March 10, 2000

Vice President, Mortgage Finance
Federal Home Loan Bank

NO-ACTION LETTER: Treatment of *De Novo* Membership (2000-NAL-02)

Dear Ms :

This is in response to the September 9, 1999 letter from former Senior Vice President [redacted] Federal Home Loan Bank (FHLBank), to Mitchell Berns, Director, Office of Supervision, your August 18, 1999 letter to Managing Director William W. Ginsberg, and other related correspondence, regarding [redacted] Bank's (Bank) failure to have at least 10 percent of its assets invested in residential mortgage loans, as required by section 4(a)(2) of the Federal Home Loan Bank Act (Bank Act), 12 U.S.C. § 1424(a)(2) (1994), and the Federal Housing Finance Board (Finance Board) Membership Regulation.

Background: Based on the information provided by the FHLBank, on June 8, 1998, the FHLBank approved the membership application of Bank, a *de novo* state-chartered industrial loan company insured by the Federal Deposit Insurance Corporation, and Bank commenced business operations on that date. Under section 4(a)(2) of the Bank Act and the Finance Board Membership Regulation, Bank had one year from that date to comply with the requirement that 10 percent of its assets be in residential mortgage loans (10 percent requirement). *See* 12 U.S.C. § 1424(a)(2) and 12 C.F.R. §§ 933.6(b), 933.10 and 933.14(a)(3) (1999). On July 28, 1998, Bank purchased its minimum stock requirement of five shares of FHLBank stock ($500).

Bank failed to meet the 10 percent requirement by June 8, 1999. On July 2, 1999, [redacted] the holding company for Bank, requested that the FHLBank extend the deadline for meeting the 10 percent requirement, based on pending regulatory approval of the sale of Bank to a nonmember, [redacted] Corporation (Corporation), which was expected to occur on or before October 31, 1999. According to the FHLBank, after the sale, Corporation would transfer mortgage loans to Bank, enabling it to meet the 10 percent requirement.

By letters dated August 18, 1999 and September 9, 1999, the FHLBank notified the Finance Board of Bank's noncompliance with the 10 percent requirement, and requested guidance on how to handle the matter. The sale of Bank to Corporation was not consummated by October 31, 1999. FHLBank staff recently advised the Finance Board that the sale of Bank to Corporation now is anticipated to occur in the first quarter of 2000.

As of September 30, 1999, Bank's total assets were $[redacted] million. Bank has never had any outstanding borrowings with the FHLBank, and, according to FHLBank staff, currently is not eligible to borrow from the FHLBank due to the FHLBank's questions about Bank's membership status and a lack of available eligible collateral. Since Bank has not taken any advances from the FHLBank, under the Bank Act, Bank has not been required to purchase any additional stock in the FHLBank. Bank has not voluntarily purchased any excess FHLBank stock. The FHLBank paid Bank a second quarter dividend of $[redacted] on July 20, 1999, a third

quarter dividend of $[redacted] on October 20, 1999, and a fourth quarter dividend of $[redacted] on January 20, 2000.

Analysis:

I. Bank's Noncompliance With Section 6(e) of the Bank Act and Section 934.17 of the Finance Board Regulations

Section 4(a)(2) of the Bank Act, as in effect at the time of the relevant actions in this matter, provided that an insured depository institution commencing business operations after January 1, 1989, may become a member of an FHLBank "if it complies with [the 10 percent requirement]" within one year after the commencement of its operations. *See* 12 U.S.C. § 1424(a)(2) (1994). Section 4(a)(2) is implemented by sections 933.6(b), 933.10 and 933.14(a)(3) of the Finance Board Membership Regulation. *See* 12 C.F.R. §§ 933.6(b), 933.10, and 933.14(a)(3) (1999). Thus, a *de novo* institution's membership is conditioned on the timely satisfaction of the 10 percent requirement. If an institution fails to satisfy this condition within the one-year period, it would not have met one of the statutory criteria for membership and the conditional approval (as well as the institution's membership) would be deemed null and void by operation of law.[1] Thus, even though the Membership Regulation is silent as to the consequences of a *de novo* institution's failure to meet the 10 percent requirement, compliance is required by statute no later than one year after commencing operations.[2]

Bank commenced business operations on June 8, 1998, but failed to comply with the 10 percent requirement by June 8, 1999. Therefore, notwithstanding Bank's pending acquisition by Corporation, Bank's conditional membership approval became null and void by operation of law on June 8, 1999. The Bank Act does not allow this date to be extended, nor does it allow compliance to be waived. After June 8, 1999, the FHL Bank should have treated Bank as a nonmember for all purposes.

Section 6(e) of the Bank Act provides that if an institution's membership in an FHLBank is terminated, any indebtedness the member owes to the FHLBank shall be liquidated in an orderly manner, as determined by the FHLBank, and upon completion of such liquidation, the capital stock owned by the member in the FHLBank shall be redeemed. *See* 12 U.S.C. § 1426(e) (1994).[3] Because Bank had no outstanding advances from the FHLBank, the FHLBank's failure to redeem Bank's stock in the FHLBank after June 8, 1999 was a violation of section 6(e) of the Bank Act

[1] Removal of the institution from membership under section 6(e) of the Bank Act and section 933.27 of the Finance Board Membership Regulation, therefore, is not necessary. *See* 12 U.S.C. § 1426(e) (1994) and12 C.F.R. § 933.27 (1999).

[2] The Membership Regulation specifically provides for conditional approval of membership applications of *de novo* institutions in connection with satisfaction of the home financing policy eligibility requirement. *See* 12 C.F.R. § 933.14(a)(4) (1999). If a *de novo* applicant fails to meet the specified Community Reinvestment Act performance condition, the applicant is deemed to be in noncompliance with the home financing policy requirement, subject to rebuttal. If the applicant fails to rebut the presumption of noncompliance, its conditional membership approval is deemed null and void, and the orderly liquidation of any outstanding indebtedness owed by the applicant to the FHLBank and, upon completion of such liquidation, the redemption of capital stock of the FHLBank is required to be carried out in accordance with section 933.29 of the Membership Regulation. Despite the absence of comparable language regarding the 10 percent requirement, it is logical to treat the failure to meet this statutory eligibility criterion in the same manner as the failure to meet the statutory home financing policy eligibility criterion. *See* Letter from Deborah F. Silberman, General Counsel, to Paul D. Hill, Federal Home Loan Bank of Atlanta, dated September 17, 1998.

[3] Under the Federal Home Loan Bank System Modernization Act of 1999 (Modernization Act), discussed further below, certain provisions of section 6(e) of the Bank Act, including the orderly liquidation and redemption of capital stock provisions, remain in effect during a transition period until the Finance Board has issued capital regulations and approved the FHLBanks' capital structure plans, after which those provisions in section 6(e) are repealed. *See* Pub. L. No. 106-102, sec. 608, 113 Stat. 1338 (Nov. 12, 1999).

Under the dividend provisions in section 934.17 of the Finance Board regulations that were in effect at the time of the relevant actions in this matter, the FHLBank was authorized to pay dividends on the paid-in value of capital stock held during the dividend period, but only for the period such stock was outstanding during the dividend period. *See* 12 C.F.R. § 934.17 (1999). Thus, if the FHLBank had redeemed all of Bank's stock in the FHLBank after June 8, 1999 as it was required to do by section 6(e), based on the period the stock was outstanding during the dividend period, Bank would have been entitled to only a *pro rata*, rather than a full, share of the second quarter dividend distribution, and no share of the third and fourth quarter dividend distributions. The FHLBank, therefore, violated section 934.17 of the Finance Board regulations by paying dividends to Bank to which it was not entitled.

II. Bank May Re-apply For Membership Without Having to Meet the 10 Percent Requirement

Because Bank's conditional membership approval became null and void on June 8, 1999, Bank must submit a new application for FHLBank membership if it wishes to be an FHLBank member. Under the Finance Board Membership Regulation, an applicant is considered to be a *de novo* applicant if its date of charter approval is within three years prior to the date the FHLBank receives its application for membership. *See* 12 C.F.R. § 933.14(a)(1) (1999). According to FHLBank staff, as of the date of this No-Action Letter, Bank's date of charter approval falls within the three-year time frame and, therefore, Bank's membership application would be subject to the membership eligibility requirements applicable to *de novo* applicants under the Membership Regulation.

Effective November 12, 1999, the Modernization Act amended section 4(a)(2) of the Bank Act to exempt from the 10 percent requirement any applicants, including *de novo* institutions, that qualify as "community financial institutions." *See* Modernization Act sec. 605 (*to be codified at* 12 U.S.C. § 1424(a)(2)(A)(4)). The Modernization Act defines a "community financial institution" to mean, generally, an institution whose deposits are insured under the Federal Deposit Insurance Act (FDIA) and that has less than $500 million in average total assets, based on an average of total assets over the three preceding years. Modernization Act sec. 602 (*to be codified at* 12 U.S.C. § 1422(13)). According to the FHLBank, Bank's deposits are insured under the FDIA and the institution had less than $500 million in average total assets as of September 30, 1999, the latest date for which figures currently are available. Assuming Bank continues to have average total assets of less than $500 million, Bank would qualify as a "community financial institution" and would not be required to meet the 10 percent requirement.

At this date, sections 933.6(b), 933.10 and 933.14(a)(3) of the Finance Board Membership Regulation, which also impose the 10 percent requirement on all new members, remain in effect. *See* 12 C.F.R. §§ 933.6(b), 933.10 and 933.14(a)(3) (1999). As a general matter, and notwithstanding the amendments made to the Bank Act by the Modernization Act, the regulations lawfully promulgated by the Finance Board remain in effect until they are formally repealed or amended by the Finance Board.[4] In some instances, however, an existing regulation may be in direct and irreconcilable conflict with certain provisions of the Modernization Act. In such a case, it is our view that the regulation, though not yet formally repealed or amended, must yield to the new law. In our opinion, the Bank case presents such a conflict. Though the Finance Board has not yet amended sections 933.6(b), 933.10 and 933.14(a)(3) to conform them to the new law, they cannot be applied to a community financial institution without negating the exemption for community financial institutions established by Congress as of November 12, 1999. Therefore, the 10 percent requirement for community financial institutions imposed by sections 933.6(b), 933.10 and 933.14(a)(3) must yield to, and in our view is overridden by, the exemption for community financial institutions in amended section 4(a)(2).

[4] The Finance Board currently is in the process of reviewing its existing regulations and preparing and adopting amendments to rescind or conform those regulations pursuant to the statutory amendments in the Modernization Act.

Thus, assuming that Bank were to qualify as a"community financial institution" under amended sections 2(13) and 4(a)(2) of the Bank Act, and were to re-apply for membership, the 10 percent requirement would not apply to it. Bank still would have to meet all other regulatory eligibility requirements for membership applicable to *de novo* applicants. *See* 12 C.F.R. §§ 933.6-933.9 and 933.11-933.14 (1999). Until Bank applies and is approved for membership, the FHLBank must treat Bank as a nonmember, for the reasons discussed above.

III. No-Action Recommendation

As discussed above, since June 8, 1999, the FHLBank has failed to comply with the requirements of section 6(e) of the Bank Act and section 934.17 of the Finance Board regulations. *See* 12 U.S.C. § 1426(e) (1994) and 12 C.F.R. § 934.17 (1999). The FHLBank's noncompliance has had no safety and soundness implications for the FHLBank, however, and Bank's membership activity has been *de minimis* in nature. Bank has had no outstanding advances with the FHLBank, holds a minimal amount of FHLBank stock, and received impermissible dividend payments that were *de minimis* in amount.

Moreover, the FHLBank made good faith efforts to notify the Finance Board of Bank's noncompliance with the 10 percent requirement, requested guidance on how to handle the matter, and reported the pending sale of Bank to an institution that, according to FHLBank staff, intended to assist Bank in complying with the 10 percent requirement. In addition, Congress subsequently eliminated the statutory 10 percent requirement for community financial institutions, and it is likely that Bank would qualify as a community financial institution and, therefore, is no longer subject to the 10 percent requirement.

In light of all of the above factors, Finance Board staff will not recommend to its Board of Directors that supervisory action be taken against the FHLBank, nor will Finance Board staff undertake any such supervisory action for the FHLBank's noncompliance with section 6(e) of the Bank Act and section 934.17 of the Finance Board regulations, for the period after June 8, 1999 through the date of the FHLBank's receipt of this No-Action Letter. This No-Action recommendation does not apply to any actions that the FHLBank may take regarding Bank's membership subsequent to the FHLBank's receipt of this No-Action Letter, though the FHLBank may have a reasonable period of time to effect the termination of Bank's conditional membership.

This No-Action Letter is based upon the factual representations made in theFHLBank's correspondence and telephone conversations with the Finance Board, and any change in those facts may warrant a different conclusion. A No-Action Letter represents a staff position and the Board of Directors of the Finance Board may modify or supersede the position taken by the staff. *See* 64 Fed. Reg. 30880 (June 9, 1999) (*to be codified at* 12 C.F.R. Part 903).

If you have any questions, please contact Mitchell Berns, Director, Office of Supervision, at (202) 408-2562.

Sincerely,

/s/ William W. Ginsberg

William W. Ginsberg
Managing Director

cc: Bruce A. Morrison J. Timothy O'Neill William C. Apgar
Mitchell Berns James L. Bothwell Deborah F. Silberman [redacted]