FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2019-03

CAPITAL STOCK MANAGEMENT

Purpose

This Advisory Bulletin provides Federal Housing Finance Agency (FHFA) guidance for each Federal Home Loan Bank (Bank) regarding the manner in which it manages its capital accounts. This guidance augments existing statutory and regulatory capital requirements.

This guidance describes FHFA's supervisory expectations regarding an appropriate level of capital stock that each Bank should maintain, expressed as a percentage of assets, in order to help preserve the cooperative nature of the Banks. Recent developments have resulted in the Banks responding to growth in their retained earnings, in part, by lowering their levels of capital stock, where both are measured as a proportion of total assets. Holding a higher proportion of total capital as retained earnings supports the maintenance of the par value of Bank capital stock, but also results in a declining proportion of capital stock which could, at some point, undermine the cooperative nature of the Banks by minimizing their members' ownership interest in them.

Background

Capital Composition

Bank regulatory capital is comprised of member paid-in Bank capital stock (capital stock) and retained earnings.[1] Each Bank has a variety of means to manage the composition of its capital accounts between those two items. For example, a Bank can increase or decrease the proportion of capital attributable to capital stock by increasing or decreasing stock purchase requirements that an institution must make for membership or for conducting certain activities, primarily member advance borrowings. The Bank also can issue stock dividends, which converts retained earnings into capital stock.

[1] For purposes of this Advisory Bulletin, capital stock includes all member paid-in Bank capital stock, including mandatorily redeemable stock.

Cooperative Nature of the Bank System

Congress established the Banks as cooperative business organizations, meaning that the Banks are to be owned and managed by their members for the purpose of providing services to those members. Specifically, only members may own capital stock in the Banks or vote to elect persons to the boards of directors, a majority of which must be officers or directors of those member institutions. The members of the Banks also own the retained earnings of the Banks, in proportion to the amount of Class B capital stock that each member owns. Only members and certain eligible associates may receive an advance, which is the primary service provided by the Banks, or may sell qualifying mortgage loans to their Bank.[2]

A fundamental aspect of the cooperative structure is that the members have a financial incentive to be fully engaged in the oversight and business of the Bank. Being so engaged helps to preserve the value of the members' investment in the capital stock of the Bank, and to maintain the availability of Bank services that benefit members. As both owners and customers of the Bank, members also are financially motivated to ensure that the Bank operates in a safe and sound manner. As a practical matter, however, the members' financial motivation to properly oversee the operations of the Bank will likely be positively correlated with the members' tangible investment in the Bank.

In recent years, the Banks have achieved significant growth in retained earnings as a proportion of total assets. Consequently, the Banks have also managed a gradual decline in capital stock as a proportion of assets. FHFA believes that it is important for a Bank to maintain a minimum capital stock-to-assets ratio in order to help preserve the cooperative structure incentives that encourage members to remain fully engaged in the oversight of their investment in the Bank. Determining an amount of capital stock that would provide some reasonable assurance that the members would continue to have a financial incentive to remain engaged in the oversight and use of the cooperative is not a matter that readily lends itself to precise calculation. Nonetheless, FHFA believes that the members of a Bank that maintains a ratio of at least two percent of capital stock to assets will continue to have adequate financial incentive to remain engaged in the cooperative, and encourages each Bank to maintain its capital stock at or above that ratio.

A factor suggesting that maintaining at least a two percent capital stock-to-assets ratio may align with sufficient member incentive to remain engaged in the cooperative is that this measure is related to the risk of capital stock impairment. Specifically, the risk of impairment is heightened as the Bank's total capital declines to near the level of two percent of assets. This is the threshold at which the prompt corrective action regulation specifies that the Director of FHFA may appoint a conservator or receiver.[3] Either of those actions would significantly increase the likelihood of impairment for the remaining amounts of capital stock. If a Bank that was approaching the two percent capital level were to be capitalized principally with retained earnings, its members would have little investment at risk if the Bank's capital levels were to

[2] Most recently, in the amended Acquired Member Asset rule, FHFA stated that the objective of the member nexus requirement in that rule is to align the mortgage purchase programs with the cooperative structure of the Bank System. 81 Fed. Reg. 91674, 91676 (Dec. 19, 2016).

[3] *See* 12 CFR 1229.1, 1229.10(a). This threshold is also well known from commercial banking regulation, where the Federal Deposit Insurance Act requires that a bank's "critical capital" be not less than two percent of total assets. 12 USC 1831o(c)(3)(B).

continue to decline, and thus less motivation to engage in actions to revive the safe and profitable operation of the Bank. Clearly, the motivation of the members to actively support the Bank would increase in step with the proportion of that capital that is capital stock and would be maximized when needed most in the circumstance of a Bank that has only about two percent of capital to assets, and all of that capital is capital stock.

Scope

The Advisory Bulletin applies only to the Banks.

Guidance

Maintaining the level of capital stock in an amount that is equal to or greater than two percent of a Bank's assets is consistent with helping preserve the cooperative nature of the Bank System. Beginning six months following the date of this Advisory Bulletin, FHFA will consider the proportion of capital stock, as measured on a daily average basis at month end, when assessing each Bank's capital management practices.

FHFA has statutory responsibility to ensure the safe and sound operations of the regulated entities and the Office of Finance. Advisory bulletins describe FHFA supervisory expectations for safe and sound operations in particular areas and are used in FHFA examinations of the regulated entities and the Office of Finance. Questions about this advisory bulletin should be directed to: SupervisionPolicy@fhfa.gov.