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Presidents and Chief Executive Officers
Federal Home Loan Banks

Subject: Membership Issues

Dear Federal Home Loan Bank Presidents:

A number of issues relating to Federal Home Loan Bank (FHLBank or Bank) membership eligibility have arisen recently both through the examination process and as a result of inquiries to the Federal Housing Finance Agency (FHFA). FHFA is issuing this supervisory letter to ensure that all FHLBanks are aware of these issues and to provide uniform guidance in the event other Banks encounter similar circumstances.

Requirements for De Novo Community Development Financial Institutions (CDFIs) – A CDFI applicant (that is not an insured depository institution) must have at least three years' worth of year-end financial statements to receive approval for FHLBank membership. FHFA regulations governing the application of the "financial condition" eligibility requirement to CDFIs provide that a CDFI applicant must submit year-end financial statements from the prior year, which must have been independently audited in accordance with generally accepted auditing standards, as well as year-end financial statements for each of the immediately preceding two years (which need not be audited). *See* 12 CFR 1263.16(b)(1)(i). A FHLBank must "consider all such information prior to acting on the application for membership." 12 CFR 1263.16(b)(1).

While the regulations include a special provision for *de novo* insured depository institutions (defined as those whose charter was approved less than three years prior to the date of application), which suspends or modifies a number of eligibility requirements that would otherwise apply to a depository institution applicant, *see* 12 CFR 1263.14, there is no equivalent provision for *de novo* CDFIs. In the preamble to the 2010 final rule adopting most of the current CDFI membership provisions, FHFA expressly addressed its decision not to include a special provision for *de novo* CDFIs, stating:

> Certain . . . commenters asked that FHFA revise § 1263.14, which establishes special procedures for *de novo* insured depository institutions, so that newly organized CDFIs could also have the benefit of those procedures. FHFA declines to amend § 1263.14 to accommodate newly organized CDFI applicants because the requirements for obtaining a depository institution charter and Federal deposit insurance are considerably more rigorous than are the processes for obtaining

> certification from the CDFI Fund. A *de novo* depository institution typically is allowed to commence business and obtain deposit insurance only after one or more bank regulatory agencies have determined that the institution is adequately capitalized, has a sound business plan, capable management, and can operate in a safe and sound manner. There is no comparable regulatory review for CDFIs; indeed, the regulations of the CDFI Fund expressly state that CDFI certification does not represent an assessment that the entity is financially viable. 12 CFR 1805.201(a). In the absence of any such independent financial evaluation of the CDFI applicants, FHFA does not believe that they should be included within the provisions for *de novo* depository institutions. 75 Fed. Reg. 678, 682-83 (Jan. 5, 2010).

Automatic Transfer of Membership – FHFA's regulations provide that, in the event a FHLBank member relocates, or redesignates, its principal place of business to a different FHLBank district, it shall become a member of the FHLBank of that district upon the purchase of the minimum amount of capital stock required for membership in that FHLBank; that is, the transferring member need not submit an application for membership with the FHLBank into whose district it is transferring and need not wait five years after divestiture of its stock in the releasing FHLBank to become a member of the receiving FHLBank. *See* 12 CFR 1263.4(b), .30(b). The regulations further provide that the transfer of membership may take place only after the FHLBanks releasing and receiving the member, respectively, agree to an orderly method of transfer. *See* 12 CFR 1263.18(d)(1). In such circumstances, the FHLBank releasing the member should notify the receiving FHLBank as soon as it becomes aware that such a transfer may take place. The receiving FHLBank may take the amount of time it needs to undertake its due diligence with respect to the transferring member and its business model, including validating that the transferring member continues to be an eligible member type as set forth in 12 CFR 1263.6.

Large Non-Member Institution Merging with a Small Member – As a general matter, when a non-member entity merges into an existing FHLBank member, the resulting institution may remain a member if it continues operating under the existing member's charter. Nonetheless, FHFA regards attempts to attain FHLBank membership through a merger transaction intended to circumvent controlling statute or regulation to be impermissible.[1] Recently, a large financial institution otherwise ineligible for FHLBank membership attempted to attain membership by merging with a much smaller FHLBank member institution controlled by their shared holding company. The surviving institution was to retain the member institution's charter, thereby effectively granting the large institution membership despite the fact that it did not meet all membership eligibility requirements. The merger had no economic justification beyond providing a means by which the larger institution could attain FHLBank membership in circumvention of statutory and regulatory requirements. FHFA advised the affected FHLBank and the merging institutions that the Agency viewed the proposed merger to be an attempted circumvention of the membership regulation and that FHFA would require the FHLBank to nullify any membership obtained in this manner.

[1] It is well established in federal case law that regulatory agencies may set aside sham transactions where an arrangement is devised to circumvent a regulatory requirement or prohibition. The federal courts have repeatedly upheld regulatory agencies' powers to look beyond the form of a transaction to its economic substance in order to further the regulatory purpose of Congress. *See, e.g.*, Crude Co. v. FERC, 135 F.3d 1445 (Fed. Cir. 1998).

Applicant's Compliance with "Financial Condition" Requirement – As provided in 12 CFR 1263.6(a), each of the applicable membership eligibility requirements must be met by the applicant itself; that is, characteristics of a parent or affiliate may not be imputed to an applicant when a FHLBank is assessing compliance with those requirements. Accordingly, in assessing whether an applicant's "financial condition is such that advances may be safely made to it," *see* 12 CFR 1263.6(a)(4), a FHLBank should assess the applicant's financial condition as a standalone entity without taking into account any support that may be provided by parents or other affiliates. A Bank may and should, however, take the financial strength of parents and affiliates into account as part of the credit underwriting process (i.e., in determining the conditions under which advances may be made to the applicant once it becomes a member).

Definition of Insurance Company – There are several issues with regard to insurance companies that are currently under review by the Bank System Insurance Working Group and thus are not addressed in this letter. However, a number of questions have arisen recently regarding application of FHFA's regulatory definition of "insurance company." Section 1263.1 of the membership regulation defines "insurance company" to mean *"an entity that holds an insurance license or charter under the laws of a State and whose primary business is the underwriting of insurance for persons or entities that are not its affiliates."* Regarding that definition, FHFA provides the following guidance:

- Given that the term "primary business" is not modified in any way, the definition plainly requires that the underwriting of insurance to non-affiliates be the primary part of a company's *total* business, not merely the primary part of the company's *insurance* business, to qualify as an "insurance company" for membership purposes.

- The reinsurance of risks ceded from entities meeting the definition of "affiliate" under 12 CFR 1263.1 may be considered to constitute "the underwriting of insurance for persons or entities that are not its affiliates" to the extent that the reinsurance is on risks incurred by non-affiliates and is not for the purpose of providing a self-insurance vehicle for an affiliate.

- When determining whether an applicant's primary business is the underwriting of insurance for non-affiliates, a Bank should, at minimum, consider data from the applicant's most recent year-end audited financial statements, which the Bank is required to review under 12 CFR 1263.16(a), in addition to year-to-date information.

- Meeting the regulatory definition of "insurance company" is an ongoing requirement, similar to the requirement that an "insured depository institution" or "CDFI" continue to meet FHFA's regulatory definitions of those terms by, respectively, continuing to maintain deposit or share insurance (or, in the case of non-federally-insured credit unions, to meet the requirements of 12 CFR 1263.19) or continuing to maintain certification from the CDFI Fund. As part of a FHLBank's periodic analysis of an insurance company member, the FHLBank should confirm that such member continues to meet the definition of insurance company in the regulation. If an insurance company member's business has changed to the extent that the Bank is unsure whether it continues to meet the definition,

the Bank should work with the member to resolve the issue in a reasonable amount of time. In such cases, the Bank should notify its EIC of the situation. In the event the member cannot come into compliance within a reasonable amount of time, the Bank must terminate its membership.

If you have any questions, please contact your respective Associate Director of Safety and Soundness Examinations.

Sincerely,

ANDRE GALEANO

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Andre D. Galeano
Deputy Director
Division of Bank Regulation

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