Subject: Redemption of Stock by a Federal Home Loan Bank that has been designated "Undercapitalized" under the Prompt Corrective Action Provisions of the Federal Housing Enterprises Safety and Soundness Act of 1992 and the Federal Housing Finance Agency Regulations.

Issue: Must a Federal Home Loan Bank (Bank) that is designated undercapitalized under the provisions of subtitle B of the Federal Housing Enterprises Safety and Soundness Act of 1992 (Safety and Soundness Act) and the Prompt Corrective Action (PCA) regulation set forth at 12 C.F.R. part 1229, subpart A meet the requirements of § 1364(e)(2) of the Safety and Soundness Act, 12 U.S.C. § 4614(e)(2) as amended by Public Law No. 110-289, § 1142, 122 Stat. 2654, 2730 (2008), and § 1229.5(b) of the regulations, 12 C.F.R. § 1229.5(b), before redeeming or repurchasing stock?

Conclusion: Yes. The requirements of §1364(e)(2) of the Safety and Soundness Act and § 1229.5(b) of the regulations would apply. The statutory language states that no Bank may undertake a capital distribution if the Bank would be undercapitalized after the transaction occurs unless it meets the requirements set forth in §1364(e)(2). This requirement applies regardless of whether the Bank was adequately capitalized or undercapitalized before the transaction. This statutory provision is self-executing and does not require a regulation to implement. While the regulatory language most clearly applies when an adequately capitalized Bank would propose to make a redemption or repurchase of stock that would cause it to become undercapitalized, these standards should logically also apply to a Bank that is undercapitalized prior to the transaction. Without such a reading, an adequately capitalized Bank that would become undercapitalized because of a transaction would be subject to more regulatory restrictions and oversight by the Director of the Federal Housing Finance Agency (Director) with regard to redemptions and repurchases of stock than would a Bank that was already undercapitalized, an absurd outcome. More importantly, nothing in the regulatory language impedes or negates the application of the statutory provision.

Discussion: Section 1364 of the Safety and Soundness Act, as amended by § 1142 of the Housing and Economic Recovery Act of 2008, states that "a regulated entity shall make no capital distribution if, after making the distribution, the regulated entity would be undercapitalized." 12 U.S.C. § 4614(e)(1), as amended by Public Law No. 110-289, § 1142, 122 Stat. 2654, 2730 (2008). An exception is allowed under paragraph (e)(2) of this provision for

redemption and repurchases of shares or ownership interests provided that the Director first finds that the transaction is made in connection with the issuance of shares or obligations in at least an equivalent amount of the redemption and will reduce the regulated entity’s financial obligations or otherwise improve its financial health. See id. Nothing in section 1364(e) states that the Director must first adopt a regulation to implement the provision or otherwise sets conditions on the application of the provision.\(^2\)

Similarly, § 1229.5(a) of the regulations provides that an adequately capitalized Bank may not make a capital distribution if after doing so the Bank’s capital would be insufficient to maintain the “adequately capitalized” classification. See 12 C.F.R. § 1229.5(a). An exception to this restriction is set forth in § 1229.5(b) of the regulations which allows the Bank to redeem or repurchase stock but only if the Director first makes the finding required under § 1364(e)(2) of the Safety and Soundness Act.\(^3\)

Section 1229.6 of the regulations applies capital distribution restrictions to a Bank that is designated as undercapitalized. See 12 C.F.R. § 1229.6(a)(3). The provision prohibits a Bank classified as undercapitalized from making a capital distribution if the distribution would result in the Bank being reclassified as significantly undercapitalized or critically undercapitalized or if such distribution, among other things, would violate any restriction on the repurchase or redemption of stock set forth in section 6 of the Bank Act or any other regulation. Id. See also Safety and Soundness Act § 1365(a)(3), 12 U.S.c. § 4615(a), as amended by Public Law No. 10-289, § 1143, 122 Stat. 2732 (2008).\(^4\)

Those regulatory provisions do not subtract from the full reach and plain language of the statutory provision, which also restricts a distribution if the Bank would be undercapitalized after the distribution regardless of whether it was adequately capitalized or undercapitalized before the distribution. The need for the Director to make the same findings should also be applicable to a Bank that is undercapitalized prior to the distribution as much as to a Bank that is adequately capitalized before the distribution. It would be unreasonable and contrary to the underlying aims

\(^2\) Section 1364(b) of the Safety and Soundness Act merely provides that the Director must by regulation: (i) establish the capital classifications specified in the statute for the Banks; (ii) establish criteria for each such classification; and (iii) classify the Banks in accordance such the capital classifications. See 12 U.S.C. § 4614(b) as amended by Public Law No. 110-289, § 1142, 122 Stat. 2730-31 (2008). The statute also provides the Director with authority to discretionarily downgrade the capital classification of a Bank based on factors other than the specific capital criteria established for each classification. See e.g. Safety and Soundness Act § 1364(c), 12 U.S.C. § 4614(c) as amended by Public Law No. 110-289, § 1142, 122 Stat. 2731 (2008).

\(^3\) Section 1229.5(b) further provides that any distribution approved under the exception must comply with any restriction on the repurchase or redemption of Bank stock set forth in Section 6 of the Bank Act. Those Bank Act restrictions include that a Bank cannot redeem or repurchase stock if “following the redemption the Bank would fail to satisfy any minimum capital requirement.” 12 U.S.C. § 1426(f). Thus, the application of the regulation limits the scope of the exception with regard to the Banks only to situations involving a discretionary downgrade in classification or where the classification is based on conditions other than a Bank’s failing to meet its minimum capital requirements. See. e.g., 12 C.F.R. § 1229.4.

\(^4\) The cited statutory provision states that “a regulated entity that is classified as undercapitalized may not make any capital distribution that would result in the regulated entity being reclassified as significantly undercapitalized or critically undercapitalized.” As § 1229.6(a)(3) of the rules makes clear, separate provisions in the Bank Act also serve to limit capital distributions by an undercapitalized Bank. See, e.g., 12 U.S.C. §§ 1426(f) and (h)(3).
of the Safety and Soundness Act’s PCA provisions that a Bank found to be undercapitalized should have greater freedom from the Director’s scrutiny with regard to the buy-back of capital stock than if it were deemed adequately capitalized prior to the transaction. Clearly there should be heightened regulatory concern with regard to a Bank’s reducing capital if the conditions already exist for it to be classified as “undercapitalized.” The relevant concern for applying the restrictions on capital distribution set forth in § 1229.5 is the classification of the Bank after the distribution rather than its classification before the distribution occurs.

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This Regulatory Interpretation is issued pursuant to 12 C.F.R. § 907.5 and is subject to modification or rescission by the Director of the Federal Housing Finance Agency.