risks, even if the hedge transactions would not meet the requirements of FAS 133. Therefore, the Finance Board is proposing to permit such transactions, provided that the Bank documents that the use of the hedging instruments is non-speculative.

Section 956.6(b) of the proposed rule would govern the documentation that each Bank must have and maintain during the life of each hedge. Proposed § 956.6(c)(1) would require that transactions with a single counterparty be governed by a single master agreement when practicable. Proposed § 956.6(c)(2) 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 currently exist in 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 hedging transactions.

Under the FMP, the Banks are limited to using a specific list of hedging instruments. The use of the listed hedging instruments by the Banks is permitted provided it is for the purpose of assisting the Bank in achieving its interest rate or basis risk management objectives. Like the FMP's Investment Guidelines, the Hedge Transaction Guidelines of the FMP contain detailed requirements that will no longer be necessary. The unsecured credit concentration limits set forth in proposed § 932.9 and the credit risk-based capital requirements set forth in proposed § 932.4 would eliminate the need for provisions addressing unsecured credit exposure and collateralization in the FMP. 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.

Q. Part 960—Off-Balance Sheet Items.

Proposed § 960.2(a) would authorize the Banks to enter into the following types of off-balance sheet transactions, subject to any requirements or restrictions set forth by the Finance Board: standby letters of credit; derivative contracts; forward asset purchases and sales; and commitments to make advances or other loans. This authorization essentially would codify 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 § 960.2(b) prohibits the Banks from making speculative use of derivative contracts by requiring that derivative instruments that do not qualify as hedging instruments pursuant to GAAP may be used only if a non-

speculative use is documented by the Bank. As previously discussed in the general context of hedging instruments, speculating with derivatives contracts is inappropriate for the Banks, as it would do nothing to further their mission, while posing risks to their safety and soundness.

III. Paperwork Reduction Act

The Finance Board has submitted to the Office of Management and Budget (OMB) an analysis of the collection of information contained in §§ 931.7 through 931.9 and 933.2 of the proposed rule, described more fully in part II of the **SUPPLEMENTARY INFORMATION**. The Banks will use the information collection to determine whether Bank members satisfy the statutory and regulatory capital stock requirements. The Banks will use the information collection to implement its new capital structure and limit member ownership of Bank stock. See 12 U.S.C. 1426; 12 CFR parts 931 and 933. Responses are mandatory and are required to obtain or retain a benefit. See 12 U.S.C. 1426.

Likely respondents and/or record keepers will be Banks and Bank members. Potential respondents are not required to respond to the collection of information unless the regulation collecting the information displays a currently valid control number assigned by OMB. See 44 U.S.C. 3512(a).

The estimated annual reporting and recordkeeping hour burden is:

- a. Number of respondents—7,512
- b. Total annual responses—52,500
- Percentage of these responses collected electronically—0%
- c. Total annual hours requested—900,648

The estimated annual reporting and recordkeeping cost burden is:

- a. Total annualized capital/startup costs—0
- b. Total annual costs (O&M)—0
- c. Total annualized cost requested—\$46,717,758.48

The Finance Board will accept written comments concerning the accuracy of the burden estimates and suggestions for reducing the burden at the address listed above.

The Finance Board has submitted the collection of information to OMB for review. Comments regarding the proposed collection of information may be submitted in writing to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Federal Housing Finance Board, Washington, D.C. 20503 by September 11, 2000.

³¹ Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133), which provides a comprehensive framework of accounting and reporting standards for derivatives. It requires that all derivatives must be carried on the balance sheet at fair value. The only exception is for derivatives that qualify as hedges in accordance with FAS 133. Certain derivatives used by the Banks would not meet the requirements for hedge accounting. For example, macro or portfolio hedging would not be allowed hedge accounting treatment under FAS 133 because a specific identification of the hedged item, which must be a specific asset or liability or a pool of similar assets or liabilities is required.

IV. Regulatory Flexibility Act

The proposed rule would apply only to the Finance Board and to the Federal Home Loan 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). Thus, in accordance with section 605(b) of the RFA, 5 U.S.C. 605(b), the Finance Board hereby certifies that the proposed rule, if promulgated as a final rule, will not have a significant impact on a substantial number of small entities.

List of Subjects

12 CFR Part 917

Community development, Credit, Federal home loan banks, Housing, Reporting and recordkeeping requirements.

12 CFR Part 925

Credit, Federal home loan banks, Reporting and recordkeeping requirements.

12 CFR Parts 930, 931, 932 and 933

Capital, Credit, Federal home loan banks, Investments, Reporting and recordkeeping requirements.

12 CFR Part 956

Community development, Credit, Federal home loan banks, Housing, Investments, Reporting and recordkeeping requirements.

12 CFR Part 960

Credit, Federal home loan banks, Investments.

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

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

1. The authority citation for part 917 continues to read as follows:

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

§ 917.9 [Removed]

§ 917.10 [Redesignate as § 917.9]

2. In part 917, remove § 917.9 and redesignate § 917.10 as § 917.9.

PART 925—MEMBERS OF THE BANKS

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

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

Part 925 [Remove Subpart D]

4. Remove subpart D from part 925.

§§ 925.24 and 925.28 [Removed]

5. Remove §§ 925.24 and 925.28.

§§ 925.25 through 925.27 [Redesignated as §§ 925.19 through 925.21]

6. Redesignate §§ 925.25 through 925.27 as §§ 925.19 through 925.21.

§§ 925.29 through 925.32 [Redesignated as §§ 925.22 through 925.25]

7. Redesignate §§ 925.29 through 925.32 as §§ 925.22 through 925.25.

Subparts E through J [Redesignate as subparts D through I]

8. Redesignate subparts E through J as subparts D through I.

9. Amend newly designated § 925.19 by revising the heading and paragraphs (a), (b) and (d), and by removing paragraph (e), to read as follows:

§ 925.19 Consolidations involving members.

(a) *Consolidation of members.* (1) Upon the consolidation of two or more institutions that are members of the same Bank into one institution operating under the charter of one of the consolidating institutions, the membership of the surviving institution shall continue and the membership of the disappearing institutions shall terminate on the cancellation of their charter. Upon the consolidation of two or more institutions each of which is a member of a different Bank, into one institution operating under the charter of one of the consolidating institutions, the membership of the surviving institution shall continue and the membership of each disappearing institution shall terminate upon cancellation of its charter, provided, however, that that if more than 80 percent of the assets of the consolidated institution are derived from the assets of a disappearing institution, then the consolidated institution shall continue to be a member of the Bank of which the disappearing institution was a member prior to the consolidation and the membership of the other institutions shall terminate upon the effective date of the consolidation.

(2) Upon the consolidation of a member into an institution that is not a member of a Bank, where the consolidated institution operates under the charter of the nonmember institution, the membership of the disappearing institution shall terminate upon the cancellation of its charter.

(b) *Notification of decision to seek membership.* When a consolidated institution resulting from a consolidation described in paragraph (a)(2) of this section has its principal place of business in a state in the same Bank district as the disappearing

institution, the consolidated institution shall have 60 calendar days after the cancellation of the charter of the disappearing institution to notify the disappearing institution's Bank that it intends to apply for membership in such Bank.

* * * * *

(d) *Treatment of outstanding indebtedness.* (1) *Prior to membership approval.* If the membership of an institution has been terminated pursuant to paragraph (a)(2) of this section, the Bank need not require the institution (or its successor) to liquidate any outstanding indebtedness owed to the Bank, as otherwise may be required pursuant to § 950.19, during:

- (i) The initial 60-day notification period;
- (ii) The 60 calendar day period following receipt of a notification that the consolidated institution intends to apply for membership; and
- (iii) The period of time during which the Bank processes the application for membership.

(2) *Failure to apply for or be approved for membership.* If the consolidated institution does not apply for membership within the required period of time, or if its application for membership is denied, then the liquidation of any outstanding indebtedness owed to the disappearing institution's Bank shall be carried out in accordance with § 950.19.

* * * * *

10. Revise newly designated § 925.20 to read as follows:

§ 925.20 Withdrawal from membership.

(a) *Notice of withdrawal.* Any institution may terminate its membership by providing to the Bank written notice of its intent to withdraw from membership. A member that has so notified its Bank shall be entitled to have continued access to the benefits of membership until the effective date of its withdrawal. A withdrawing member may cancel its notice of withdrawal at any time prior to its effective date by providing a written cancellation notice to the Bank. A Bank may impose a fee, to be specified in its capital plan, on a member that cancels its notice of withdrawal.

(b) *Termination of membership.* The notice of withdrawal shall indicate the date on which the membership is to terminate, which may be no later than the date on which the last of the applicable stock redemption periods ends. If the notice fails to specify an effective date for the withdrawal, the Bank shall deem the withdrawal to take effect on the date the last of the

applicable stock redemption periods ends.

(c) *Stock redemption periods.* The receipt by a Bank of a notice of withdrawal shall commence the applicable 6-month and 5-year stock redemption periods for all Bank stock held by that member, unless the member previously has provided a notice of stock redemption. In the case of an institution the membership of which has been terminated as a result of a merger or other consolidation into a nonmember or into a member of another Bank, the applicable stock redemption periods shall be deemed to commence on the date on which the member's charter is cancelled, unless the member previously has provided a notice of stock redemption.

(d) *Certification.* No institution may withdraw from membership unless, on the date that the membership is to terminate, there is in effect a certification from the Finance Board that the withdrawal of a member will not cause the Bank System to fail to satisfy its obligations under 12 U.S.C. 1441b(f)(2)(C) to contribute toward the interest payments owed on obligations issued by the Resolution Funding Corporation.

11. Revise newly designated § 925.21 to read as follows:

§ 925.21 Removal from membership.

(a) *Grounds for removal.* The board of directors of a Bank may terminate the membership of any institution that fails to comply with any requirement of the Bank Act, any regulation adopted by the Finance Board, or any requirement of the Bank's capital plan, or that becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under federal or state law.

(b) *Stock redemption.* The applicable 6-month and 5-year stock redemption periods shall commence on the date that the Bank removes an institution from membership, unless the institution previously has provided a notice of stock redemption to the Bank.

(c) *Membership rights.* An institution whose membership is terminated involuntarily under this section shall have no right to obtain any of the benefits of membership after the effective date of its removal.

12. Revise newly designated § 925.22 to read as follows:

§ 925.22 Liquidation of indebtedness.

(a) *In general.* If an institution withdraws from membership or its membership is otherwise terminated, the Bank shall determine an orderly manner for liquidating all indebtedness

owed by that member to the Bank, as well as all other items, including letters of credit, derivatives, or deposits. After all such obligations relating to the member have been extinguished, the Bank shall return to the member all collateral pledged by the member to the Bank to secure its obligations to the Bank.

(b) *Lien on Bank stock.* If a withdrawing member is indebted or otherwise obligated to a Bank, the Bank shall not redeem any Bank stock held by the member until after the indebtedness and other obligations to the Bank have been extinguished.

13. Revise newly designated § 925.23 to read as follows:

§ 925.23 Readmission to membership.

(a) *In general.* An institution that has withdrawn from membership, or otherwise has terminated its membership, may not be readmitted to membership in any Bank for a period of 5 years from the date on which its membership terminated.

(b) *Exceptions.* An institution that transfers membership between two Banks without interruption shall not be deemed to have withdrawn from Bank membership. Any institution that withdrew from Bank membership prior to December 31, 1997, and for which the 5-year period has not expired, may apply for membership in a Bank at any time, subject to the approval of the Finance Board and the requirements of 12 CFR part 925.

14. In subchapter E, add new parts 930, 931, 932 and 933 to read as follows:

PART 930—DEFINITIONS APPLYING TO RISK MANAGEMENT AND CAPITAL REGULATIONS

Sec.

930.1 Definitions.

Authority: 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

§ 930.1 Definitions.

As used in this subchapter:

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).

Capital plan means the approved capital structure plan that each Bank is required to develop and submit to the Finance Board for approval pursuant to 12 CFR 933.1.

Class A stock means capital stock issued by a Bank, including subclasses, that has the characteristics specified by § 931.1(a) of this subchapter.

Class B stock means capital stock issued by a Bank, including subclasses,

that has the characteristics specified by § 931.1(b) of this subchapter.

Contingency liquidity has the meaning set forth in § 917.1 of this chapter.

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

Credit risk has the meaning set forth in § 917.1 of this chapter.

Derivative contract means generally a financial contract the value of which is derived from the values of one or more underlying assets, reference rates, or indices 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.

Exchange rate contracts include cross-currency interest-rate swaps, forward foreign exchange rate contracts, currency options purchased, and any similar instruments that give 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).

GAAP means generally accepted accounting principles.

General allowance for losses means an allowance established by a Bank in accordance with GAAP for losses, but which does not include any amounts held against specific assets of the Bank.

Government Sponsored Enterprise, or GSE, 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.

Market risk has the meaning set forth in § 917.1 of this chapter.

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.

Operating risk-based capital ratio means the ratio of permanent capital to total assets at which the Bank intends to operate.

Operating total capital ratio means the ratio of total capital to total assets at which the Bank intends to operate.

Operations risk has the meaning set forth in § 917.1 of this chapter.

Permanent capital of a Bank means the amount paid-in for Class B stock plus its retained earnings.

Regulatory risk-based capital requirement means the amount of permanent capital that a Bank is required to maintain in accordance with § 932.3 of this chapter.

Regulatory total capital requirement means the amount of total capital that a Bank is required to maintain in accordance with § 932.2 of this chapter.

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

Retained earnings means the retained earnings, as determined in accordance with GAAP.

Total assets means the total assets of a Bank, as determined in accordance with GAAP.

Total capital of a Bank means the sum of permanent capital, the amounts paid-in for Class A stock, the amount of any general allowance for losses, and the amount of other instruments identified in a Bank's capital plan that the Finance Board has determined to be available to absorb losses incurred by such Bank.

Unrealized net losses on available-for-sale securities means the unrealized net losses on available-for-sale securities, as determined in accordance with GAAP.

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.

PART 931—FEDERAL HOME LOAN BANK CAPITAL STOCK

Sec.

- 931.1 Classes of capital stock.
- 931.2 Issuance of capital stock.
- 931.3 Voting rights.
- 931.4 Dividends.
- 931.5 Preferences on liquidation, merger, or consolidation.
- 931.6 Transfer of capital stock.
- 931.7 Membership investment in capital stock.
- 931.8 Activity-based stock purchase requirement.
- 931.9 Concentration limits.
- 931.10 Redemption and purchase of capital stock.
- 931.11 Capital impairment.

Authority: 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

§ 931.1 Classes of capital stock.

The authorized capital stock of a Bank shall consist of the following instruments:

- (a) Class A stock, which shall:
 - (1) Have a par value of \$100 per share;
 - (2) Be issued and redeemed only at its par value;
 - (3) Be redeemable in cash only on six-months written notice to the Bank; and
 - (4) Pay a stated dividend that has a priority over the payment of dividends on the Class B stock.
- (b) Class B stock, which:
 - (1) Shall have a par value that is to be determined by the Bank and is to be included in the capital plan;
 - (2) May be issued at its par value or at a price other than its par value, as determined by the Bank;
 - (3) Shall be redeemable in cash and at par value only on five-years written notice to the Bank;
 - (4) Shall be subordinated to the stated dividend payable on the Class A stock; and
 - (5) Shall confer an ownership interest in the retained earnings and paid-in surplus of the Bank upon acquisition of the stock by a member; and

(c) Any one or more subclasses of Class A or Class B stock, each of which may have different rights, terms, conditions, or preferences, but each subclass also shall have all of the characteristics of its respective class, as specified in paragraph (a) or (b) of this section.

§ 931.2 Issuance of capital stock.

(a) *In general.* A Bank may issue any one or more classes or subclasses of capital stock authorized by § 931.1 and shall not issue any other class of capital stock. A Bank shall issue its stock only

to its members and only in book-entry form, and the Bank shall act as its own transfer agent. All issuances of capital stock shall be in accordance with the provisions of an approved capital plan.

(b) *Initial issuance.* In connection with the initial issuance of Class A or Class B stock (or any subclass of either), a Bank may issue such stock in exchange for its existing stock, through a conversion of its existing stock, or through any other fair and equitable method of distribution to the eligible purchasers, and may distribute its then-existing unrestricted retained earnings as shares of Class B capital stock.

(c) *Membership and activity-based issuance.* A Bank may issue capital stock as a requirement of membership only in accordance with § 931.7, and may issue capital stock as a requirement for conducting business with the Bank only in accordance with § 931.8.

(d) *Limitation on issuance.* A Bank shall not issue stock to a member or group of affiliated members if the issuance would result in such member or group of affiliated members owning more than 40 percent of any class (including its subclasses) of the outstanding capital stock of the Bank, or such lesser percentage established in its capital plan pursuant to § 931.9.

§ 931.3 Voting rights.

(a) *In general.* (1) The capital plan of each Bank shall specify the manner in which the members of the Bank are to elect directors, shall specify the other corporate matters, if any, on which the members of the Bank may vote, shall describe the voting preferences, if any, to be given to any particular class or subclass of capital stock, and shall indicate whether any class or subclass of capital stock may be voted cumulatively and, if so, the matters on which such cumulative voting would be permitted.

(2) A Bank that has issued any Class B stock shall assign voting rights to the Class B stock and, in its discretion, also may assign voting rights to its outstanding Class A stock or may assign voting rights to all members generally without regard to the class or number of shares of stock held by the members.

(3) Within each class or subclass of capital stock to which the capital plan has assigned voting rights, each share of stock shall have equal voting rights, but a Bank may give voting preferences to one or more classes or subclasses of capital stock and may permit any class or subclass of capital stock to vote separately from the other classes and subclasses of capital stock.

(4) No member or group of affiliated members of a Bank shall be permitted to

cast more than 20 percent of the votes eligible to be cast in any election by any class or subclass of capital stock on any matter on which the stockholders may vote. A Bank may establish a lower percentage limit in its capital plan.

(b) *Election of directors.* (1) The number of elected directors for each Bank shall be as provided by section 7 of the Act (12 U.S.C. 1427), except that the provisions of section 7 that require the elected directorships to be designated as representing the members located in each of the states within the Bank district and those provisions that require the number of votes each member may cast in an election to be determined based on the number of shares of Bank stock held by the member (or by the average number of shares held by all members in that state) as of the most recent year end shall not apply.

(2) With regard to the election of directors, the capital plan may allocate the voting rights among the members on any reasonable basis, such as on the basis of the class (or subclass) of capital stock outstanding, the asset size of the members, or the states in which the members are located. The capital plan shall, to the extent feasible, provide for the representation on the board of directors of smaller members that own Class B stock, especially members that are community financial institutions.

§ 931.4 Dividends.

(a) *In general.* A member, including a withdrawing member, shall be entitled to receive any dividends that a Bank declares on its capital stock for as long as the member owns the stock.

(b) *Class A stock.* The capital plan of a Bank shall establish the basis on which the stated dividends on the Class A stock are to be calculated, and shall provide whether such dividends are to be cumulative or non-cumulative. Thereafter, the Bank shall pay dividends on the Class A stock in accordance with that method and shall pay such dividends before paying any dividends on the Class B stock of the Bank. After payment of the stated Class A dividend, the board of directors of the Bank, in its discretion, may augment the stated dividend, which may be paid before, concurrently with, or after payment of dividends on the Class B stock.

(c) *Class B stock.* The board of directors of a Bank may authorize the payment of a dividend on the Class B stock, and shall determine the amount of such dividend. The board of directors may establish different dividend rates or preferences for different subclasses of the Class B stock, and may establish a dividend for one or more subclasses of

the Class B stock that tracks the economic performance of certain Bank assets, such as Acquired Member Assets. Any dividend that tracks the performance of specific Bank assets shall be proportionately appropriate for the level of risk and profitability associated with the underlying assets. Any dividends on the Class B stock shall be payable only from the net earnings or retained earnings of the Bank, determined in accordance with GAAP, shall be paid only after the payment of the stated dividend on the Class A stock, and shall be non-cumulative.

§ 931.5 Preferences on liquidation, merger, or consolidation.

In the event of a liquidation, merger, or other consolidation of a Bank, the holders of the Class A stock shall be entitled to receive the par value of their stock, plus any accumulated dividends, before the Bank or its successor may redeem, or pay any dividends on, the outstanding Class B stock that had been issued by the Bank that has been liquidated, merged, or consolidated.

§ 931.6 Transfer of capital stock.

(a) A member of a Bank may transfer the capital stock of the Bank only to another member of the Bank or to an institution that is in the process of becoming a member of the Bank. Any such stock transfers shall be at a price agreed to by the parties.

(b) No Bank shall permit the transfer of any class (including subclasses) of its capital stock to a member, or group of affiliated members, to the extent that such transfer would result in that member or group of members owning more than 40 percent of such class or subclass of the capital stock of the Bank, or such lesser percentage established in its capital plan pursuant to § 931.9. In the event of a transfer of Bank stock that occurs as a result of a merger, acquisition, or other consolidation of two or more members of a Bank that results in the surviving member holding more than 40 percent of any class or subclass of Bank stock, the Bank and the member shall agree to a plan for the member to divest any stock pursuant to § 931.9.

§ 931.7 Membership investment in capital stock.

A Bank may require each member to invest in the Class A stock of the Bank as a condition to becoming and remaining a member of the Bank. If a Bank establishes such a mandatory membership investment, it shall allow each member the option of satisfying the requirement by investing a lesser

proportional amount in Class B stock, as determined by the Bank. If a Bank is at or above its operating total capital ratio and its operating risk-based capital ratio, it shall not require members to purchase capital stock. A Bank also may establish an annual membership fee to be assessed in lieu of a mandatory stock investment for its members.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069– with an expiration date of .)

§ 931.8 Activity-based stock purchase requirement.

(a) *In general.* As a condition for entering into a particular business transaction with a member, a Bank may require the member to purchase an amount of Class A or Class B stock.

(b) *Alternative arrangements.* A Bank may enter into a written contractual agreement with a member under which the member commits to purchase a specific number of shares of a particular class or classes of Bank stock at a specified price, with the purchase to be completed and all payments made at a future date to be determined by the Bank, and such agreement may be used to satisfy the activity-based stock purchase requirement in paragraph (a) of this section, if the use of such alternative arrangements is approved as part of the Bank's capital plan.

(c) *Limitations.* The amount of Class B stock that a Bank may require a member to purchase under paragraph (a) of this section shall be based on the risk characteristics associated with the type and duration of asset to be acquired by the Bank as a result of the particular transaction with that member. A Bank shall not require a member to purchase any Class B capital stock either under paragraph (a) or paragraph (b) of this section to the extent that the amount of stock to be purchased would cause the Bank to exceed its operating total capital ratio and operating risk-based capital ratio.

(d) *Retention of stock.* A Bank shall not prohibit a member that has purchased capital stock in accordance with this section from selling the stock to another member, subject to the limitations of § 931.11.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069– with an expiration date of .)

§ 931.9 Concentration limits.

No member, or group of affiliated members, of a Bank shall own more than 40 percent of any class (including,

in the aggregate, all subclasses of a class) of the outstanding capital stock of the Bank, or such lower limit established in the capital plan. If at a given time, a member, or group of affiliated members, of a Bank acquires stock such that they own more than 40 percent of any class (including, in the aggregate, all subclasses of any class) of the outstanding capital stock of the Bank, or such lower limit established in the capital plan, the Bank and member (or members) shall agree to a plan under which the member (or members) will divest sufficient shares of such stock as necessary to comply with this section.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069- with an expiration date of .)

§ 931.10 Redemption and purchase of capital stock.

(a) *Redemption.* A member may redeem capital stock of the Bank by providing the requisite written notice to the Bank of its intent to redeem the stock. For Class A stock, a member shall provide 6 months written notice, and for Class B stock a member shall provide 5 years written notice. At the expiration of the applicable notice period, the member shall be entitled to receive from the Bank the par value of the stock in cash. A member shall not have pending at any one time more than one notice of redemption for any class of Bank stock. A Bank may impose a fee, as specified in its capital plan, on a member that cancels a pending notice of redemption.

(b) *Purchase.* A Bank shall not be obligated to redeem its capital stock other than in accordance with paragraph (a) of this section, but a Bank, in its discretion, may purchase its outstanding Class A or Class B capital stock at any time at a negotiated price.

§ 931.11 Capital impairment.

A Bank may not redeem or purchase any capital stock without the prior written approval of the Finance Board if the Bank is not in compliance with any regulatory capital requirement or would fall out of compliance with any regulatory capital requirement as a result of the redemption or purchase.

PART 932—FEDERAL HOME LOAN BANK CAPITAL REQUIREMENTS

Sec.

- 932.1 Capital provisions transition requirements.
- 932.2 Total capital requirement.
- 932.3 Risk-based capital requirement.
- 932.4 Credit risk capital requirement.
- 932.5 Market risk capital requirement.
- 932.6 Operations risk capital requirement.
- 932.7 Reporting requirements.

- 932.8 Minimum liquidity requirements.
- 932.9 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, 1440, 1443, 1446.

§ 932.1 Capital provisions transition requirements.

(a) *General transition provision.* Not later than three years after the effective date of its capital plan, each Bank shall:

(1) Have sufficient total capital to comply with the requirement of § 932.2 and

(2) Have sufficient permanent capital to comply with the requirement of § 932.3.

(b) *Risk management.* Before its new capital structure may take effect, each Bank shall obtain the approval of the Finance Board for the internal market risk model or a cash flow model used to calculate the market risk component of its risk-based capital requirement, and for the risk assessment procedures and controls (whether established as part of its risk management policy or otherwise) to be used to manage its credit, market, and operations risks.

(c) *Financial Management Policy.* After obtaining the approvals required by paragraph (b) and as of the end of the transition period specified in its capital plan, a Bank shall be governed exclusively by the capital requirements of § 932.2 or § 932.3. Until such date, the risk management requirements of the Financial Management Policy shall continue to apply to that Bank.

(d) *Issuance of capital stock.* Until a Bank has issued capital stock in accordance with its approved capital plan, it shall continue to be governed by the minimum stock purchase and stock retention requirements of the Act, as in effect on November 11, 1999. Upon the initial issuance of stock in accordance with its capital plan, the minimum stock purchase and stock retention requirements of the Act as in effect on November 11, 1999, will cease to apply to that Bank and the purchase and retention of capital stock by its members shall be governed by the approved capital plan and other applicable regulations.

§ 932.2 Total capital requirement.

(a) Each Bank shall maintain at all times total capital in an amount equal to at least 4.0 percent of the Bank's total assets.

(b) Each Bank also shall maintain at all times a leverage ratio of total capital to total assets of at least 5.0 percent of the Bank's total assets, where the ratio is computed by multiplying the Bank's

permanent capital by 1.5 and all other components of total capital are included at face value.

(c) For reasons of safety and soundness, the Finance Board may require an individual Bank to have and maintain more total capital than mandated by paragraph (a) of this section.

§ 932.3 Risk-based capital requirement.

(a) *In general.* Each Bank shall maintain at all times permanent 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 §§ 932.4, 932.5 and 932.6, respectively.

(b) *Exception.* For reasons of safety and soundness, the Finance Board may require an individual Bank to have a greater amount of permanent capital than required by paragraph (a) of this section.

§ 932.4 Credit risk capital requirement.

(a) *General requirement.* A Bank's credit risk capital requirement shall be equal to the sum of the Bank's credit risk capital charges for all on-balance sheet assets and off-balance sheet items.

(b) *Credit risk capital charge for on-balance sheet assets.* Except as provided in paragraph (h)(1) of this section, a Bank's credit risk capital charge 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 asset pursuant to paragraph (d)(2) of this section.

(c) *Credit risk capital charge for off-balance sheet items.* Except as provided in paragraph (h)(2) of this section, a Bank's credit risk capital charge 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 item pursuant to paragraph (d)(2) 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, the specific credit risk percentage requirements set forth in Tables 1.1 through 1.4 of this part applicable to a Bank's on-balance sheet assets and credit equivalent amounts of its off-balance sheet items.

(2) *Bank determination of specific credit risk percentage requirements.* (i) Each Bank shall determine the credit risk percentage requirement applicable

to the book value of each on-balance sheet asset and the on-balance sheet equivalent value of each off-balance sheet item by identifying the category set forth in Table 1.1, Table 1.2, Table 1.3 or Table 1.4 of this part to which the asset or item belongs based upon, as applicable, the type of asset or item, its

demonstrated credit rating (as determined in accordance with paragraphs (d)(2)(ii) and (d)(2)(iii) of this section), and its remaining maturity. The applicable credit risk percentage requirement for a specific on-balance sheet asset or off-balance sheet item shall be used to calculate the

credit risk capital charge for such asset or item in accordance with paragraphs (b) or (c) of this section respectively. The relevant categories and credit risk percentage requirements are provided in the following Tables 1.1 through 1.4 of this part:

TABLE 1.1.—REQUIREMENT FOR ADVANCES

Type of Advances	Percentage applicable to on-balance sheet equivalent value
Advances with:	
Remaining maturity <= 4 years	0.07
Remaining maturity > 4 years to 7 years	0.20
Remaining maturity > 7 years to 10 years	0.40
Remaining maturity > 10 years	0.45

TABLE 1.2.—REQUIREMENT FOR RESIDENTIAL MORTGAGE ASSETS

Type of residential mortgage asset	Percentage applicable to on-balance sheet equivalent value
Highest Investment Grade	0.45
Second Highest Investment Grade	0.55
Third Highest Investment Grade	0.90
Fourth Highest Investment Grade	3.40
If Downgraded to Below Investment Grade After Acquisition By Bank:	
Highest Below Investment Grade	35.00
Second Highest Below Investment Grade	100.00
All Other Below Investment Grade	100.00

TABLE 1.3.—REQUIREMENT FOR RATED ASSETS OR ITEMS OTHER THAN ADVANCES OR RESIDENTIAL MORTGAGE ASSETS

	Percentage applicable to on-balance sheet equivalent value				
	<=year	>1 yr to 3 yrs	>3 yrs to 7yrs	>7 yrs to 10 yrs	>10 yrs
U.S. Government Securities	0.00	0.00	0.00	0.00	0.00
Highest Investment Grade	0.15	0.44	0.88	1.45	2.05
Second Highest Investment Grade	0.15	0.47	1.00	1.50	2.35
Third Highest Investment Grade	0.20	1.80	2.50	3.30	4.30
Fourth Highest Investment Grade	1.30	2.90	4.20	5.20	6.80
If Downgraded Below Investment Grade After Acquisition by Bank:					
Highest Below Investment Grade	5.00	15.00	17.00	18.00	20.00
Second Highest Below Investment Grade	22.00	35.00	37.00	37.00	37.00
All Other	100.00	100.00	100.00	100.00	100.00

TABLE 1.4.—REQUIREMENT FOR UNRATED ASSETS

Type of unrated asset	Percentage applicable to on-balance sheet equivalent value
Cash	0.00
Premises, Plant, and Equipment	8.00
Investments Under § 940.3(a)(5) of this chapter	8.00

(ii) When determining the credit rating used to identify the applicable

credit risk percentage requirement from

Tables 1.2 and 1.3 of this part, each Bank shall apply the following criteria:

(A) For assets or items that are rated directly by an NRSRO, the credit rating shall be the NRSRO's credit rating for the asset or item as determined in accordance with paragraph (d)(2)(iii) of this section.

(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 corresponding obligor counterparty, third party guarantor, or collateral backing the asset or item, the credit rating that shall apply to the asset or item, or portion of the asset or item, so guaranteed or collateralized, shall be the credit rating corresponding to such obligor counterparty, third party guarantor, or underlying collateral, as determined in accordance with paragraphs (d)(2)(iii) of this section. If there are multiple obligor counterparties, third party guarantors, or collateral instruments backing an asset or item not rated directly by an NRSRO, or any specific portion thereof, then the credit rating that shall apply to that asset or item, or specific portion thereof, shall be the highest credit rating among such obligor counterparties, third party guarantors, or collateral instruments, as determined in accordance with paragraph (d)(2)(iii) of this section. Assets or items shall be deemed to be backed by collateral for purposes of this paragraph if the collateral is:

- (1) Actually held by the Bank or an independent, third-party custodian, or by the Bank's member if permitted under the Bank's collateral agreement with such party;
- (2) Legally available to absorb losses;
- (3) Of a readily determinable value at which it can be liquidated by the Bank;
- (4) Held in accordance with the provisions of the Bank's member products policy established pursuant to § 917.4 of this chapter; and

(5) Subject to an appropriate discount reflecting the price risk underlying the collateral.

(C) For residential mortgage assets and other assets or items, or relevant portion of an asset or item, that do not meet the requirements of paragraphs (d)(2)(ii)(A) or (d)(2)(ii)(B) of this section, and are not identified in Tables 1.1 or Table 1.4 of this part, the Bank shall determine its own credit rating for such assets or items, or relevant portion thereof, using credit rating standards available from an NRSRO or other

similar standards. This credit rating, as determined by the Bank, shall be used to identify the correct credit risk percentage requirement under Table 1.2 of this part for residential mortgage assets, or under Table 1.3 of this part for all other assets or items.

(iii) In determining the credit ratings under paragraph (d)(2)(ii)(A) and (d)(2)(ii)(B) of this section, a Bank shall apply the following criteria:

(A) 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);

(B) Where a specific asset or item has received more than one credit rating from a given NRSRO, the most recent credit rating shall be used;

(C) Where a specific asset or item has received credit ratings from more than one NRSRO, the lowest credit rating shall be used.

(e) *Calculation of credit equivalent amount for off-balance sheet items other than derivative contracts.* (1) *General requirement.* 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 shall be equal to the face amount of the instrument multiplied by the credit conversion factor assigned to such risk category of instruments, subject to the exceptions in paragraph (e)(2) of this section, provided in the following Table 2 of this part:

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

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

(2) *Exceptions.* The credit conversion factor shall be zero for Other Commitments With Original Maturity of Over One Year and Other Commitments With Original Maturity of One Year or Less, for which credit conversion factors of 50 percent or 20 percent would otherwise apply, 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.*

(1) *General requirement.* The credit equivalent amount for a derivative contract that is not subject to a qualifying bilateral netting contract shall be the sum of the current credit exposure and the potential future credit exposure of the derivative contract, where the current credit exposure is determined in accordance with paragraph (f)(2) of this section and the potential future credit exposure is determined in accordance with paragraph (f)(3) of this section.

(2) *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.

(3) *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 notional amount of the derivative contract by one of the assigned credit conversion factors, modified as may be required by paragraph (f)(3)(ii) of this section, for the appropriate category as provided in the following Table 3 of this part:

TABLE 3.—CREDIT CONVERSION FACTORS FOR POTENTIAL FUTURE CREDIT EXPOSURE DERIVATIVE CONTRACTS
[in percent]

Residual maturity	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 years5	5	8	7	12
Over five years	1.5	7.5	10	8	15

(ii) In applying the credit conversion factors in Table 3 of this part the following modifications shall be made:

(A) For derivative contracts with multiple exchanges of principal, the conversion factors are multiplied by the number of remaining payments in the derivative contract; and

(B) 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.

(iii) If a Bank uses an internal model to determine the potential future credit exposure 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 of this part for another type of derivative contract.

(iv) 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 when determining potential future credit exposures using Table 3 of this part.

(v) If a Bank uses Table 3 of this part to determine the potential future credit exposures for credit derivatives contracts, the credit conversion factors provided in Table 3 for Interest Rate contracts shall also apply to the credit derivative contracts.

(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, where:

(i) The net current credit exposure equals:

(A) 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 values is positive; or

(B) Zero, if the net sum of the mark-to-market values is zero or negative; and

(ii) The adjusted sum of the potential future credit exposure (A_{net}) is calculated as follows:

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

where:

(A) A_{gross} is the gross potential future credit exposure, *i.e.*, the sum of the potential future credit exposure, calculated in accordance with paragraph (f)(3) of this section, for each individual derivative contract subject to the qualifying bilateral netting contract;

(B) NGR is the net to gross ratio, *i.e.*, the ratio of the net current credit exposure to the gross current credit exposure; and

(C) 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 non-corporate 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.* (1) *Specific credit risk capital charge for on-balance sheet assets hedged with credit derivatives.* The credit risk capital charge for an on-balance sheet asset shall be zero if a credit derivative is used to hedge the credit risk on that asset, provided that:

(i) Either:

(A) The credit derivative and the on-balance sheet asset are of identical remaining maturity, and the asset being referenced in the credit derivative is identical to the underlying asset;

(B) If the on-balance sheet asset and the asset referenced in the credit derivative are identical, but the remaining maturities of the on-balance sheet asset and the credit derivative are different, the remaining maturity of the credit derivative is two years or more; or

(C) If the remaining maturities of the on-balance sheet asset and the credit derivative are identical, but the on-balance sheet asset is different from the asset referenced in the credit derivative,

the asset referenced in the credit derivative and the on-balance sheet asset have been issued by the same obligor, the asset referenced in the credit derivative ranks *pari passu* to or more junior than the on-balance sheet asset, and cross-default clauses apply; and

(ii) The credit risk capital charge for the credit derivative contract calculated pursuant to paragraph (c) of this section is still applied.

(2) *Specific credit risk capital charge for certain derivative contracts.* The credit risk capital charge for the following derivative contracts shall be zero:

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

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

(i) *Date of calculations.* Unless otherwise directed by the Finance Board, a Bank must perform all calculations required by this section using the assets and off-balance sheet items held by the Bank, and, if applicable, the values or credit ratings of such assets or items, as of the close of business of the last business day of the month for which the credit risk capital charge is being calculated.

§ 932.5 Market risk capital requirement.

(a) *General requirement.* (1) A Bank's market risk capital requirement shall equal the sum of:

(i) The market value of the Bank's portfolio at risk from movements in interest rates, foreign exchange rates, commodity prices, and equity prices that could occur during periods of market stress, where the market value of the Bank's portfolio at risk is determined using an internal market risk model that fulfills the requirements of paragraph (b) of this section and that has been approved by the Finance Board; and

(ii) The amount, if any, by which the Bank's current market value of total capital is less than 95 percent of the Bank's book value of total capital, where:

(A) The current market value of the total capital is calculated by the Bank after determining the current market value of its assets, liabilities and off-balance sheet items using the internal market risk model, or cash flow model, approved by the Finance Board under paragraph (d) of this section; and

(B) The book value of the Bank's total capital is calculated in accordance with GAAP.

(2) A Bank may substitute a cash-flow model to derive a market risk capital requirement comparable to that calculated using an internal risk model under paragraph (a)(1) of this section, provided that:

(i) The Bank obtains Finance Board approval of the cash-flow model and of the assumptions to be applied to the model; and

(ii) The Bank demonstrates to the Finance Board that the cash flow model considers the same factors and a comparable degree of stress as required for an internal market risk model and as set forth in paragraph (b) of this section, taking into account the difference in model structure.

(b) *Measurement of market value at risk under a Bank's internal market risk model.* (1) Each Bank shall use an internal market risk model that estimates the market value of the Bank's on-balance sheet assets and liabilities and off-balance sheet items, including related options, and measures the market value of the Bank's portfolio at risk of its on-balance sheet assets and liabilities and of off-balance sheet items, including related options, from all sources of the Bank's market risks, except that a Bank's model need only incorporate those risks that are material.

(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 measures of the market value of the Bank's portfolio at risk 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 options' 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 at a minimum:

(i) The Bank's internal market risk model must provide an estimate of the market value of the Bank's portfolio at risk such that the probability of a loss greater than that estimated shall be no more than one percent;

(ii) The Bank's internal market risk model must incorporate scenarios that reflect changes in interest rates, interest rate volatility, and shape of the yield curve, and changes in market prices, equivalent to those that have been observed over 120-business day periods of market stress. For interest rates, the

relevant historical observation period is to start from the end of the previous month and to go back to the beginning of 1978; and

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

(5) For any consolidated obligations denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, the Bank must meet the following requirements:

(i) The relevant foreign exchange, equity price or commodity price risks associated with the consolidated obligations must be hedged in accordance with § 956.6:

(ii) In addition to fulfilling the criteria of paragraph (b)(4) of this section, the Bank's internal market risk model must calculate an estimate of the market value of the Bank's portfolio at risk due to the material foreign exchange, equity price or commodity price risk, such that, at a minimum:

(A) The probability of a loss greater than that estimated must not exceed one percent;

(B) The scenarios reflect changes in foreign exchange, equity, or commodity market prices that have been observed over 120-business day periods of market stress, as determined using historical data that is from an appropriate period and satisfactory to the Finance Board; and

(C) The measure of the market value of the Bank's portfolio at risk may incorporate empirical correlations within or among foreign exchange rates, equity prices, or commodity prices, subject to a Finance Board determination that the model's system for measuring such correlations is sound; and

(iii) If there is a default on the part of a counterparty to a derivative or hedging contract linked to foreign exchange, equities or commodities, 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 or cash flow model.* (1) Each Bank shall conduct an independent validation of its internal market risk model or cash flow model within the Bank that is carried out by personnel not reporting to the business line responsible for conducting business transactions for the Bank. Alternatively, the Bank may obtain independent validation by an outside party qualified to make such determinations. Validations will be done 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 or cash flow model.* Each Bank shall obtain approval from the Finance Board of its internal market risk model or its cash flow model, including subsequent material adjustments to the model made by the Bank prior to its use. A Bank shall make all adjustments to its model that may be directed by the Finance Board.

(e) *Date of calculations.* Unless otherwise directed by the Finance Board, a Bank must perform any calculations or estimates required under this section using the on-balance sheet assets and liabilities and off-balance sheet items held by the Bank, and if applicable, the values of any such holdings, as of the close of business of the last business day of the month for which the market risk capital requirement is being calculated.

§ 932.6 Operations risk capital requirement.

(a) *General requirement.* Except as allowed in accordance with paragraph (b) of this section, a Bank's operations risk capital requirement shall at all times equal 30 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement.

(b) *Alternative requirements.* With the approval of the Finance Board, a Bank may have an operations risk capital requirement equal to less than 30 percent but no less than 10 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement if:

(1) The Bank provides an alternative methodology for assessing and quantifying an operations risk capital requirement; or

(2) The Bank obtains insurance to cover operations risk from an insurer rated at least the second highest investment grade credit rating by an NRSRO.

§ 932.7 Reporting requirements.

Each Bank shall report to the Finance Board by the 15th day of each month its risk-based capital requirement by component amounts, and its actual total capital amount and permanent capital amount, calculated as of the close of business of the last business day of the preceding month, or more frequently, as may be required by the Finance Board.

§ 932.8 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 five business 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.

§ 932.9 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) *Unsecured extensions of credit to single counterparty.* (1) *General requirement.* Unsecured extensions of credit by a Bank to a single counterparty that arise from the Bank's on- and off-balance sheet transactions shall not exceed the product of the maximum capital exposure limit applicable to such counterparty, as set forth in paragraph (a)(2) and Table 4 of this part, multiplied by the lesser of:

- (i) The Bank's total capital; or
- (ii) The counterparty's Tier 1 capital, or total capital (as defined by the counterparty's principal regulator) if Tier 1 capital is not available.

(2) *Bank determination applicable maximum exposure limits.* The applicable maximum capital exposure limits for specific counterparties are assigned to each counterparty based upon the credit rating of the counterparty, as determined in accordance with paragraph (a)(3) of this section, and are provided in the following Table 4 of this part:

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)
Highest Investment Grade	15
Second Highest Investment Grade	12
Third Highest Investment Grade	6
Fourth Highest Investment Grade	1.5
Below Investment Grade or Other	1

(3) *Bank determination of applicable credit ratings.* In determining the applicable credit rating category under Table 4 of this part, the following criteria shall be applied:

- (i) If a counterparty has received more than one rating from a given NRSRO,

the most recent credit rating shall be used;

(ii) If a counterparty has received credit ratings from more than one NRSRO, the lowest credit rating shall be used;

(iii) If a counterparty has received different credit ratings for its transactions with short-term and long-term maturities:

(A) The higher credit rating shall apply for purposes of determining the allowable maximum capital exposure limit applicable to the total amount of unsecured credit extended by the Bank to such counterparty; and

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

(iv) If a counterparty is placed on a credit watch for a potential downgrade by an NRSRO, the credit rating from that NRSRO at the next lower grade shall be used; and

(v) If a counterparty is not rated by a NRSRO, the Bank shall determine the applicable credit rating by using credit rating standards available from an NRSRO or other similar standards.

(b) *Unsecured extensions of credit to affiliated counterparties.* The total amount of unsecured extensions of credit by a Bank to all affiliated counterparties shall not exceed the product of the maximum capital exposure limit provided under Table 4 of this part based upon the highest credit rating of the affiliated counterparties, as determined in accordance with paragraph (a)(3) of this section, multiplied by the lesser of:

- (1) The Bank's total capital; or
- (2) The combined Tier 1 capital, or

total capital (as defined by each affiliated counterparty's principal regulator) if Tier 1 capital is not available, of all of the affiliated counterparties.

(c) *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 arising from on- and off-balance sheet transactions 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 (as defined by each counterparty's principal regulator) 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 arising from on- or off-balance sheet transactions to any single counterparty or group of affiliated counterparties that exceeds 5 percent of the Bank's total assets.

PART 933—BANK CAPITAL STRUCTURE PLANS

Sec.

933.1 Submission of plan.

933.2 Contents of plan.

933.3 Implementation of plan.

Authority: 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

§ 933.1 Submission of Plan.

(a) *In general.* Within 270 days after the date of publication of the final capital rule, the board of directors of each Bank shall submit to the Finance Board a capital plan that would establish a new capital structure for the Bank and that would provide sufficient capital for the Bank to comply with its regulatory total capital requirement and regulatory risk-based capital requirement. The Finance Board, upon a demonstration of good cause, may approve a reasonable extension of the 270-day period for submission of the plan. A Bank may not implement its capital plan, or any amendment to the plan, until after the Finance Board has approved the plan or amendment, and the Finance Board shall determine the effective date for each capital plan.

(b) *Failure to submit a capital plan.* If a Bank fails to submit a capital plan to the Finance Board within the 270 day period, including any approved extension, the Finance Board may establish a capital plan for that Bank, take any enforcement action against the Bank, its directors, or its executive officers section 2B(a)(5) of the Act (12 U.S.C. 1422b(a)(5)), or merge the Bank in accordance with section 26 of the Act (12 U.S.C. 1446) into another Bank that has submitted an acceptable capital plan.

§ 933.2 Contents of Plan.

The capital plan for each Bank shall include, at a minimum, the following provisions:

(a) *Classes of capital stock.* The capital plan shall:

(1) Indicate each class or subclass of capital stock that the Bank will offer to its members;

(2) Indicate the terms, rights, and preferences for each class and subclass of capital stock to be issued by the Bank;

(3) Provide that the payment for Class B stock confers on the member an ownership interest in the retained

earnings and paid-in surplus of the Bank;

(4) Specify the manner in which the members of the Bank are to elect directors, specify the other corporate matters, if any, on which the members of the Bank may vote, describe the voting preferences, if any, to be given to any particular class or subclass of capital stock, and indicate whether any class or subclass of capital stock may be voted cumulatively and, if so, the matters on which such cumulative voting would be permitted; and

(5) Establish the basis on which the stated dividends on the Class A stock are to be calculated, and provide whether such dividends are to be cumulative or non-cumulative.

(b) *Capital stock issuance.* The capital plan shall:

(1) Describe the manner in which the Bank intends to solicit its members for voluntary purchases of its capital stock; and

(2) Specify the operating total capital ratio and the operating risk-based capital ratio at which the Bank intends to operate, which shall be greater than the regulatory total capital requirement and regulatory risk-based capital requirement, respectively.

(c) *Membership investment or fee structure.* The capital plan shall:

(1) Require, as a condition of membership, that a member either maintain a specified investment in the Class A stock of the Bank or pay to the Bank an annual membership fee, and describe the method used by the Bank to calculate such investment or fee;

(2) Allow each member that is required to invest in the capital stock of the Bank the option of investing in Class B stock, if authorized by the Bank, rather than in the Class A stock, in some lesser amount as determined by the Bank, subject to § 931.7 of this subchapter;

(3) Require the board of directors of the Bank to review and adjust the membership investment periodically to ensure that the Bank complies with the regulatory total capital requirement and the regulatory risk-based capital requirement;

(4) Require members to comply promptly with any adjusted membership investment; and

(5) Specify a fee, if any, on a member that cancels a notice of withdrawal or a notice of redemption and describe the method used by the Bank to calculate such fees.

(d) *Transfer of Bank stock.* The capital plan shall:

(1) Establish the criteria for the issuance, redemption, retirement, or purchase of Bank stock by the Bank, and

for the transfer of Bank stock between members of the Bank;

(2) Provide that the stock of the Bank may only be issued to or held by the members of the Bank, and that no entities other than the Bank or its members may trade the stock of the Bank; and

(3) Specify the maximum percentage of a class or subclass of stock a Bank may transfer to a member, or group of affiliated members, not to exceed 40 percent of any class or subclass of stock.

(e) *Termination of membership.* The capital plan shall address the manner in which the Bank will provide for the disposition of its capital stock that is held by institutions that terminate their membership, and the manner in which the Bank will liquidate claims against its members, including claims resulting from prepayment of advances prior to their stated maturity.

(f) *Independent review of plan.* The capital plan shall include the report from an independent certified public accountant regarding the extent to which the implementation of the plan would affect the redeemable stock issued by the Bank and the report from an NRSRO regarding the extent to which the implementation of the plan would affect the credit rating of the Bank.

(g) *Implementation.* The capital plan shall demonstrate that the Bank has made a good faith determination that the Bank will be able to implement the plan as submitted and that the Bank will be in compliance with its regulatory total capital requirement and its regulatory risk-based capital requirement after the plan is implemented.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069- with an expiration date of .)

§ 933.3 Implementation of Plan.

(a) *In general.* Each Bank's capital plan shall:

(1) Provide for the manner in which the Bank shall issue Class A or Class B stock (or any subclass of either), which may be through an exchange for its existing stock, a conversion of its existing stock, or any other fair and equitable method of distribution to eligible purchasers;

(2) Provide what shall happen to the existing Bank stock owned by a member that does not affirmatively elect to convert or exchange its existing Bank stock into either Class A or Class B stock, or some combination thereof; and

(3) Include a transition provision that specifies the date on which the plan is to take effect, and that specifies the date,

not to exceed three years from the effective date of the plan, on which the Bank shall be in full compliance with its regulatory total capital requirement and regulatory risk-based capital requirement.

(b) *Member transition.* The capital plan for each Bank may include a provision allowing any institution that was a member of the Bank on November 12, 1999, a period of up to three years from the effective date of the plan in which to comply with the membership investment requirements of the capital plan.

PART 956—FEDERAL HOME LOAN BANK INVESTMENTS

15. The authority citation for part 956 continues to read as follows:

Authority: 12 U.S.C. 1422a(a)(3), 1422b(a), 1431, 1436.

16. Add a new § 956.6, to read as follows:

§ 956.4 Use of hedging instruments.

(a) *Applicability of GAAP.* Derivative instruments that do not qualify as hedging instruments pursuant to GAAP may be used only if a non-speculative use is documented by the Bank.

(b) *Documentation requirements.* (1) Transactions with a single counterparty shall be governed by a single master agreement when practicable.

(2) 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.

17. In subchapter G, add a new part 960 to read as follows:

PART 960—OFF-BALANCE SHEET ITEMS

Sec.

960.1 Definitions.

960.2 Authorized off-balance sheet items.

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

§ 960.1 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.

§ 960.2 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 961;

(2) Derivative contracts;

(3) Forward asset purchases and sales; and

(4) Commitments to make advances or other loans.

(b) *Speculative use prohibited.* Derivative instruments that do not qualify as hedging instruments pursuant to GAAP may be used only if a non-speculative use is documented by the Bank.

Dated: May 22, 2000.

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

Bruce A. Morrison,
Chairman.

[FR Doc. 00-17153 Filed 7-12-00; 8:45 am]

BILLING CODE 6725-01-P