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FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1263

RIN 2590-AA39

Members of Federal Home Loan Banks

AGENCY: Federal Housing Finance Agency

ACTION: Final Rule.

SUMMARY: The Federal Housing Finance Agency (FHFA) has adopted a final rule revising its regulations governing Federal Home Loan Bank (Bank) membership. The final rule adopts several key revisions included in the Notice of Proposed Rulemaking. These revisions will prevent the circumvention of the statute's membership restrictions by ineligible entities using captive insurers as conduits for Bank membership by defining the term "insurance company" to exclude captive insurers, thereby making them ineligible for Bank membership; permit any Bank that has admitted captives to membership a transition period within which to wind down its affairs with those entities; require a Bank to obtain and review an insurance company's audited financial statements when considering its application for membership; clarify the standards by which a Bank is to determine the "principal place of business" for its members, including specific standards for insurance companies and community development financial institutions; and remove obsolete provisions and make numerous non-substantive textual revisions so as to provide greater clarity. The final rule does not implement the proposed rule's provisions with respect to continuing eligibility requirements, in order, as explained below, to avoid compliance burdens that may outweigh the benefits. The specific

revisions made, and the rationale for making them, are set forth in the **Supplementary Information** below.

DATES: Effective Date: [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Eric M. Raudenbush, Assistant General Counsel, Office of General Counsel, Eric.Raudenbush@fhfa.gov, (202) 649-3084; or Julie Paller, Senior Financial Analyst, Supervisory and Regulatory Policy, Division of Bank Regulation, Julie.Paller@fhfa.gov, (202) 649-3201 (not toll-free numbers), Federal Housing Finance Agency, 400 Seventh Street, SW., Washington, DC 20219. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

SUPPLEMENTARY INFORMATION:

I. Background

A. Overview of the Existing Bank Membership Requirements

1. Statutory requirements

The Federal Home Loan Bank System (Bank System) consists of eleven district Banks and the Office of Finance. The Banks are wholesale financial institutions, organized under authority of the Federal Home Loan Bank Act (Bank Act) to serve the public interest by enhancing the availability of residential housing finance and community lending credit through their member institutions and, to a very limited extent, through certain eligible nonmembers.[1] Each Bank is structured as a regional cooperative

[1] See 12 U.S.C. 1423, 1431(e), 1432(a). See also Fahey v. O'Melveny & Myers, 200 F.2d 420, 446 (9th Cir. 1952) (stating that a Bank is "a federal instrumentality organized to carry out public policy"); ADAPSO v. FHLBB, 568 F.2d 478, 480 (6th Cir. 1977) (stating that the Banks remain federal instrumentalities although

in that it is owned and controlled by member institutions located within its district, which are its primary customers.[2]

The Banks carry out their public policy function primarily by providing low cost loans, known as advances, to their members. These must be fully secured by one or more specific types of collateral, including residential mortgage loans and residential mortgage-backed securities, but also government securities, cash, other real estate related collateral, and, in some cases, secured small business, agriculture, or community development loans, or securities backed by such loans.[3] In most cases, Bank members must use the proceeds of long-term advances (that is, advances with an original term to maturity of more than five years) to fund residential housing finance, although, since 1999, smaller bank and thrift members have also been permitted to obtain long-term advances to fund small business and community development activities.[4] Bank members may use the proceeds of shorter-term advances for any business purpose. The Banks also may provide members with a limited range of other products and services, such as they provide through the "acquired member asset" (AMA) programs, under which they may purchase qualifying residential mortgage loans from their members or facilitate the sale of such loans to third-party investors.[5]

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their stock is now held entirely by private entities). In addition to advances to members, the Bank Act also authorizes the Banks to make advances to nonmember mortgagees, including state housing finance agencies, that have been approved under title II of the National Housing Act, 12 U.S.C. 1707, et seq., and that meet certain additional requirements. See 12 U.S.C. 1430b. These entities are referred to as "housing associates" in FHFA's regulations. See 12 CFR 1201.1, 1264.1-.6, 1266.16-.17.

[2] Specifically, only members may own the capital stock of a Bank, 12 U.S.C. 1426(a)(4)(B), all members are required to maintain a minimum investment in Bank stock, 12 U.S.C. 1426(c)(1), each Bank is managed by a board of directors that is elected by its members, see 12 U.S.C. 1427(a), (b), (c), and (with limited exceptions noted in footnote 1 above) only members may obtain advances and access other products and services provided by a Bank, see 12 U.S.C. 1429, 1430(a)(1), 1430b.

[3] 12 U.S.C. 1430(a)(3).

[4] See 12 U.S.C. 1430(a)(2).

[5] See 12 CFR part 955.

The Banks fund their operations principally through the issuance of consolidated obligations (COs), which are debt instruments issued on their behalf by the Office of Finance (a joint office of the Banks) and on which all of the Banks are jointly and severally liable.[6] Congress has vested in the Banks market advantages designed to enable them to raise funds in the capital markets at interest rates only slightly higher than those on comparable Treasury instruments. These government-sponsored entities have various advantages, which include, among other things: the exemption of the Banks' corporate earnings and the earnings on their COs from state and federal income taxes;[7] the classification of the Banks' COs as "exempted securities" under the Securities Act of 1933 and as "government securities" under the Securities Exchange Act of 1934;[8] and the authority of the U.S. Department of the Treasury (Treasury Department) to purchase up to $4 billion in COs under certain circumstances and the fact that Congress has occasionally granted it authority to purchase higher amounts during periods of financial crisis.[9] These market advantages were designed to enable the Banks to provide low-cost wholesale funding to their member institutions so that, in turn, those members could provide long-term home mortgage loans to consumers at a reasonable cost. These advantages accrue not only to consumers, but also to the members themselves, which benefit from a lower cost of funds that makes those institutions more competitive in their markets as compared with non-members who do not have access to such low-cost wholesale funding.

In line with the public policy goals underlying the creation of the Banks and in

[6] See 12 U.S.C. 1431; 12 CFR part 1270.
[7] See 12 U.S.C. 1433.
[8] See 12 U.S.C. 1426a(c)(2)
[9] See 12 U.S.C. 1431(i), (*l*).

conjunction with its decision to provide the Banks, and consequently their members, with the market advantages described above, Congress made a decision to limit eligibility for Bank membership to the types of financial institutions listed in section 4(a) of the Bank Act. When the statute was originally enacted in 1932, these included thrift institutions of various types that existed at the time (*i.e.*, building and loan associations, savings and loan associations, cooperative banks, homestead associations, and savings banks), as well as insurance companies. Since 1932, Congress has amended section 4(a) to expand the list of institutions that may be eligible for Bank membership only three times, adding federally insured depository institutions in 1989,[10] non-depository Community Development Financial Institutions (CDFIs) in 2008,[11] and non-federally insured credit unions in 2015.[12] Today, because most depository institutions (including the types of thrifts listed in section 4(a)) are now federally insured, essentially four types of institutions may be eligible for membership: (1) federally insured depository institutions (including banks and thrifts whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) and credit unions whose deposits are insured by the National Credit Union Administration (NCUA)); (2) insurance companies; (3) CDFIs that are certified by the Community Development Financial Institutions Fund of the Treasury Department;

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[10] See Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 704, 103 Stat. 183, 415 (1989).

[11] See Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1206, 122 Stat. 2654, 2787 (2008). CDFI credit unions were eligible for Bank membership prior to 2008 due to their status as insured depository institutions.

[12] On December 4, 2015, the President signed into law an amendment to section 4(a) of the Bank Act that allows any non-federally insured credit union meeting certain specified criteria to be treated as an "insured depository institution" for purposes of determining its eligibility for Bank membership. See Fixing America's Surface Transportation Act, Pub. L. No. 114-94, § 82001 (2015). This final rule does not implement or otherwise address that recent statutory amendment. To the extent that regulatory revisions are necessary or appropriate to implement the amendment, they must be the subject of a separate rulemaking.

and (4) non-federally insured credit unions meeting certain statutory criteria. Entities that do not fall within one of those categories are ineligible for Bank membership.

While qualifying as one of those enumerated types of institutions is one prerequisite for membership eligibility, an institution must meet several other requirements set forth in section 4 of the Bank Act in order to obtain membership. Section 4(a)(1) of the Bank Act requires that an institution, regardless of type: (A) be duly organized under the laws of any state or the United States; (B) be subject to inspection and regulation under banking, or similar, laws of a state or the United States; and (C) "makes such home mortgage loans as, in the judgment of the Director [of FHFA], are long-term loans."[13] An institution that fails to satisfy any of those requirements is not eligible for Bank membership. (Hereinafter, those requirements are referred to as the "duly organized," "subject to inspection and regulation," and "makes long-term home mortgage loans" requirements, respectively).

Section 4(a)(2) of the Bank Act imposes additional eligibility requirements on insured depository institutions that were not members of a Bank as of January 1, 1989. These require that any such institution: (A) have at least 10 percent of its total assets in "residential mortgage loans"; (B) be in a financial condition such that advances may be safely made to it; and (C) show that the character of its management and its home-financing policy are consistent with sound and economical home financing.[14] (Hereinafter, those requirements are referred to as the "10 percent," "financial condition," "character of management," and "home financing policy" requirements, respectively).

[13] 12 U.S.C. 1424(a)(1). In lieu of being subject to inspection and regulation by a state or federal regulator, a CDFI applicant must be certified as a CDFI by the Treasury Department. See 12 U.S.C. 1424(a)(1)(B).
[14] 12 U.S.C. 1424(a)(2).

However, section 4(a)(4) exempts from the "10 percent" requirement any "community financial institution" (CFI),[15] which the statute defines as an FDIC-insured depository institution with less than $1 billion in average total assets (adjusted annually for inflation) over the preceding three years.[16]

2. FHFA's existing Bank membership regulation

FHFA's regulation on Bank membership, located at 12 CFR part 1263, specifies how and when an institution must demonstrate compliance with each of the statutory membership eligibility requirements and otherwise implements those requirements. The regulation also establishes requirements relating to the membership application process, determination of the appropriate Bank district for membership, members' purchase and redemption of Bank capital stock, and voluntary or involuntary termination and reacquisition of membership.

The regulation requires all insured depository institutions, insurance companies, and CDFIs to meet six requirements in order to be considered eligible for membership: the "duly organized," "subject to inspection and regulation,"[17] and "makes long-term home mortgage loans" requirements, which by statute apply to all types of institutions; and the "financial condition," "character of management," and "home financing policy" requirements, which FHFA and its predecessor agency, the Federal Housing Finance Board (Finance Board), have applied by regulation to all institutions as a matter of safety

[15] 12 U.S.C. 1424(a)(4).
[16] 12 U.S.C. 1422(10)(A). By statute, FHFA must annually adjust the $1 billion CFI asset limit for inflation. 12 U.S.C. 1422(10)(B). The inflation-adjusted CFI limit for 2015 was $1.123 billion. See 80 FR 6712 (Feb. 6, 2015).
[17] As provided in the statute, an institution certified as a CDFI by the Treasury Department's CDFI Fund is deemed to have met the "subject to inspection and regulation" requirement by virtue of that certification. See 12 CFR 1263.6(a)(2), 1263.8.

and soundness.[18] Paralleling the statute, the membership regulation requires that non-CFI depository institutions also meet the "10 percent" requirement in order to be eligible for membership, but does not extend that requirement to CFIs, CDFIs or insurance companies.[19] However, the regulation does require institutions that are not insured depository institutions (*i.e.*, insurance companies and CDFIs) to have "mortgage-related assets" that "reflect a commitment to housing finance" in order to be considered eligible.[20]

For each of the six general eligibility requirements and for the "10 percent" requirement, part 1263 includes at least one separate section specifying in more detail how a Bank that is considering an institution's application for membership is to determine whether the applicant satisfies the requirement.[21] An applicant that meets the criteria of any of those more detailed provisions is deemed to be in compliance with the corresponding statutory eligibility requirement, although that presumption may be rebutted if the Bank obtains substantial evidence to the contrary.[22] Conversely, an applicant that does not meet the criteria of the more detailed provisions is presumed to be out of compliance with the corresponding statutory eligibility requirements. With respect to several of the requirements, the presumption of non-compliance can be rebutted if

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[18] 12 CFR 1263.6(a).
[19] 12 CFR 1263.6(b).
[20] 12 CFR 1263.6(c). The regulation does not define the term "mortgage-related assets."
[21] See 12 CFR 1263.7-.18. In the case of the "financial condition" requirement, there are two such sections—one (§ 1263.11) setting forth the specific criteria for insured depository institutions and another (§ 1263.16) setting forth the specific criteria for insurance companies and CDFIs. There are also separate sections setting forth specific criteria for determining all of the eligibility requirements for recently chartered insured depository institutions (§ 1263.14) and for determining some of the eligibility requirements for recently consolidated institutions of any type (§ 1263.15).
[22] 12 CFR 1263.17(a).

certain additional criteria are met.[23] However, the presumption of non-compliance arising from failure to meet the criteria for the "makes long-term home mortgage loans," and "10 percent" requirements (as well as the "duly organized" requirement) is conclusive and may not be rebutted.

In the case of the "10 percent" requirement, the regulation deems any insured depository institution to which that statutory requirement applies to have satisfied that requirement if, at the time of its application for Bank membership, its most recently filed regulatory financial report indicates that it has at least 10 percent of its total assets in "residential mortgage loans."[24] In contrast to the "10 percent" requirement, neither the Bank Act nor the regulation establishes a quantitative standard for determining compliance with the "makes long-term home mortgage loans" requirement. The regulation deems an institution to have satisfied that statutory requirement if, at the time of its application for Bank membership, its most recently filed regulatory financial report demonstrates that it originates or purchases long-term home mortgage loans.[25] The regulation does not specify the level of activity that is needed to meet the requirement. The membership regulation does not require a Bank to determine an institution's

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[23] See 12 CFR 1263.17(b) through (f).

[24] The regulation defines the term "residential mortgage loan," which the statute does not define, to include generally all assets that qualify as home mortgage loans (see definition in footnote 25 below), regardless of whether the underlying loans are "long-term" or not, plus loans secured by junior liens on one-to-four family property or multifamily property, loans secured by manufactured housing, funded residential construction loans, and mortgage pass-through securities representing an ownership interest in, or mortgage debt securities secured by, any of those types of assets. 12 CFR 1263.1.

[25] 12 CFR 1263.9. The Bank Act defines the term "home mortgage loan" to mean "a loan made by a member upon the security of a home mortgage." 12 U.S.C. 1422(4). In turn, the statute defines the term "home mortgage" to mean a first mortgage, or its equivalent, upon real estate on which one or more homes or dwelling units are located. 12 U.S.C. 1422(5). The existing regulation supplements the statutory definition of "home mortgage loan" by defining the term generally to include any loan or interest in a loan that is secured by a first lien mortgage or any mortgage pass-through security that represents an undivided ownership interest in such loans or in another security that represents an undivided ownership interest in such loans. 12 CFR 1263.1. The regulation also defines the term "long-term," which the statute does not define, to mean "a term to maturity of five years or greater." See id.

compliance with either the "10 percent" or "makes long-term home mortgage loans" requirement once that institution has become a Bank member.

B. FHFA's Review of the Membership Regulation

This final rule is one of the results of a continuing review of FHFA's Bank membership regulation that the Agency began in 2010. Most of the fundamental aspects of the existing membership regulation were adopted as part of two rulemakings undertaken by the Finance Board in the mid-1990s.[26] Although the membership regulation was subsequently amended several times (in some cases to make important substantive changes[27]), until 2010 there had been no comprehensive review of the regulation as a whole since it was amended to grant the Banks the authority to approve or deny membership applications in 1996. FHFA's decision to undertake such a review was prompted in part by the evolution of the financial services industry in the intervening years, which had given rise to a number of issues that the existing regulation either did not address or addressed inadequately. The goal of this review, which is ongoing, has been to determine whether the existing regulatory provisions continue to effectively implement the requirements of the Bank Act and the Federal Housing Enterprises

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[26] In 1993, the Finance Board adopted a new membership regulation in order to implement the revisions to the statutory membership requirements made by FIRREA in 1989. See 58 FR 43522 (Aug. 17, 1993). Most of the existing material addressing the general eligibility requirements (now located in § 1263.6), the stock requirements (§§1263.19-.23), and membership withdrawal, termination, and readmission requirements (§§ 1263.24-.30) was adopted at that time. A 1996 rulemaking made significant revisions and additions to the regulation in order to authorize the Banks to approve or deny all membership applications. See 61 FR 42531 (Aug. 16, 1996). Prior to that time, the Finance Board had the ultimate authority to approve or deny membership applications, although it had delegated some of that decision-making authority to the Banks in the case of institutions meeting certain "safe harbor" criteria. Most of the existing material regarding the application process (§§ 1263.2-.5) and the rebuttable presumptions that apply to the various eligibility requirements (§§ 1263.7-.18) were adopted as part of the 1996 rulemaking.

[27] For example, the regulation was amended in 2000 to implement the new statutory exemption of CFIs from the "10 percent" requirement, see 65 FR 13866 (Mar. 15, 2000), and in 2010 to implement the statutory amendments making non-depository CDFIs eligible for membership, see 75 FR 678 (Jan. 25, 2010).

Financial Safety and Soundness Act of 1992 (Safety and Soundness Act) and to fulfill the purposes underlying those requirements. FHFA has also sought to determine whether certain provisions that do not need substantive revision should nonetheless be revised to address questions that have arisen about their application, or simply to read more clearly or conform more closely to the style, structure and nomenclature FHFA now uses in its other regulations.

In December 2010, after FHFA had completed an initial review of the membership regulation, the Agency published an Advance Notice of Proposed Rulemaking (ANPR) in which it requested comments on a number of issues.[28] Primary among those issues was whether the existing regulation was effectively implementing the statutory "10 percent," "makes long-term home mortgage loans," and "home financing policy" eligibility requirements. The ANPR asked whether it would be appropriate to establish more objective and quantifiable standards for either of the latter two requirements and whether any or all of those requirements should be revised to explicitly apply on a continuing basis, rather than only at the time of admission to membership. The ANPR also requested comment on other issues, including whether, in light of FHFA's supervisory concerns about the acceptance of so-called "captive" insurers as members by several Banks, the Agency should amend the regulation to exclude such entities from Bank membership. FHFA received 137 comment letters in response to the ANPR, almost all of which opposed revising the membership regulation in any of the ways discussed in the notice. However, because very few of those letters provided detailed responses to the questions FHFA asked, the Agency continued to study the issues

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[28] See 75 FR 81145 (Dec. 27, 2010).

and ultimately decided to proceed with a Notice of Proposed Rulemaking (proposed rule).

C. The Proposed Rule

FHFA published a proposed rule in the *Federal Register* on September 12, 2014.[29] It proposed to make two fundamental changes to the Bank membership regulation, as well as several other substantive, but less fundamental, changes, and numerous non-substantive revisions to clarify various existing regulatory provisions.

First, the proposed rule would have revised the regulation to require that an institution hold at least one percent of its assets in home mortgage loans in order to be deemed to satisfy the statutory "makes long-term home mortgage loans" requirement and to require that each Bank member comply with that "one percent" requirement and, where applicable, with the "10 percent" requirement on an ongoing basis as a condition of remaining a member. The proposed rule would have required each Bank to determine member compliance with those ongoing requirements annually, using data from members' regulatory financial reports where possible, to calculate the relevant ratios based on a three-year rolling average. Members found to be out of compliance with either requirement would have been given one year to return to compliance. As proposed, the rule would have required a Bank to terminate the membership of any institution that remained out of compliance for two consecutive years.

Second, the proposed rule sought to address the growing use of captive insurers as vehicles through which parent companies not meeting the membership eligibility requirements of the Bank Act could circumvent those requirements and gain access to

[29] See 79 FR 54848 (Sept. 12, 2014).

low-cost Bank advances to fund their own operations and investments.[30] Several real estate investment trusts (REITs), which are not eligible for Bank membership, had established captive subsidiaries that became Bank members and then obtained advances that were disproportionately large in comparison with the investments and operations of the captives themselves, and additional REITs and other ineligible entities were seeking to do the same. This, combined with the facts that many of the parents were guaranteeing repayment of the advances made to their captive subsidiaries and providing the collateral for those advances, led FHFA to the conclusion that the real purpose of those arrangements was to provide the non-member REITs with access to Bank funding to which they were not legally entitled.

The proposed rule would have addressed this supervisory concern by defining the term "insurance company"—which is not defined in either the Bank Act or the existing regulation—to exclude captives, thereby rendering those types of entities ineligible for Bank membership. Specifically, the proposed rule would have defined "insurance company" to mean "a company whose primary business is the underwriting of insurance

[30] A captive is a special-purpose insurer formed primarily to underwrite the risks of its parent company or affiliated companies. A typical captive resembles a traditional commercial insurance company in that it is licensed under state law, sets premiums and writes policies for the risks it underwrites, collects premiums, and pays out claims. The biggest difference between a captive insurer and a commercial insurance company is that a captive does not sell insurance to the general public. In 1972, Colorado became the first state in the U.S. to enact legislation recognizing and governing captives as a class of entity distinct from commercial insurance companies. To date, over 30 states and the District of Columbia have enacted such captives-specific statutes. Primarily because captives do not sell insurance to the general public, these state statutes establish standards for the formation, licensing, operation, and supervision of captives that are generally less onerous than either the state statutory regimes that apply to commercial insurance companies or the state and federal laws under which depository institutions are chartered, operated, and supervised. See Frank Seneco, Wesley Sierk & Evan Jehle, Do-It-Yourself Insurance, Private Wealth Magazine, July/Aug. 2014, at 21-22, http://www.fa-mag.com/news/do-it-yourself-insurance-18548.html?issue=230 (last visited Dec. 8, 2015); see also National Association of Insurance Commissioners, Captive and Special Purpose Vehicle Use Subgroup of the Financial Condition Committee, Captives and Special Purpose Vehicles—An NAIC White Paper (June 6, 2013), http://www.naic.org/store/free/SPV-OP-13-ELS.pdf (last visited Dec. 8, 2015).

for nonaffiliated persons or entities." A typical captive, whose primary business is the underwriting of insurance for its parent company or for other affiliates, would not be included within the scope of the proposed definition of "insurance company." Because, as discussed above, the Bank Act and the membership regulation limit eligibility for Bank membership to institutions that qualify as an insured depository institution, a CDFI, or an insurance company, defining "insurance company" to exclude captives effectively removes such entities from among the types of institutions that may be eligible for membership.

Although the proposed rule would have made all captives ineligible for membership, it would have permitted any captive that had been admitted to membership prior to the publication date of the proposed rule to remain a member of its current Bank for five years following the effective date of the final rule. However, the rule would have capped the amount of advances that a Bank could have outstanding to such a member at 40 percent of the member's total assets and prohibited a Bank from making a new advance, or renewing an existing advance, with a maturity date beyond the five-year grace period. As proposed, the regulatory text would not have explicitly addressed the treatment of any captives that a Bank may have admitted to membership on or after the date on which the proposed rule was published. FHFA stated in the **Supplementary Information** to the proposed rule, however, that it would interpret the regulation to require the immediate termination of such captives' membership and the prompt liquidation of any outstanding advances.

The proposed rule also would have made several other substantive, but less fundamental, changes: (1) to expand the list of assets that qualify as "home mortgage

loans" to include all types of mortgage-backed securities (MBS) (as opposed to only mortgage pass-through securities) that are fully backed by qualifying whole loans; (2) to require that a Bank examine an insurance company applicant's most recent audited financial statements in determining whether it meets the "financial condition" eligibility requirement; and (3) to revise the existing regulation and add a new provision addressing how a Bank should determine the "principal place of business" (and, therefore, the appropriate Bank district for membership) for insurance companies or CDFIs. In addition to those primary revisions, FHFA also proposed to make a number of conforming changes necessary to integrate the new requirements into the regulation and to make numerous non-substantive revisions to clarify various regulatory provisions.

D. Overview of Comments on the Proposed Rule

The proposed rule initially provided for a comment period of 60 days, but, in response to numerous requests, FHFA extended the comment period to 120 days.[31] The extended comment period closed on January 12, 2015, and FHFA received over 1,300 comment letters in response to the proposed rule. Nearly 60 percent of the comment letters came from bank and thrift institutions and related trade associations; about 12 percent came from credit unions and related trade associations. The remainder of the letters were from the Banks (all of which sent more than one letter), insurance companies, CDFIs, affordable housing agencies and organizations, various types of community support organizations, home builders, REITs, public officials, and others. About two-thirds of all letters were versions of one form letter template or another.

Few of the comment letters expressed support for any aspect of the proposed rule,

[31] See 79 FR 60384 (Oct. 7, 2014).

and the vast majority expressed opposition to, or requested that FHFA withdraw, the entire rule. The most commonly expressed concerns arose from a belief that the rule, if implemented, would result in the Banks having fewer members on average and that this, in turn, would result in a reduction in their income. This, commenters contended, would compromise the Banks' ability to act as reliable sources of liquidity, inhibit their ability to carry out their housing finance and community development mission, and reduce the amount of funds available for their Affordable Housing Programs and Community Investment Cash Advance programs. However, few of the commenters expressing these views provided factual support for their opinions or attempted to quantify the effects they believed the rule would have on the Banks' operations.

FHFA reviewed every comment letter and considered all of the comments in developing the final rule. The primary comments regarding each of the substantive aspects of the proposed rule, as well as FHFA's responses to some of those comments, are discussed immediately below. Comments addressing specific rule provisions are discussed in part III of this **Supplementary Information**, which describes the final rule in detail and the ways in which it differs from the proposed rule.

1. Comments on the proposed ongoing asset ratio requirements

Over 800 of the comment letters addressed FHFA's proposal to measure compliance with the "makes long-term home mortgage loans" requirement based on a quantitative standard and to apply that quantitative requirement to members on an ongoing basis. Over 600 of the letters addressed the proposal to apply the "10 percent" requirement to members on an ongoing basis. Almost all of the commenters addressing those proposals were opposed to the proposed revisions. Approximately 66 percent of

those opposed to the ongoing quantitative “makes long-term home mortgage loans” requirement and approximately 51 percent of those opposed to the ongoing “10 percent” requirement stated that managing their balance sheets for compliance would hinder members’ business by putting them in the position of choosing between optimal balance sheet management and continued access to their Banks as a source of liquidity. About half of the commenters opposed to the proposed revisions stated that members would be harmed by losing membership in the Bank System and about half also cited concerns regarding the additional regulatory burden on members.

As further objections to the proposal, commenters also stated, among other things, that the proposal would create a significant operational burden on the Banks because the member financial information required to determine compliance with the ongoing requirements is not perfectly aligned with specific call report line items; the proposal would provide little or no benefit to the Bank System; members could never be certain that FHFA would not increase the quantitative requirements in the future; the proposed ongoing requirements would reduce membership levels at the Banks; the current regulations and collateral requirements already ensure that members maintain a nexus to the Banks’ housing finance mission; the proposed ongoing requirements have no foundation in the Bank Act or its legislative history; and the requirements do not take into account that financial services organizations are often structured such that they hold mortgages and mortgage securities in various entities within their corporate organization for a range of business reasons.

Commenters also expressed concerns specific to the proposal to make the “10 percent” requirement ongoing, including that CFIs with total assets approaching the CFI

threshold amount might forego acquiring another institution or reduce other activities that could grow their business solely because doing so would push their asset size above the CFI threshold and thus make them immediately subject to the "10 percent" requirement. In addition, some commenters expressed concern that, because the Bank Act does not exempt smaller credit unions from the "10 percent" requirement as it does for small banks and thrifts, the proposed changes would impose a disproportionately greater compliance burden on small credit unions than they would on small banks and thrifts.

Having reviewed all of the comment letters addressing the proposed ongoing asset ratio requirements, FHFA has decided not to include those revised requirements in the final rule. The Agency's research indicates that over 98 percent of current members likely would be in compliance with both proposed requirements (as applicable). This suggests that, for the time being, FHFA can address its supervisory concerns about members abandoning their commitment to housing finance by continuing to monitor the levels of residential mortgage assets held by members.

FHFA also recognizes that establishing a system to monitor members' compliance with the proposed ongoing asset ratio requirements could pose an additional incremental burden on the Banks and their members, particularly on members whose asset ratios are close to the required minimums. FHFA also carefully considered the comments received from the credit union industry, which contended that the proposed ongoing "10 percent" requirement would impose a disproportionate burden on small credit unions because they cannot qualify as CFIs. That view is consistent with the Agency's recent research, which indicates that, of the current members that would not meet an ongoing "10 percent" requirement, about 68 percent of them would be small credit unions.

Although FHFA has determined not to adopt the ongoing asset ratio requirements as part of the final rule, the Agency believes that members' ongoing commitment to housing finance is important to ensuring fidelity to the Bank Act and the purposes for which the Bank System was established and that the issue warrants continued monitoring going forward. FHFA therefore will continue to monitor this issue carefully and may revisit the issue in the future should its monitoring reveal a need for further action. Any such action would be undertaken through a separate rulemaking, with prior notice to, and an opportunity for comments from, all interested parties.

2. Comments on the proposed exclusion of captives from membership

About 400 of the comment letters addressed FHFA's proposal to exclude captives from Bank membership to some degree, with about 60 of those letters treating the issue in some depth. Almost all of the letters expressed opposition to all aspects of the captives proposal and none expressed support for the overall proposal. Almost all of the commenters' specific arguments in opposition to the captives proposal fell into two general categories: (1) that FHFA does not have the legal authority to implement the proposal; and (2) that the proposal is flawed from a policy perspective. Many commenters included arguments falling into both categories in their letters.

A few of the comment letters expressed no opposition to the proposal, but suggested some clarifying textual revisions. One commenter explicitly supported the idea of excluding REIT-controlled captives from membership, stating that, because REITs are uninsured, they pose "unnecessary risks" to the Bank system and, because REITs already benefit from tax preferences, it is questionable public policy to allow them access to the lower cost funding the Banks provide. However, that commenter was

opposed to the exclusion of captives controlled by other types of entities.

a. Comments on FHFA's legal authority to implement the captives proposal

Commenters who expressed legally based objections to the captives proposal made three types of arguments in support of those objections: (1) FHFA lacks the legal authority to define the term "insurance company" to exclude captives; (2) irrespective of its general authority, FHFA cannot legally exclude all captives from membership as proposed because the proposal lacks a factual basis, arbitrarily singles out captives, or is overly broad; and (3) in any event, FHFA lacks the legal authority to terminate or require termination of a captive member. These three general categories, including most of the specific legal arguments offered within those categories, are addressed in turn below.

The general legal argument expressed most frequently in the comment letters was that FHFA lacks the legal authority to define the term "insurance company" to exclude captives. Many commenters stated that, because "insurance company" is not defined in the statute, the term must be given what they believe to be its plain meaning—*i.e.*, that a captive must be considered to be an "insurance company" under the Bank Act, apparently because it is chartered or licensed under state insurance laws. Because a captive is considered to be an "insurance company" under the laws of the states that have captive insurance statutes, these commenters argued, FHFA has no authority to interpret the term any differently for purposes of the Bank Act, and thus cannot exclude captives from the category of "insurance company" as used in the Bank Act. In support of this argument, several commenters specifically cited the federal McCarran-Ferguson Act,[32] which reserves to the states the authority to regulate and tax the business of insurance, except in

[32] 15 U.S.C. 1011-1015.

cases where Congress has adopted a statutory provision that explicitly provides otherwise.

Numerous commenters argued that FHFA's proposal to define "insurance company" to exclude captives from membership is outside the Agency's authority because it runs contrary to Congress's clear intent regarding the meaning of the term and the scope of Bank membership. In this vein, many cited the fact that the Bank Act provides that "any" insurance company may be eligible for membership as evidence of Congress's unambiguous intent to prohibit the Bank System regulator from narrowing the scope of the term to exclude any entity chartered as any type of insurance company. Others disputed FHFA's assertion in the proposed rule that in 1932 Congress could not have contemplated that the term "insurance company" would include captives because they did not exist at that time. These commenters contended that the concept of "self-insurance" has existed for hundreds of years and that other types of self-insurance vehicles did exist in 1932, although they were not at that time referred to as "captives." Several commenters also noted that Congress has never acted to exclude captives from membership, despite the fact that an increasing number of states have adopted captive insurance statutes since the first such statutes were enacted domestically in the 1970s. Finally, many commenters cited Congress's decision to extend eligibility for Bank membership to commercial banks and credit unions in 1989 and to CDFIs in 2008 as evidence of its intent to effect "an inclusive and expansive approach" to membership and characterized FHFA's attempt to exclude captives from membership as running counter to that intent.

In addition to the broader assertions that FHFA lacks any authority to interpret the

scope of the term "insurance company" as not including captives, numerous commenters argued, more narrowly, that the Agency cannot legally implement the specific approach set forth in the proposed rule because it lacks any factual basis to justify that approach. Many of the commenters advancing such arguments mischaracterized the Agency's proposal to exclude captives as being based primarily on either safety and soundness concerns or a view that captives (or their parents) do not support housing finance. Those making such mischaracterizations asserted, and in some cases cited specific evidence, that the assumptions underlying those purported bases are erroneous. Others, who correctly characterized FHFA's primary goal as being to prevent the circumvention of the statute by ineligible entities, such as REITs, that have formed captives for the express purpose of gaining access to Bank funding to which they are not legally entitled, argued that the proposed rule provided no evidence to show a factual basis for those concerns.

Some commenters argued that, even if FHFA has a legitimate factual basis for its concerns regarding the ability of ineligible entities to obtain indirect access to Bank funding through eligible subsidiaries, the Agency's decision to focus only on the exclusion of captives in the proposed rule is arbitrary because it disregards the possibility that other types of members could be utilized for a similar purpose.

While commenters advancing the foregoing argument asserted that the proposed prohibition would be too narrow, others asserted that it would be overly broad. Commenters taking the latter view contended that, if FHFA wishes to prevent entities that are not eligible for Bank membership from using captives to access Bank funding, then it should exclude from membership only captives that are owned by ineligible entities or, even more narrowly, only captives that FHFA has determined are actually being used as a

funding conduit for an ineligible parent.

Finally, a number of commenters, while not conceding that FHFA has the authority to prevent the Banks from accepting captives as new members going forward, argued specifically that the Agency may not terminate, or require the Banks to terminate, captives that have already been approved for membership under the existing regulations. In support of this contention, several commenters noted that, while the Bank Act at one time explicitly authorized the Bank System regulator to require a Bank to terminate a member in certain circumstances, Congress removed this explicit authorization in 1999.

Another commenter who focused on FHFA's comments in the proposed rule **Supplementary Information** regarding the possibility that captive membership may pose unique safety and soundness issues asserted that those concerns could not serve as a basis for requiring the termination of captive members until the Agency had taken the steps required by section 8 of the Bank Act.[33] Specifically, the commenter asserted that section 8 of the Bank Act requires FHFA, if it believes that any of the state laws under which captives are regulated give rise to safety and soundness concerns, to undertake a study of those laws and that only after concluding that a state's laws fail to provide adequate protection to the Banks may FHFA restrict the membership of otherwise eligible members in that state.

One commenter asserted that termination of existing captive members would give rise to a "takings" claim against the United States in that it would deprive former captive members of their right to a pro rata share of the retained earnings of their former Banks and of access to Bank advances and other products and services without adequate

[33] 12 U.S.C. 1428.

compensation. The commenter argued that, therefore, such termination is prohibited under a ruling by the U.S. Court of Appeals for the D.C. Circuit that no federal agency may adopt a rule that would give rise to a "takings" claim against the United States unless it is expressly authorized it to do so by statute.[34]

b. Comments asserting that the proposal is flawed from a policy perspective

While many of the commenters did not address FHFA's legal authority to implement the proposed exclusion of captives from membership, almost all of the commenters asserted that doing so would represent a poor policy choice. The arguments made in support of commenters' policy-based objections focused primarily on issues of (1) safety and soundness, (2) mission achievement, and (3) the financial health of the Banks, their members, and the overall residential mortgage market.

Again focusing on FHFA's comments regarding the possibility that captive membership may pose unique safety and soundness issues, numerous commenters argued that captives do not pose safety and soundness risks that are materially greater than or different from those posed by other types of members. These commenters offered a number of contentions in support of this argument, including that captives are subject to regulatory regimes that are generally the same as those that apply to traditional insurers and are supervised in a similar fashion; captives have a lower rate of insolvency and default than traditional insurers because they tend to be over-capitalized and operated conservatively so as to ensure that they will be able to pay the claims of their owners; and Banks have been admitting captives as members for over 20 years and have experienced no losses on advances to captive members. Other commenters asserted that

[34] See Bell Atlantic Tel. Cos. v. FCC, 24 F.3d 1441, 1445-46 (D.C. Cir. 1994).

to the extent that captives may present unique safety and soundness concerns, those concerns can be addressed with more targeted requirements, such as requiring captive members to meet special seasoning requirements, minimum capital levels, or maximum leverage ratios. Still others contended that the Banks already have sufficient processes and procedures to manage any additional risk that captives may pose.

Many commenters urged FHFA to continue to allow captives—particularly those controlled by REIT parents—to be admitted to Bank membership, stressing that mortgage REITs' substantial commitment to the residential mortgage market in the U.S. is consistent with the mission of the Banks. Going further, many argued that, contrary to the approach taken in the proposed rule, FHFA should actually encourage membership approval for REIT-controlled captives as a means of increasing the level of private capital in the residential mortgage market. Several of these commenters asserted that the collateral requirements applying to Bank advances would tend to dissuade entities whose business practices are not consistent with the housing finance mission of the Banks from forming captives in order to gain access to Bank advances.

A number of commenters argued that FHFA offered no analysis of the financial impact the proposed exclusion of captives would have on the Banks and their members. Many commenters noted that the Bank System benefits from a diverse and robust membership and asserted that eliminating one class of existing and potential members would result in lost income for the Banks now and in the future. At least one commenter asserted that, for certain Banks, the financial impact of the proposal could be so significant as to jeopardize their independent status, thereby forcing them to consolidate with other Banks. Many commenters pointed out that any action that might reduce the

income of any Bank to any extent would necessarily reduce the amount of funds available for those Banks' Affordable Housing Programs (AHP) because the statute requires 10 percent of a Bank's earnings to be dedicated to its AHP.

In addition to the predictions of negative consequences for the Banks and their members, a number of commenters asserted that preventing mortgage REITs and similar companies from accessing Bank funding through captive subsidiaries would have negative consequences for the overall residential mortgage market. Noting that the long-term and reliable nature of Bank funding assists in reducing the likelihood that mortgage market crises will occur and in mitigating such crises when they do occur, several of these commenters argued that preventing captive parents from accessing that funding could increase instability in the residential mortgage market by reducing liquidity and curtailing the availability of long-term funding.

c. Comment letters suggesting alternative approaches

A number of commenters suggested alternative approaches to address what they perceived to be FHFA's concerns regarding captives that would be less severe than the outright exclusion of all captives from Bank membership.

Several commenters that believed FHFA's concerns to be primarily related to safety-and-soundness or mission achievement issues suggested that the Agency could address these concerns by adopting borrowing, financial condition, or mission standards to apply specifically to captives (or, in some cases, to insurance companies generally). For example, one commenter suggested that FHFA could require ongoing periodic reporting to the Bank of information that would allow it to adequately assess the financial health and investment strategies of, and other risk metrics pertaining to, both the captive

and its parent; apply a more stringent mission test to potential captive members and their parents using asset or income tests; or require that all collateral pledged by captives or their parents to secure advances be real estate related.

Commenters that more appropriately focused on FHFA's primary concern—the misuse of the captive vehicle by non-eligible entities—stated that FHFA should prevent those practices specifically, without excluding all captives from membership. For example, some suggested that the final rule allow captives with a parent or affiliate that is itself eligible for Bank membership to remain eligible. One such commenter favored the use of captives to allow parent companies that are themselves eligible for membership ("particularly . . . institutions that now have substantially higher liquidity requirements than in the past") essentially to become members of more than one Bank, which the commenter asserted "would not only help to serve the industry's liquidity needs, but would reduce the concentration risk posed by large institutions belonging to only one or two [Banks]."

Other commenters suggested that the final rule exclude from membership only captives that FHFA or the Banks have determined are owned by non-eligible entities that are using or have used those captives as conduits to receive Bank funding for their own use. Those commenters did not provide much detail as to how that would be accomplished, although one suggested that FHFA itself should review captives' applications for Bank membership in order to determine the purpose behind each application. Finally, one commenter, who asserted that FHFA "is not well informed about captives," suggested that the Agency should "increase its knowledge in this area and find ways to address issues raised in the [proposed rule] by participating in a task

force with insurance regulators and others in the captive insurance industry."

d. Results of FHFA's review of comments on the captives proposal

FHFA has reviewed all of the comments regarding its proposal to exclude captives from Bank membership and has studied especially closely the considered opinions of those commenters that addressed the issue in depth. After giving careful consideration to all of the viewpoints expressed, the Agency has decided to finalize the captives provisions essentially as proposed, albeit with some minor modifications to the transition provisions. The final provisions, the reasons FHFA has decided to adopt them, the bases for FHFA's conclusion that it possesses the authority to adopt those provisions, and the Agency's responses to the points raised in the comment letters are all discussed in detail in parts II and III of this **Supplementary Information**.

3. Comments on the other substantive proposed revisions

About 80 commenters addressed the proposal to require a Bank to obtain and review an insurance company applicant's most recent audited financial statements in determining whether it meets the "financial condition" eligibility requirement. Nearly all of the commenters opposed the inclusion of that requirement in the final rule. Most of those commenters based their objections on the assertion that the requirement would be burdensome for insurance companies—especially those that are not required by law to have their financial statements reviewed by an outside auditor. FHFA has considered these concerns, but has decided to include the requirement, as proposed, in the final rule.

The Agency recognizes that there are costs associated with obtaining audited financial statements. It also believes, however, that there are significant benefits to the Banks from being able to rely on financial statements that have been audited by a third

party, particularly when assessing an insurance company's financial condition prior to admitting it to membership, which is the only time at which this requirement will apply. Even with this additional requirement, the financial information that insurance company applicants will be required to provide to the Banks will be far less than the financial information that insured depository institution applicants must provide.

About 80 of the comment letters addressed the parts of the proposed rule that would have amended the regulations governing how an institution's principal place of business is to be determined which, in turn, dictates the Bank it may join. The proposal included one provision specific to insurance companies and CDFIs, which would have required a Bank to use objective factors to identify the geographic location from which an insurance company or CDFI conducts the predominant portion of its business operations. The proposal also would have revised the general provision, which presumes the location of an institution's "home office" to be its principal place of business, by adding a requirement that the institution actually conduct business from its home office in order to benefit from that presumption. The effect of that revision would have been to prevent a Bank from relying solely on an institution's state of domicile or incorporation as the principal place of business for Bank membership purposes.

Most of the comments focused specifically on the effect the proposed revisions would have on insurance companies.[35] Almost all of those commenters (with the exception of a few of the Banks, as discussed below) opposed the proposed revisions and stated their preference that the final rule should instead provide that an insurance company's principal place of business shall in all cases be its state of domicile (*i.e.*, the

[35] One comment letter addressed the issue specifically as it relates to CDFIs and expressed support for the approach taken in the proposed rule.

state in which it is chartered). The commenters preferred the latter approach to the standard set forth in the proposed rule because they believed that it would be simpler to apply and would ultimately impose less burden on both the Banks and state insurance regulators. In other words, under a state of domicile standard each Bank would then need to deal only with the insurance regulators and insurance laws of the states within its district, and each insurance regulator would then need to establish a working relationship only with its local Bank.[36]

Although there may be some practical benefits to using the state of domicile as a proxy for an institution's principal place of business, the core question is whether such an approach would be consistent with the requirements of the Bank Act. FHFA has previously determined that the term "principal place of business" contemplates a physical location at which a company conducts the predominant portion of its business activities, and that a "presence" that is legal only, without any actual business activity, falls short of what the Bank Act requires. While the state laws under which insurance companies and CDFIs are chartered typically require companies to provide an in-state address for service of legal notices or for other purposes, those laws do not necessarily require a company to maintain any kind of business presence in the state. It is possible, then, that an insurance company or a CDFI may not conduct *any* of its business in its state of domicile. To amend the regulation, as the commenters suggest, to provide that the principal place of business of an insurance company or CDFI is in all cases to be its state of domicile would

[36] FHFA expects each Bank to communicate regularly with the regulator for each of its insurance company members and to be thoroughly familiar with the state insurance laws that apply to each of those members. See FHFA Advisory Bulletin AB 2013-09, Collateralization of Advances and Other Credit Products to Insurance Company Members (Dec. 23, 2013). Regardless of where an insurance company may be licensed to do business or where it carries out its back office operations, it is regulated and supervised by the insurance regulator of its state of domicile under the laws of that state.

allow for the possibility that a Bank member's principal place of business could be a location at which it actually has *no* place of business. Such a result would not comport with FHFA's view of the term "principal place of business" and thus would not be consistent with the requirements of the Bank Act.

II. Treatment of Captive Insurers Under the Final Rule

FHFA has carefully considered the thoughts and opinions expressed in the comment letters and thoroughly analyzed possible alternative means of addressing its concerns about the use of captive insurers by entities not eligible for Bank membership to gain access to Bank advances. Having done so, the Agency has decided to include in the final rule, with some modifications, the provisions excluding captives from Bank membership and requiring the Banks, after a transition period, to terminate the membership of all captives that were admitted under the existing regulations. As proposed, the final rule defines "insurance company" to exclude captives, thereby making them ineligible for Bank membership.

These provisions of the final rule address FHFA's supervisory concerns about the ability of entities ineligible for Bank membership (including mortgage REITs and other entities) to circumvent the Bank Act and obtain *de facto* Bank membership through captive subsidiaries that become members and then act as conduits to low-cost Bank funding for the ineligible entity. The use of captives for this purpose under the existing regulation has grown dramatically in recent years, and has continued since the publication of the proposed rule. FHFA has well-founded concerns that this use of captive subsidiaries is open to multiple types of ineligible entities such as equity REITs, hedge funds, investment banks, and finance companies and that the practice may spread

to those and other types of ineligible entities once they become aware of the advantages of gaining *de facto* Bank membership through such arrangements. As regulator of the Bank System, FHFA is responsible for ensuring the effective implementation of the provisions and purposes of the Bank Act. That responsibility includes ensuring that only entities eligible for Bank membership obtain the benefits of membership. FHFA is fulfilling that responsibility by including in this final rule provisions intended to prevent further use of captives to circumvent the membership eligibility requirements of the Bank Act.

Like the proposed rule, the final rule also sets forth a transition provision permitting captives that became members prior to the publication date of the proposed rule to remain members for five years after the effective date of the final rule, but limiting their outstanding advances to 40 percent of their assets and, while permitting new advances below the 40 percent threshold, prohibiting new advances or renewals that mature beyond the five-year transition period. The final rule also contains an additional transition provision, not included in the proposed rule, to address the treatment of captives admitted to membership on or after the date of publication of the proposed rule. This provision permits any Bank that has admitted such captives one year following the effective date of the final rule within which to terminate the membership of those captives. The rule allows such captives until the end of that one-year period (or until the date of termination, if earlier) to repay their existing advances, but prohibits them from taking new advances or renewing existing advances that expire during that grace period.

In reaching its decision to include these provisions in the final rule, FHFA gave due consideration to the fact that the vast majority of commenters addressing the

proposed exclusion of captives from membership objected to that aspect of the proposed rule. Ultimately, however, the volume of adverse comments does not drive FHFA's policy determinations, particularly in this case, where FHFA has found significant evidence that REITs and other entities have been forming captives solely for the purpose of providing ineligible institutions access to Bank advances.

FHFA carefully considered the merits of the opinions expressed and assertions made by commenters, including from those commenters that provided verifiable information that the Agency could assess as part of the rulemaking process. The arguments taken as a whole did not persuade the Agency that the existing statute should be applied to allow admission of captives to membership. The policy reasons behind FHFA's decision to include the captives provisions in the final rule, the legal bases for including those provisions, and the Agency's responses to a number of specific comments are set forth in detail below.

A. Policy Reasons for Excluding Captives from Bank Membership

1. Until recently, only a few captives had become Bank members, and most of those had parents or other affiliated entities that were eligible to be Bank members themselves.

As mentioned above, the Bank Act provides that, in addition to insured depository institutions and CDFIs, "any . . . insurance company" shall be eligible to become a member of a Bank if it meets the applicable requirements. The Bank Act does not define "insurance company," and neither FHFA nor its predecessor agencies had previously adopted a regulatory definition of that term. Consequently, as a practical matter, any entity chartered or licensed as an "insurance company" under state law and that has met

the other applicable requirements historically has been permitted to become a Bank member. Because captive insurers are chartered or licensed as insurance companies under the laws of states that have enacted captive insurance statutes, a number of those types of entities have been permitted to become Bank members under the existing membership regulation.

Although a Bank first admitted a captive to membership over twenty years ago, until recently Banks had accepted very few captives. The first captive to be admitted became a member in 1994. In the ensuing years, up until mid-2012, no more than eleven additional captives joined the Bank System. Most of the captive members that were admitted during that time period have parent companies that either are themselves eligible to be Bank members or are holding companies that own another eligible entity.

2. Recently, there has been a dramatic increase in captive members and applicants, almost all of which are controlled by ineligible entities seeking access to Bank funding.

Over the last several years, however, new captive members and membership applications by captives have shown a significant and accelerating increase. Since mid-2012, the Banks have admitted 27 new captive members, 25 of which are owned by mortgage REITs, finance companies, and other types of entities that are not themselves eligible for membership. Twenty of those 25 have become members since the publication of the proposed rule in September of 2014. This trend has become a matter of growing concern to FHFA, as it has become increasingly clear that captives are being promoted and used as vehicles to provide access to Bank funding and to other benefits of membership for institutions that are legally ineligible for membership. The Banks that

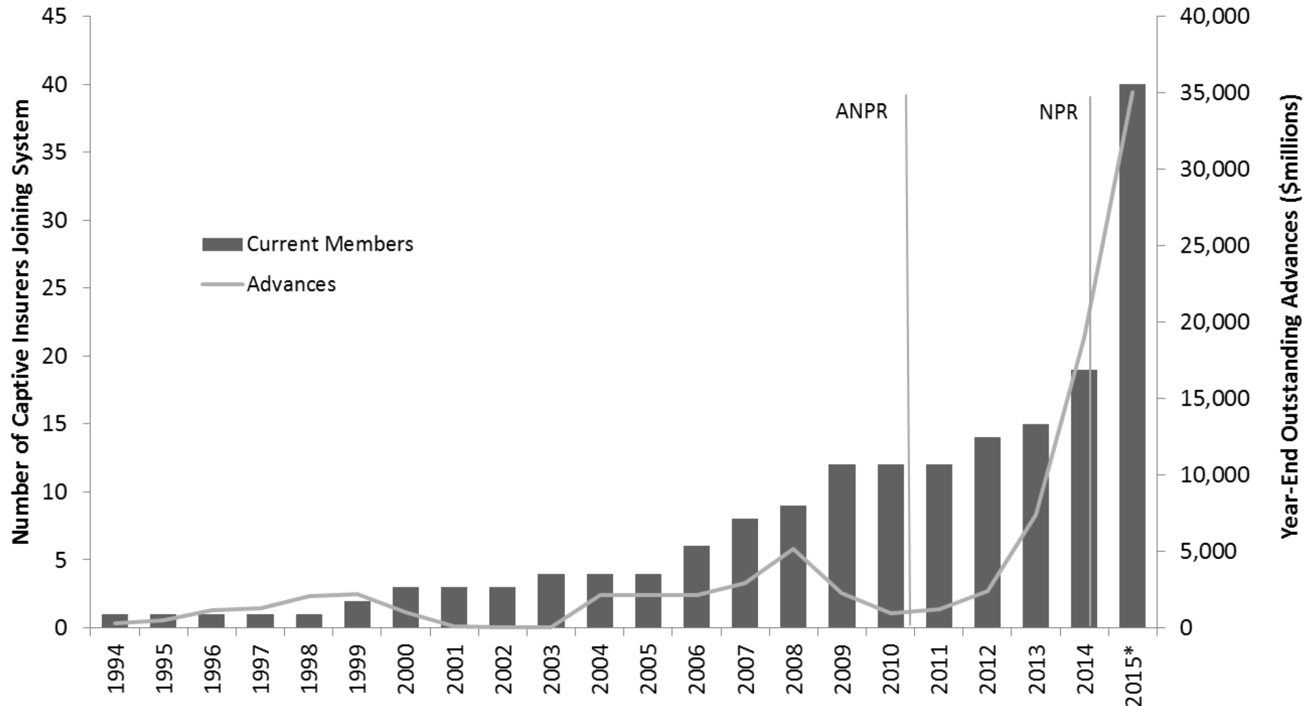
have accepted these captive members have based their approvals on the financial strength of the parent and not the captive itself and have projected a level of advances activity that is disproportionately large in relation to the captives own business operations and related investment needs. In many cases (although, to date, not all), captive members have fulfilled the projections reflected in the membership digests by maintaining disproportionately large levels of outstanding advances, almost all of which have been secured by collateral provided by the parent. As a result of these developments, FHFA sees a current need to define "insurance company" in a manner that will prevent the creation of such *de facto* membership arrangements.

The information contained in the membership application digests prepared by the Banks in connection with the admission of most of those captive subsidiaries supports a conclusion that they applied for membership—and, in fact, were established—for the primary purpose of accessing Bank funding for their parents' business needs; they did not seek membership to obtain support for their own operations or investments.[37] As an initial matter, those digests indicate that all but one of the 25 captive members owned by a REIT or similar ineligible entity were *de novo* entities at the time they applied for membership; at least 20 of the 25 had been chartered within the preceding six months and all but one of the remaining five had been chartered within the preceding 12 months. The digests also show that the dollar amounts of anticipated advances to be made to most of those captives are grossly disproportionate to the amount of insurance business

[37] The regulations require that a Bank "prepare a written digest for each applicant stating whether or not the applicant meets each of the [applicable membership eligibility requirements], the Bank's findings, and the reasons therefor." See 12 CFR 1263.2(b). Since September 2012, FHFA has had a special data request in place pursuant to which it has received from the Banks the membership digests for each new insurance company and CDFI member approved during that time period. See FHFA Special Data Request SDR 2012-02, "Membership Decision Documentation for New Insurance Company and CDFI Members" (Sept. 17, 2012).

underwritten by the captive, contemplate that the parents will provide both the collateral and a guaranty for the captives' debt, and, in some cases, acknowledge that the captives will use the advance proceeds to make loans to their parents. The Banks themselves recognized the conduit nature of these captives by basing their assessment of the financial condition of their new captive members, and the amount of advances they may obtain, on the financial resources of their parents, rather than on the captives themselves.

The chart below illustrates the recent dramatic increases in the number of captive members and in the amount of advances outstanding to captive members.



3. <u>There are currently ongoing efforts to encourage ineligible entities to use captive subsidiaries as a means of accessing low-cost Bank funding.</u>

Numerous public statements made by captive management companies and consultants, insurance regulators, and the parent companies themselves tend to confirm that almost all of the captives in the recent wave of new members and applicants were established and applied for membership for the purpose of providing their ineligible parents with access to Bank funding and other benefits of membership. For example,

Marsh & McLennan (Marsh), a firm that characterizes itself as "the world's leading captive manager," published an article in its quarterly newsletter in early 2014 stating that it had been working with REIT clients since the summer of 2013 "to create captives for the purpose of accessing funding with the Federal Home Loan Bank system" and advertising that "low-cost funding" obtained from a Bank through a captive subsidiary can allow a REIT parent to "increase leverage and improve liquidity at attractive rates."[38] After noting that captives were being formed in two particular states to permit access to the two Banks in whose respective districts those states lie, Marsh concluded by stating that its captive advisory team "is likely to begin forming captives in other domiciles to access additional branches of the [Bank System]." It is clear from that article, as well as from a contemporaneous Marsh report containing similar statements,[39] that the firm is not encouraging existing captives to become Bank members to obtain funding for their own investments and operations, but is instead encouraging REITs and possibly other ineligible entities to create new captives to use as conduits to low-cost Bank funding for their own operations.

At around the same time that Marsh published those materials, another firm, Willis Group Holdings PLC (which describes itself as "a leading global risk advisor, insurance and reinsurance broker") published a brochure on its website entitled "Joining the Federal Home Loan Bank Offers Significant Advantages for Captive Owners,

[38] See Marsh & McLennan Companies, Using Captives to Access Federal Home Loan Banking System Funding, Marsh Insights: Captives (Mar. 2014) at 5, http://usa.marsh.com/Portals/9/Documents/6454MA14-12785CAPNewsletter03-2014.pdf (last visited Dec. 8, 2015).

[39] See Marsh & McLennan Companies, The Evolution of Captives: 50 Years Later (Annual Captive Benchmarking Report) (May 2014) at 2, 5.

Including Low Interest Loans and Letters of Credits [sic]."[40] After describing how the firm had "experienced a significant increase in existing and prospective captive owners looking to join [a Bank] via a captive subsidiary" and summarizing the benefits of Bank membership, the brochure concludes by encouraging "[p]rospective members [to] contact Willis or the regional [Bank] to discuss the prospect of their captive joining the [Bank]."

Even state insurance regulators have been publicly extolling the advantages a company can enjoy by having a captive subsidiary become a Bank member. For example, a recent article that focused on the formation of so-called "831(b) captives" quoted one state's regulator as remarking that such captive entities can be "a portal for membership" in the Bank System.[41] In the same vein, several of the mortgage REITs that commented on the proposed rule revealed their intentions regarding their captive subsidiaries by advocating "access by mortgage REITs" to the Bank System, describing the proposed rule as "[d]enying access to [Bank] funding for a mortgage REIT," or making similar statements.

4. Captives are uniquely suited to act as conduits for accessing the Bank System.

Among the types of institutions that, to date, have been considered eligible for Bank membership, captive insurers are uniquely suited to act as conduit vehicles for

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[40] Willis Group Holdings, Joining the Federal Home Loan Bank Offers Significant Advantages for Captive Owners, Including Low Interest Loans and Letters of Credits, Willis Global Captive Management Alert (Apr. 2014), http://www.willis.com/documents/publications/services/captives/20140426_50294_PUBLICATION_Global_Captive_Management_Alert_FINAL.pdf (last visited Dec. 8, 2015).

[41] See Caroline McDonald, Steady As She Goes: 2014 Domicile Captive Review, Risk Management (Aug. 1, 2014), http://www.rmmagazine.com/2014/08/01/steady-as-she-goes-2014-captive-domicile-review/ (last visited Dec. 8, 2015). An "831(b) captive," sometimes referred to as a "microcaptive," is a captive that does not underwrite life insurance and that generates annual premiums of $1.2 million or less. Under section 831(b) of the Internal Revenue Code, such an entity can elect to pay federal income tax based only on its investment income instead of on its taxable income as a corporation. 26 U.S.C. 831(b). The use of 831(b) captives by individuals and businesses has drawn close scrutiny from the Internal Revenue Service in recent years.

business entities that wish to gain access to the Bank System, but that are ineligible to become members in their own right. Because captives are self-insurance mechanisms and typically do not sell insurance policies to the public at large, it is generally far easier and less expensive to charter, capitalize, and operate a captive than to establish and operate a traditional life or casualty company that sells policies to the public.[42] This was cogently explained by the captive regulator of one of the leading domestic captive domiciles in a response to a "Frequently Asked Question" (FAQ) appearing on its official website. There, the regulator noted that, while "[c]ommercial insurance companies sell insurance to the general public and are licensed in all states in which they do business," captives by contrast "directly insure only their owners," are "licensed in only one state, and operate[] under the captive insurance law of that domicile." Because of those differences, the regulator explained, "the degree of regulatory oversight required for captives is less than that which is required for commercial insurers."

Despite the fact that captives are already easier to establish and more lightly regulated than commercial insurance companies, the competition among states to attract businesses to organize captive subsidiaries in their respective borders is leading some states to amend, or modify the manner in which they apply, their captive laws to further

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[42] See Daniel Schwarcz, A Critical Take on Group Regulation of Insurers in the United States, 5 U. C. Irvine L. Rev. 537, 555 (Aug. 2015) (stating that captives have typically been viewed "as presenting limited regulatory concerns" due to their status as self-insurance mechanisms and that "[a]s a result, captives are subject to very limited regulatory restrictions: their financial statements are not publicly available, they do not have to comply with statutory accounting rules and the associated reserve requirements, and they generally are not subject to standard risk-based capital requirements"). One state insurance regulator, in reporting to the state legislature on the desirability of enacting insurance legislation specific to captives, stated that a captive "is not regulated like an admitted insurance carrier, but operates under relaxed rules governing the captive's formation, capitalization, and solvency." In noting in this **Supplementary Information** the differences between the regulation of captives and the other types of institutions that have, to date, been considered eligible for Bank membership, FHFA is not expressing any judgment as to the adequacy of captive regulation generally or in any particular state with a captive statute, for purposes of the limited businesses for which captives are organized.

reduce the regulatory burdens in relation to those imposed by other states. In a recent report prepared by a state insurance regulator that was required by statute to study the advisability of establishing a captive insurer industry in that state, that regulator recommended that the state's legislature "forgo captive legislation at this time" in part because "the industry has developed in ways that have caused considerable regulatory concern at the federal and state levels." The report explained, "To become a thriving captive domicile today, a state must be willing to relax important regulatory safeguards. Attractive new domiciles are those that have a high risk appetite, demand few hurdles to formation, have low premium taxes and fees, have minimal solvency and capital requirements, and require little in the way of reporting."[43]

The competition between states is further evidenced by a proliferation of press releases from state insurance regulators touting their selection as, or nomination for, a "U.S. captive domicile of the year" award that is bestowed annually by a major captive industry magazine. For example, one state regulator noted in a press release regarding its selection as a finalist for the 2015 award that, after having twice amended its captive laws in recent years, the state had "positioned itself to become a preferred domicile to

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[43] In addition, a 2011 New York Times article entitled "Seeking Business, States Loosen Insurance Rules," came to conclusions that were similar to those reached by the state insurance regulator quoted above. The article, which appeared on the newspaper's front page, cited numerous examples of states competing among themselves to relax their regulatory requirements in order to attract captives to their respective domiciles. It reported that one state, after observing the success of another in attracting captives, responded by amending its laws governing the tax rates captives must pay on premium revenues to make its rates lower than those of the other state; this prompted the other state to reconsider its own rates. The article also noted that the number of captives domiciled in a particular state had doubled in the preceding calendar year, after its insurance commissioner was given the power to exempt captives from various provisions of the state's captive insurer laws. The bulk of the article was devoted to investigating the growing trend of commercial insurance companies forming captives to reinsure blocks of outstanding policies in order to take advantage of the lower reserve requirements that apply to captives under the laws of some states. See Mary Williams Walsh and Louise Story, Seeking Business, States Loosen Insurance Rules, New York Times (New York ed.) (May 8, 2011) at A1, http://www.nytimes.com/2011/05/09/business/economy/09insure.html?pagewanted=all&_r=0 (last visited on Dec. 8, 2015).

companies seeking a sophisticated regulatory infrastructure." An article in the sponsoring magazine announcing the winner of the 2015 award (which, ultimately, was not the state regulator that issued the above-quoted press release) stated that its judges selected the announced winner in part because, "despite being an established jurisdiction, [the victorious domicile] continues to review its statute on an annual basis to ensure it continues delivering efficiency and value."[44]

The same characteristics that make captives far more viable than traditional insurance companies to use as vehicles for achieving *de facto* Bank membership also set them apart from insured depository institutions in that respect. Given the many obstacles to obtaining a commercial bank, savings and loan, or credit union charter,[45] as well as the comprehensive systems of prudential regulation and supervision to which those types of institutions are subject, FHFA must regard as highly improbable the prospect of an ineligible entity chartering a depository institution for the primary purpose of providing itself with *de facto* Bank membership. FHFA is unaware of a single instance of such an occurrence in the history of the Bank System. The additional layer of supervision and examination to which a company would become subject under either the Bank Holding Company Act[46] or the Savings and Loan Holding Company Act[47] if it were to acquire control of a commercial bank or savings and loan association makes those types of

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[44] See Richard Cutcher, 2015 US Captive Services Awards: Winners Announced, Captive Review (Aug. 11, 2015), http://captivereview.com/news/2015-us-captive-services-awards-winners-announced/ (last visited on Dec. 8, 2015).

[45] See, e.g., Patricia A. McCoy, Banking Law Manual: Federal Regulation of Financial Holding Companies, Banks and Thrifts § 3.02[2] (Matthew Bender, 2nd ed. 2015) (explaining that, because depository institution charters "can be (and often are) denied for a variety of reasons, including unacceptable management, poor prospects for financial success, no perceived need for the institution's services or a competitive threat to existing institutions in the same market," they serve as "powerful if erratic controls on entry into commercial banking and the thrift industry").

[46] See 12 U.S.C. 1844; see also 12 CFR part 225 (implementing regulations).

[47] See 12 U.S.C. 1467a; see also 12 CFR parts 238, 239 (implementing regulations).

institutions even more unlikely to be used as mere conduits to Bank funding. In contrast, the lack of any such requirements applying to the parent of a captive makes captives an especially attractive membership channel for REITs and other ineligible entities that are not subject to the type of inspection and regulation that applies to institutions that are eligible for Bank membership. The requirements for certification of CDFIs similarly make them unsuitable vehicles to serve as conduits for Bank funding to ineligible parents.[48]

5. FHFA has a well-founded concern that the use of captives as conduits to Bank funding will grow beyond mortgage REITs to include additional entities that have little or no connection to housing finance.

As is evidenced by the recent surge in captive applications and membership approvals, an increasing number of mortgage REITs and similar ineligible entities have decided that the amount of effort and expense associated with forming and operating a captive is low enough to make it feasible to use this method to gain access to the Bank System. In light of the example set by those that appear to have successfully circumvented the statutory membership requirements through the use of captive subsidiaries, as well as the previously described efforts by some in the captives industry to promote this practice, FHFA expects that the prevalence of this practice will continue to grow unabated if the Agency does not take action now to end it. Having seen increasing numbers of mortgage REITs use the captive vehicle to gain access to the Bank

[48] To be eligible for CDFI certification, an organization must have a primary mission of promoting community development; provide both financial and educational services; serve and maintain accountability to one or more defined target markets; maintain accountability to a defined market; and be a legal, non-governmental entity at the time of application (with the exception of Tribal governmental entities). 12 CFR 1805.201. An entity must meet quantitative mission requirements in order to obtain and maintain certification as a CDFI.

System, the Agency is concerned that other types of entities, which may have no connection to housing finance, will begin to form captives for the same purpose.

Indeed, some connected with the insurance industry have advocated the use of captives to provide access to the Bank System regardless of whether the parent company has any connection with residential mortgage lending. For example, an article re-published on the website of one state's department of insurance in 2011 reported that a "budding concept is for captive owners, nonbank companies included, to use their captive insurers as portals to cheap bank credit under a federal banking law [*i.e.*, the Bank Act] enacted decades before the first captive appeared." The article revealed that the concept is one that the state's captive regulator wants "companies like manufacturers that have nothing to do with home financing" to consider and that he is "promoting the concept with captive managers," in part as "an engine of captive growth" in his state. The same article also quoted a number of risk management consultants as stating that the use of captives as conduits to access Bank funding "could grow" and "sounds like a wonderful arbitrage opportunity," that "[r]esidential builders could benefit, as well as healthcare institutions" from the strategy, and that it would be a "prudent thing" for a captive owner to take advantage of the opportunity to access such low-cost capital even if the owner is "building cars or running hotels."[49] As noted above, Bank advances need not be collateralized with residential mortgage assets and need not be used for residential housing finance if they are of less than five years maturity.

The Agency's concerns about the prospect of wider use of the captive vehicle also arise from a number of other factors. Recently, for example, the first captive member

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[49] See Dave Lenckus, Cashing In On Captives, Risk & Insurance Newsletter (Mar. 1, 2011).

owned by an equity REIT (as opposed to a mortgage REIT) joined the Bank System and, for the first time, a captive owned by an investment bank (in this case through a number of intermediating subsidiaries) was approved for Bank membership. In addition, at least one mortgage bank recently inquired about the possibility of a Bank admitting to membership a captive subsidiary that it proposed to establish for that purpose. While the use of captive subsidiaries to access the Bank System by entities that are not involved with housing finance is nascent, recent history with traditional insurance companies and, more recently, with REITs has shown that once one portion of an industry realizes the benefits of obtaining access to Bank advances, others in that industry will follow.[50]

6. The Bank Act specifies the types of institutions that may be eligible to be Bank members, and FHFA must act to prevent the continued circumvention of those eligibility requirements by entities that are not eligible.

Abundant evidence exists of a prevalent and growing practice by entities that are themselves ineligible for Bank membership using captive subsidiaries to achieve a *de facto* membership status that effectively provides them with the same access to advances that is available to the types of institutions that are eligible to become members under the Bank Act. In light of the evidence, FHFA has concluded that it must take action to prohibit that practice in order to ensure the fulfillment of one of the key elements of the statutory scheme established by Congress—limiting Bank membership to the types of institutions specified in the Bank Act.

As discussed above, section 4(a) of the Bank Act specifically enumerates the

[50] Although insurance companies have been eligible for membership since 1932, until recently only a very few insurance companies actually have become members. While only 31 insurance companies and captives were Bank members in 1996, 304 were members at the end of 2014.

types of institutions that may be eligible for membership. By necessary implication, the statute must be read as a clear statement by Congress that entities of a type not included on that list of eligible institutions are not authorized to become members or otherwise to obtain the benefits of Bank membership, regardless of the extent to which those entities may be engaged in some part of the residential mortgage market. FHFA believes that in order to give effect to this congressional intent it must look to the substance of these transactions, and cannot ignore that the economic reality behind the growing trend of captive memberships is that the captives are being used to create a *de facto* membership for entities that are not among the types of entities that may become Bank members directly.

Many commenters asserted that Congress's failure thus far to exclude captives from membership despite their increasing prevalence in the U.S. since the 1970s must necessarily lead to the conclusion that it has no concerns about the manner in which they are currently being used. Therefore, those commenters argue, FHFA must continue to consider captives to be a type of insurance company that is eligible for Bank membership. Congress's intent concerning the meaning of the term "insurance company," as used in the Bank Act, as well as FHFA's authority to interpret that term in the current context, are discussed in detail below. However, on the specific point raised by commenters, the phenomenon of ineligible companies using captives as a conduit to obtain access the Bank System is a very recent development. FHFA does not regard the lack of congressional action on the issue of Bank membership for captive insurers to be indicative of any particular congressional intent. FHFA will not attempt to interpret the views of a current Congress that has not acted to amend a statute enacted by a prior

Congress decades earlier.

Other commenters cited Congress's decision to extend eligibility for Bank membership to commercial banks and credit unions in 1989 and to CDFIs in 2008 as evidence of its intent to effect "an inclusive and expansive approach" to membership and characterized FHFA's attempt to exclude captives from membership as running counter to that intent. To the contrary, FHFA views those actions as an indication that when Congress determines that it is appropriate to permit a particular type of institution to have access to the Bank System, it will amend the Bank Act to expressly authorize that access. For example, at the time Congress enacted the Bank Act in 1932, the primary institutional holders of non-farm residential mortgage debt were savings and loan associations,[51] which held 21.4 percent, followed by savings banks at 17.1 percent, life insurance companies at 11.1 percent, and commercial banks at 10.4 percent.[52] Despite the fact that commercial banks were significant participants in originating and investing in residential mortgage loans at that time, Congress declined to include them in the list of entities eligible for Bank membership. That remained the case until 1989, when Congress made federally insured commercial banks and credit unions eligible for membership. Moreover, although representatives of the mortgage banking industry have lobbied

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[51] These were then also referred to by various other names, such as those used in section 4(a) of the Bank Act—building and loan associations, cooperative banks, and homestead associations. See Leo Grebler, David M. Blank & Louis Winnick, Capital Formation in Residential Real Estate: Trends and Prospects 203, n.14 (1956).

[52] See Grebler, supra at 473. The percentages shown are as of December 31, 1931. In 1932, as well as for decades before and up through the early 1970s, many life insurance companies were heavily involved in the origination of home mortgage loans through extensive mortgage lending networks. See Kenneth A. Snowden, The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s 5-8 (Nat'l Bureau of Econ. Research, Working Paper No. 16244, 2010). At some points during those years, life insurance companies held more than 20 percent of all domestic non-farm residential mortgage debt. See Grebler, supra at 472-74; Snowden, supra at 5. See also Raymond J. Saulnier, Urban Mortgage Lending by Life Insurance Companies 1-9 (1950).

Congress to amend the Bank Act to allow mortgage bankers to become Bank members based on their active role in supporting residential housing finance, Congress has not done so.[53]

Similarly, Congress has not authorized REITs to become members. If Congress believed that REITs' involvement in the residential mortgage markets warranted them having access to Bank advances, it could have authorized them to become members, just as it did for certain CDFIs in 2008[54] and for certain non-federally insured credit unions in 2015,[55] when it amended the Bank Act to make those types of entities eligible for membership. The fact that it has not done so for REITs, or for other types of entities that are not enumerated in section 4(a) of the Bank Act, leads FHFA to conclude that Congress has not intended to permit those entities access to Bank funding.

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[53] For example, at a November 2013 hearing of the Senate Committee on Banking, Housing, and Urban Affairs on a bill to reform the secondary mortgage markets, the Chairman-elect of the Mortgage Bankers Association testified that "Congress should give serious consideration to expanding Federal Home Loan Bank membership eligibility to include access for non-depository mortgage lenders" and to "community lenders of a variety of business models, including independent mortgage bankers." Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market: Hearing on S. 1217 Before the S. Comm. on Banking, Housing, and Urban Affairs, 113th Cong. 65-66 (Nov. 5, 2013) (statement of Bill Cosgrove, Chief Executive Officer, Union Home Mortgage Corp., and Chairman-Elect, Mortgage Bankers Association). Earlier, the Housing and Community Development Act of 1992 required that the Finance Board and the Department of Housing and Urban Development, among other agencies, each study a multitude of issues related to the Bank System, including possible measures to increase membership in the System, and report to Congress on their recommendations with respect to those issues. See Pub. L. No. 102-550, § 1393, 106 Stat. 3672, 4009-11 (1992). For reasons relating to mission, safety and soundness, and competitive balance, the reports produced by both agencies recommended against expanding the list of institutions that may be eligible for Bank membership to include mortgage banks. See Federal Housing Finance Board, Report on the Structure and Role of the Federal Home Loan Bank System 119 (Apr. 1993); U.S. Department of Housing and Urban Development, Office of Policy Development and Research, Report to Congress on the Federal Home Loan Bank System, Vol. II 6-12 (Apr. 1994). In addition, at a 1994 hearing, Under Secretary of the Treasury for Domestic Finance Frank N. Newman testified that, as recommended in the reports, the Treasury Department did not believe that membership eligibility should be expanded beyond then-currently eligible group of depository institutions and insurance companies. See The Future of the Federal Home Loan Bank System: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs on the Need for a Comprehensive Legislative Package to Update and to Strengthen the Federal Home Loan Bank System's Mission, Structure, Capital Requirements, and Regulatory Oversight, 103rd Cong., 4, 25 (June 15, 1994).

[54] See Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1206, 122 Stat. 2654, 2787 (2008).

[55] See Fixing America's Surface Transportation Act, Pub. L. No. 114-94, § 82001 (2015).

Whether entities that are currently ineligible for membership should be permitted to have access to Bank advances is the type of public policy issue that is for Congress to address. By precluding ineligible institutions from gaining *de facto* membership through captive insurers, the final rule has the effect of preserving the decision of whether to allow REITs access to the Bank System for Congress to address, should it choose to do so. The transition periods, both the five-year transition for pre-NPR captives and the one-year transition for the post-NPR captives, will provide Congress sufficient time to consider whether Bank membership should be extended to additional categories of members before the Banks are required to begin terminating the membership of existing captive members. If Congress determines that permitting REITs, or any other entities that are not currently eligible, to have such access is the appropriate policy, then it will amend the Bank Act to make them explicitly eligible for membership as it has done in the past for commercial banks, credit unions, and CDFIs. If it decides to do so, it may also wish to consider whether special statutory provisions should be enacted with respect to REITs or other entities not subject to inspection and regulation to address their unregulated status, which would set them apart from other types of entities that are currently eligible, and whether and how to except them from the current statutory requirement that members be "subject to inspection and regulation."[56]

B. Legal Authority of FHFA to Exclude Captives from Membership and to Require the Banks to Terminate the Membership of Captives Previously Admitted

[56] For example, when Congress added CDFIs to the list of eligible member types, Congress exempted them from the requirement that they be subject to inspection and regulation (because they are not) and instead provided that they must be certified as CDFIs by the Treasury Department. See 12 U.S.C. 1424(a)(1)(B).

FHFA possesses ample legal authority to adopt a regulation defining the term "insurance company" to exclude captives, thereby rendering them ineligible for membership, and to require the Banks to terminate the membership of all captives that they had admitted to membership before FHFA adopted this final rule making captives ineligible.

1. Congress granted FHFA broad regulatory authority to ensure that the purposes of the Bank Act are carried out.

Congress has given FHFA, through its Director, broad authority to administer the Bank Act. Specifically, Congress granted the Director of FHFA general regulatory authority over the Banks and specified that he is to exercise that authority to ensure that the purposes of the Bank Act and the Safety and Soundness Act (under which the Agency is established) are carried out.[57] Congress also enumerated a number of principal duties for the Director of FHFA, which include the duty to ensure that each Bank complies with the regulations issued under the Bank Act and Safety and Soundness Act, and granted the Director the authority to exercise such incidental powers as he deems necessary to fulfill his duties and responsibilities in the supervision and regulation of the Banks.[58] Congress also provided the Director of FHFA with specific authority to issue any regulations and take other regulatory actions that he deems necessary not only to implement and enforce the specific requirements of the Bank Act, but also to ensure that the Banks operate in a safe and sound manner and that the purposes of the statutes are accomplished.[59] Thus, FHFA has the authority to adopt regulations that the Director deems necessary to

[57] 12 U.S.C. 4511.
[58] 12 U.S.C. 4513(a)(1), (2).
[59] 12 U.S.C. 4526(a).

implement the specific membership provisions of the Bank Act, as well as those that the Director deems necessary to ensure that the purposes behind the statutory membership provisions are accomplished. By necessary implication, the grant of authority to ensure that the provisions and purposes of the Bank Act are carried out includes with it the authority to adopt regulations necessary to ensure that neither the Banks, their members, nor any other parties take any actions to circumvent, frustrate, or subvert the provisions or purposes of the Bank Act.

2. Congress clearly delineated the types of institutions that may be eligible for Bank membership.

It is clear from the language of section 4(a)(1) of the Bank Act that Congress intended to permit only the types of institutions listed in that section to become Bank members and that it did not intend to permit any institutions not listed therein to become members. It also is reasonable to infer from the statutory language that Congress intended that entities not explicitly deemed eligible for membership should not be able to obtain indirectly any of the principal benefits of Bank membership—including the access to low-cost advances that the Banks are able to provide because of their statutory market advantages—that they are not permitted to obtain directly.[60] Although Congress did include insurance companies among the types of institutions that may be eligible to become members, it manifestly did not include REITs, hedge funds, investment banks, finance companies, or other types of general business entities.[61]

3. Captives are being used to circumvent the membership eligibility provisions

[60] To enable the Banks to better fulfill their public policy mission, Congress vested in them market advantages that some might view as depriving government treasuries of revenue and exposing taxpayers to risk. This supports the conclusion that Congress intended to strictly limit access to the Bank System.
[61] See 12 U.S.C. 1424(a)(1).

of the Bank Act and are uniquely suited to be used for that purpose.

As described in detail above, FHFA has determined that ineligible entities have been circumventing the statutory provisions limiting the types of entities that may become Bank members by using captive subsidiaries as vehicles to access the benefits of membership to which they are not legally entitled. As also detailed above, captives as a class are uniquely suited to being used for that purpose due to the limited scope of their business activities, which makes them easier and less expensive to establish and operate, and because they are more lightly regulated than commercial insurance companies or insured depository institutions. There is also a relative absence of restrictions on the activities and investments of a captive's parent, as compared to those that apply to an entity that establishes a federally insured bank or savings association subsidiary. These unique characteristics, as among the types of institutions that are permitted to become Bank members under the existing membership regulation, have led captive promoters, insurance regulators, and others with vested interests in expanding the ubiquity of captives to promote them as vehicles through which REITs and other ineligible entities—including those having no connection to housing finance—may obtain access to low-cost Bank advances. This, along with the examples set by those whose attempts to use captives to obtain access to the Bank System have so far met with apparent success, makes it likely that the practice of using of captives for that purpose will continue to grow in the absence of any action by FHFA to halt the practice.

4. FHFA has the authority to take action to prevent the circumvention of the provisions and purposes of the Bank Act.

The authorities conferred upon FHFA by the Bank Act and the Safety and

Soundness Act, described above, empower the Agency to adopt a regulation to prevent this circumvention of the provisions and purposes of the Bank Act. Given that the vast majority of captive members are being used by ineligible entities to circumvent the statutory membership eligibility requirements and, aside from this illegitimate use, have little or no reason to be Bank members, FHFA is not required to treat those types of captives as "insurance companies" for membership purposes simply because they are chartered or licensed under state insurance statutes. The Agency has sufficient legal authority, through its mandate to ensure that the purposes of the statute are carried out, to consider the economic realities of these arrangements—*i.e.*, that the parent companies are the true parties in interest, while the captives act merely as conduits—and to take appropriate regulatory action.

FHFA has determined that the most effective and appropriate way to prevent the use of captives as vehicles to provide *de facto* membership for ineligible entities is to adopt a regulation defining the heretofore undefined term "insurance company" to exclude from membership all captives that may feasibly be used for that purpose. As discussed in part III of this **Supplementary Information**, FHFA has taken special care to define "insurance company" so that captives having the characteristics that give rise to the Agency's concerns will be excluded, while those institutions that do not engender such concerns and that would be regarded as carrying out the business of insurance as traditionally understood (even if they are denominated as "captives" under their states' insurance laws) will continue to be considered as insurance companies for purposes of determining eligibility for Bank membership.

5. Viewed in the context of today's marketplace, in contrast to that of 1932, the

meaning of "insurance company" is ambiguous and, therefore, FHFA may adopt a reasonable interpretation of that term to effect the purposes of the Bank Act.

An administrative agency has authority to interpret and define the terms of the statutes that it administers, especially terms that are undefined.[62] Among the specific types of entities that are eligible for Bank membership, Congress has defined only "insured depository institution."[63] Congress did not define the term "insurance company" or provide any other guidance about its meaning. This leaves the term open to FHFA to define, provided that the definition is reasonable given the provisions and purposes of the Bank Act.

Many commenters expressed the opinion that defining "insurance company" to exclude captives would be in contradiction to the unambiguously expressed intent of Congress as embodied in the plain language of the Bank Act, which provides that "any . . . insurance company" may be eligible for membership. By basing their assertions as to the plain meaning of section 4(a)(1) on the fact that the term "insurance company" is preceded by the word "any" in that paragraph (as are all the other terms used to describe the types of institutions that may be eligible for membership), many commenters begged the essential question of what constitutes an "insurance company" for purposes of the Bank Act in the first place. A few commenters asserted or implied that the statutory

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[62] See Astrue v. Capato, 132 S.Ct. 2021, 2026 (2012); Chevron U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843-44 (1984); Securities Industry Association v. Clarke, 885 F.2d 1034 (2d Cir. 1989), cert. denied, 493 U.S. 1070 (1990).

[63] See 12 U.S.C. 1422(9) (defining "insured depository institution" to include banks and savings associations the deposits of which are insured by the FDIC and credit unions the share accounts of which are insured by the NCUA). In addition, although Congress did not define the term "community development financial institution," it did provide that only those CDFIs that have been certified by the Treasury Department are eligible for membership. See 12 U.S.C. 1424(a)(1)(B).

membership provisions must be read as including captives because captives are "organized, licensed and regulated" under state insurance statutes or "meet[] the definition of an insurance company under state law."[64] FHFA does not believe that such a reading is required, particularly where, as here, it would result in an interpretation that allows circumvention of specific provisions of the Bank Act and subverts the scheme of the statute as a whole. In other contexts, the Supreme Court has held that a federal regulator may reasonably define an activity or a transaction as not insurance under federal law even if state law would treat it as such.[65]

Sometimes a statutory term that appears on its face to have a commonly understood meaning may be shown to be ambiguous when it is considered in light of the statute's overall structure, purpose, and history.[66] Construing the term "insurance company" to include any type of entity organized under a state's insurance statutes would allow companies that are not eligible for Bank membership to continue to use captives—or any entities having similar characteristics that might be developed under a different

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[64] In support of this argument, several commenters specifically cited the federal McCarran-Ferguson Act, which provides, in pertinent part, that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance." See 15 U.S.C. 1012(b). However, nothing in this final rule relates in any way to the regulation of the business of insurance or to the taxation or imposition of fees on any captive or commercial insurance company.

[65] In Nationsbank v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995) ("VALIC"), the U.S. Supreme Court declined to apply a state law-based definition of "insurance" to a federal banking statute. There, the Court upheld the Comptroller of the Currency's classification of annuities as investments, rather than as insurance, under the National Bank Act (NBA), despite respondent's assertions that Congress intended to define "insurance" under the NBA by reference to state law, under which annuities are typically regulated as insurance. In upholding the Comptroller's classification, the Court stated, among other things, "the federal banking law does not plainly require automatic reference to state law here. The Comptroller has concluded that the federal regime is best served by classifying annuities according to their functional characteristics. Congress has not ruled out that course. . .; courts, therefore, have no cause to dictate to the Comptroller the state-law constraint VALIC espouses." 513 U.S. at 261-262. See also Helvering v. LeGierse, 312 U.S. 531 (1941) (holding that a transaction was not an insurance transaction for federal tax purposes despite its comprising a set of insurance policies under state law).

[66] See King v. Burwell, 135 S. Ct. 2480 (2015); FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 132-133 (2000).

moniker—as a means of providing them with *de facto* membership. In this case, an ambiguity arises because an unconstrained reading of "insurance company" would result in a situation that is contrary to Congress's clear intent to limit the benefits of Bank membership to the several types of institutions listed in section 4(a)(1) of the Bank Act. In contrast, a reading of the term that encompasses insurance companies as they were understood when the Bank Act was enacted, not including captives, would be fully consistent with that provision and with the statutory scheme as a whole.

The ambiguity also arises because it is highly unlikely that Congress considered in 1932 whether captives, which did not then exist, or any class of entity having similar characteristics that would allow the entities to be readily used to circumvent the statutory requirements, should be deemed to be included within the term "insurance company." It is most likely that the term "insurance company" would have been understood by Congress and others in 1932 to refer to a company that was in the business of insurance as it was then understood—that is, the shifting of risk by the insured to a larger class of policyholders through the intermediation of the insurance company—and not to a mechanism for the administration of self-insurance.[67] The current phenomenon of captives as a legal vehicle for managing the parent company's self-insurance did not exist in 1932 and cannot have been within the contemplation of Congress. Captives in the modern sense began to appear only in the late 1950s and early 1960s. Even for many

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[67] See Helvering v. LeGierse, 312 U.S. 531, 539-40 (1941) (stating that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing" and finding that the transaction at issue did not involve those features and therefore was not insurance under the federal income tax laws); Spring Canyon Coal Co. v. Commissioner of Internal Revenue, 43 F.2d 78, 80 (10th Cir. 1930) (holding that a company's contribution to a self-insurance reserve was not deductible as an insurance premium under the federal income tax laws because there was no shifting of risk). In 1932, life insurance companies originated and invested in large numbers of residential mortgage loans; these longer-term assets were well matched in duration to their life insurance liabilities. Captives do not share that business model.

years after U.S. companies first began to form captive subsidiaries, those captives had to be domiciled off-shore, because the state insurance laws that existed at the time made it prohibitively expensive to form and operate a captive in the United States.[68] Colorado became the first U.S. jurisdiction to adopt legislation authorizing the chartering and licensing of captives in 1972,[69] and the captive trend did not begin to gain any real momentum until the mid-1980s.

Although some commenters asserted that early forms of captives existed in 1932 and that Congress must therefore have intended to include them as eligible for membership, those commenters did not identify any example of a captive as it is defined in FHFA's final regulation,[70] nor did they cite anything in the legislative history of the Bank Act that addresses self-insurance by any name. There is scant mention of insurance companies in the legislative history of the Bank Act, although it is logical to infer that Congress specifically included insurance companies among the types of institutions eligible for membership because life insurance companies were actively involved in originating and investing in residential mortgage loans at that time. Life insurance companies, among other classes of insurance companies, would have fit within the

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[68] See Shanique Hall, Recent Developments in the Captive Insurance Industry, NAIC Center for Insurance Policy and Research Newsletter (Jan. 2012), http://www.naic.org/cipr_newsletter_archive/vol2_captive.htm (last visited Dec. 8, 2015).

[69] Maureen A. Sanders, Risk Retention Groups: Who's Sorry Now?, 17 S. Ill. U. L. J. 531, 542, n. 76 (1993).

[70] Some commenters referred to the Church Properties Fire Insurance Corporation, which was formed by lay leaders of the Episcopal Church in 1929 in order to "reduce costs by selling direct to churches and their affiliated organizations." See Episcopalians Form Fire Insurance Concern To Reduce the Cost of Policies on Churches, New York Times (May 23, 1929) at 1. To the extent that this entity could be characterized as an equivalent of a modern captive, it appears to have been most similar to either an association captive or a group captive, most of which would likely qualify as an "insurance company" under the final rule definition. Although the terms used vary from state to state, an "association captive" is generally understood to be a captive that it is sponsored or owned by a group of entities within a particular trade, industry, or service organization and that insures only the risks of its owners or their affiliates. See Hall, supra.

traditional view of an insurance company as being an institution that underwrites insurance for entities that are not its affiliates.

Because the types of captives that are now, and recently have been, seeking Bank membership did not come into existence until well after Congress enacted the Bank Act, FHFA does not believe that it is possible to conclude, as some commenters have asserted, that Congress would have intended to include such entities among those eligible for Bank membership. Reasonably assuming that Congress viewed the term "insurance company" in its traditional sense, it would not have had any reason to consider the possibility that another type of business entity could have organized an insurance company and then used it as a vehicle for obtaining advances from a Bank to fund its own investments or business operations.

Thus, changing factual circumstances have generated an ambiguity in the term "insurance company." The definition of that term contained in the final rule is consistent with its historical use in the statute and with the purposes of the statute, but necessarily results in a definition that would exclude some modern entities licensed or chartered under a state's insurance statutes. Because Congress has not defined the term and because it is ambiguous for the reasons discussed, FHFA has the legal authority to define "insurance company" in a manner that is reasonable in light of the provisions and purposes of the Bank Act.

6. It is reasonable to define "insurance company" to exclude captives.

Defining "insurance company" to exclude captives is reasonable for three fundamental reasons, all of which have been thoroughly addressed above. First, doing so is consistent with section 4(a)(1) of the Bank Act, which is reflective of a congressionally

created statutory scheme to limit the benefits of Bank membership to the types of institutions specifically listed therein. Second, captives are uniquely suited to serve as vehicles for the circumvention of that statutory provision and its underlying purposes and are being actively promoted for that use, and there is no countervailing public policy reason for them to be Bank members on the basis of their own functions, separate from their parents'. Third, defining "insurance company" in this manner is consistent with the likely intent of Congress, which would have viewed an insurance company as being a company in the business of "risk-shifting and risk-distributing," as the Supreme Court described insurance less than a decade after the enactment of the Bank Act.[71] In addition, it is highly unlikely that Congress contemplated the existence of any class of eligible financial institution having the characteristics of modern captives (which, as discussed, did not then exist) that make captives feasible to use as funding conduits for entities Congress did not deem eligible for Bank membership, and even less likely that Congress would have approved of such use, which effectively circumvents the very membership restrictions it imposed.

Several commenters asserted that the Agency's proposal to address that concern by focusing only on captives was "arbitrary" (and therefore not within the Agency's authority to adopt) because it disregarded the possibility that other types of members had passed advance proceeds on to non-members through intercompany transfers and could continue to do so in the future. The majority of members that are not captives are owned by holding companies that are not themselves eligible for membership and there is little question that advance proceeds may flow through to the parent companies in many cases.

[71] Helvering v. LeGierse, 312 U.S. at 539.

Given the fungibility of money and the typically complex structures of modern financial institutions, it would be extremely difficult for FHFA, or any agency, to develop a workable means of preventing all such transfers. However, even assuming that a small number of non-captive members could be acting effectively as conduits for their parent companies, no evidence suggests that any type of member institution other than captives is, as a class, being used to any material degree for such purposes. In contrast, there is abundant evidence, detailed above, that almost all members that are captives as defined in the final rule were established and sought to become Bank members for the primary purpose of acting as conduits for their ineligible parents. Given this, as well as their unique suitability for such purposes and the general absence of any other compelling rationale for them to be members, FHFA's exclusion of captives in this final rule is reasonable.

7. FHFA has the authority to require the termination of captives that were previously admitted to Bank membership.

Section 6(d)(2)(A) of the Bank Act provides that the board of directors of a Bank "may terminate" the membership of any member institution if, "subject to the regulations of the Director" of FHFA, it determines that any of the statutory grounds for termination exist. Those grounds include a failure to comply with any provision of the Bank Act or FHFA regulations.[72] A number of commenters asserted that this provision vests discretionary termination authority in each Bank and that, consequently, FHFA does not have the authority to require a Bank to terminate the membership of captives that were admitted under the regulations in force at the time of admission. In support of that

[72] 12 U.S.C. 1426(d)(2)(A).

assertion, several of those commenters also noted that the Bank Act had previously contained a provision explicitly authorizing the Bank System regulator to remove a member for cause (including failure to comply with statutory or regulatory provision) after a hearing, but that Congress removed that explicit authorization in 1999 when it adopted the current termination provision.[73]

Although the 1999 amendments did transfer the mechanism of termination from the Bank System regulator to the Banks themselves, it is not plausible to suggest, as do the commenters, that Congress thereby stripped the regulator of its authority to require the removal of a member when doing so is necessary to halt a violation of the statute or regulations. The use of the words "may terminate" indicates that Congress intended to permit a Bank's board of directors some degree of discretion in deciding whether and when to terminate an institution's membership, but that discretion is limited by the statutory language subjecting the exercise of that termination authority to the regulations of the Director.[74] In this case, the Director has adopted regulatory amendments implementing a provision of the Bank Act in a way that makes captives—including those that were previously admitted—ineligible for membership. When effective, the amended regulation will be binding on the Banks, which will be obliged to comply with its provisions to the same extent that they are obliged to comply with any other statutory or regulatory requirement.

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[73] See Financial Services Modernization Act of 1999, Pub. L. No. 106-102, § 608, 113 Stat. 1338, 1461 (1999).

[74] In addition, as the Court of Appeals for the D.C. Circuit has explained, "'May' ordinarily connotes discretion, but neither in lay nor legal understanding is the result inexorable. Rather, the conclusion to be reached 'depends on the context of the statute, and on whether it is fairly to be presumed that it was the intention of the legislature to confer a discretionary power or to impose an imperative duty.'" Thompson v. Clifford, 408 F.2d 154, 158 (D.C. Cir. 1968) (citations omitted); see also Halverson v. Slater, 129 F.3d 180, 188-189 (D.C. Cir. 1997).

Section 6(d)(2)(A) may permit a Bank to exercise its discretion, for example, in deciding whether and when to terminate the membership of an institution that has committed a statutory or regulatory violation for which no particular sanction is specified. The express caveat in section 6(d)(2)(A) making a Bank's termination authority subject to FHFA regulations, as well as FHFA's broad powers as supervisor and regulator of the Banks and its statutory duty to administer the Bank Act in a manner that promotes the Act's purposes and protects the public interest, provide the Agency with sufficient authority to adopt a regulation that, as the final rule does, specifies the circumstances in which a violation of the law requires a Bank to exercise its termination authority. The exercise of this regulatory authority is appropriate where, as here, the violation is not one of technical noncompliance with a minor requirement, but of the fundamental principles defining eligibility for membership and access to the Bank System, the purposes of which would be undermined if membership were allowed to continue. For these reasons, when a member is in violation of a lawfully adopted regulation for which the required sanction is termination of membership, a Bank does not have the discretion to refuse to terminate the member when and as required by the regulation.

Apart from questioning FHFA's power to regulate the Banks' termination authority under section 6(d)(2)(A), a few commenters offered other reasons that they believed the Agency cannot require a Bank to terminate the membership of its existing captive members. One asserted that requiring the termination of existing captive members would give rise to a "takings" claim against the United States in that it would deprive former captive members of their right to a pro rata share of the retained earnings

of their former Banks and of access to Bank advances and other products and services, without adequate compensation. Citing a ruling by the U.S. Court of Appeals for the D.C. Circuit that no federal agency may adopt a regulation that would give rise to a "takings" claim unless it is expressly authorized it to do so by statute,[75] the commenter further argued that FHFA may not adopt a regulation requiring termination because such an express statutory authorization does not exist.

Bank members—even those that are in compliance with all statutory and regulatory eligibility requirements—have no constitutionally protected property interest in continuing Bank membership. Although the Bank Act specifies that the holders of a Bank's the Class B stock "shall own the retained earnings, surplus, undivided profits, and equity reserves, if any, of the [Bank]," it also makes clear that, "[e]xcept as specifically provided in [section 6 of the Bank Act] or through the declaration of a dividend or a capital distribution by a [Bank], or in the event of liquidation of the [Bank], a member shall have no right to withdraw or otherwise receive distribution of any portion of the retained earnings of the [Bank]."[76] But even if members did have a constitutionally protected property interest in Bank membership, FHFA's regulation effects neither a *per se* taking nor a regulatory taking as courts have developed those concepts.

A *per se* taking occurs when the government physically appropriates real or personal property for its own use without just compensation.[77] A captive terminated as required under the final rule will be fully compensated when the Bank redeems its Bank

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[75] See Bell Atlantic Tel. Cos. v. FCC, 24 F.3d 1441, 1445-46 (D.C. Cir 1994).
[76] 12 U.S.C. 1426(h). See also Fahey v. O'Melveny & Myers, 200 F.2d 420, 467 (9th Cir. 1952) (holding that the "purchase of [Bank] stock is a condition of [Bank] membership and does not confer proprietary interest or a property right of any kind in any [Bank] itself").
[77] See Horne v. Dep't of Agriculture, 135 S. Ct. 2419, 2426-27 (2015).

stock for par value (the same amount paid by the captive when it acquired the stock) in the manner provided under the Bank's capital plan. Regardless of compensation, the captive's Bank stock will not have been physically appropriated by the government for its own use. Thus, there will have been no *per se* taking.

Neither will there be a regulatory taking, which occurs when the government imposes a restriction on the use of property that results a severe and unwarranted diminution in the property's value.[78] The terminated member will not only receive the par value of its Bank stock when the stock is redeemed, but will also continue to receive any dividends declared up to the time its stock is redeemed. Thus, there can be no claim that the economic value of the stock will have been destroyed. In addition, because the Banks have independent power to terminate membership, members have a reasonable expectation that their membership may be terminated at some point. Because dividend payments are at all times subject to the approval of the Bank's board of directors, there is no reasonable investment expectation that dividends will continue to be paid. Finally, because the captives became Bank members with full knowledge that all Bank activities are heavily regulated, they cannot claim to have had a reasonable investment-backed expectation that the regulatory regime would remain forever static. This is especially true in the case of entities that became members for the purpose of circumventing the statutory membership requirements.

Another commenter, who focused on FHFA's comments in the proposed rule **Supplementary Information** regarding the possibility that captive membership may pose unique safety and soundness issues, asserted that those concerns could not serve as a

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[78] See Horne, 135 S. Ct. at 2427.

basis for requiring the termination of captive members until the Agency had taken the steps required by section 8 of the Bank Act. Section 8 requires that FHFA keep abreast of the state laws under which Bank members are chartered and regulated, and states that if FHFA concludes that the laws of any state provide inadequate protection to a Bank in making or collecting advances, the Agency may "withhold or limit the operation" of any Bank in that state until satisfactory conditions are established.[79] The commenter asserted that this statutory provision prohibits FHFA from taking any action with respect to captive members until it has first undertaken a study of all of the state laws under which they operate, and only after concluding that a particular state's laws fail to provide adequate protection to a Bank.

FHFA rejects the assertion that section 8 may be read to limit in any way the steps the Agency may take in fulfilling its statutory duty to ensure the safe and sound operation of the Banks. Even if section 8 could be so construed, it would not limit the Agency's ability to require the termination of captive members. Although the proposed rule discussed some safety and soundness concerns to which captive membership gives rise, the Agency's proposal and its ultimate decision to exclude captives from Bank membership and to require the termination of existing captives stems from its conclusion that they are being used to circumvent the statutory requirements governing the types of institutions that may become Bank members, and not primarily from safety and soundness concerns regarding captive insurers.[80] FHFA re-emphasizes that point in this

[79] See 12 U.S.C. 1428.
[80] After describing the proposed captives provisions in the **Supplementary Information** to the proposed rule, FHFA stated that it was proposing to take those actions "to address supervisory concerns about certain institutions that are ineligible for Bank membership, but that are using captives as vehicles through which

final rule.

C. Discussion of Other Arguments Raised by Commenters

Most of the arguments made by commenters in opposition to the proposed captives provisions have been addressed in the discussion above regarding the legal and policy bases for FHFA's adoption of the final captives provisions. However, some commenters made other arguments that are not addressed above and that warrant discussion.

Many commenters stressed that mortgage REITs' substantial commitment to the residential mortgage market in the U.S. is consistent with the mission of the Banks, and argued that allowing them to access the low-cost funding that the Banks are able to provide will increase the level of private capital in the residential mortgage market, benefiting existing and potential homeowners and the public. Others similarly argued that preventing REITs from accessing Bank funding through their captive subsidiaries could increase instability in the residential mortgage market by reducing liquidity and curtailing the availability of long-term funding. FHFA acknowledges that mortgage REITs play a large role in the residential mortgage market and does not question the legitimacy of their activities. However, while FHFA has the duty to ensure that the operations and activities of the Banks "foster liquid, efficient, competitive, and resilient national housing finance markets," it also has a duty to ensure that the Banks carry out that mission "only through activities that are authorized under and consistent with" the Bank Act and the Safety and Soundness Act.[81] Having concluded that the channeling of

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they can obtain Bank advances to fund their business operations." See 79 FR 54848, 54853 (Sept. 12, 2014).

[81] 12 U.S.C. 4513(a)(1)(B).

low-cost Bank funding to REITs and other ineligible entities through captive members is not authorized by or consistent with the Bank Act, the Agency is compelled to take action to put an end to that practice until such time, and on such terms, as Congress authorizes that access. Similarly, it is not appropriate for FHFA to expand Bank membership beyond the framework established by Congress in order to provide greater macroeconomic stability in times of financial stress, as urged by some commenters.

A number of other commenters argued that FHFA offered no analysis of the financial impact the proposed exclusion of captives would have on the Banks and their members, and asserted that excluding captives from membership would result in reduced income for the Banks in the short run and lost opportunities for income growth in the future. Any projection the Agency might attempt to make regarding the exclusion of captives would be speculative. Despite the fact that the number of captive members has increased dramatically since 2012, they still constitute a very small percentage of the Banks' membership base, and the number that would have been approved for membership in future years cannot be estimated. Similarly, while the amount of advances currently outstanding to captives is known, it is not possible to project what future levels would have been because of the difficulty of estimating not only the number of potential captive members forgone, but also what their level of demand for advances would have been.

Regardless of the financial impact, which is unknown, FHFA cannot allow the Banks to continue to engage in activities that it has concluded are not authorized under the law. Congress mandated the establishment of the Banks in order to advance public policy goals and, in order to ensure that they could fulfill those goals, provided them with

initial funding from the Treasury Department and granted them tax and other advantages not generally enjoyed by ordinary for-profit corporations. Accordingly, unlike ordinary corporations, the Banks are not free to undertake any and all activities that they judge to be profitable from a business perspective without regard to the limitations imposed by their authorizing statute. Against the uncertain financial impact on the Banks of this regulation must be counterbalanced the equally uncertain financial effects of expanded government exposure and possible economic distortions from supporting expanded categories of businesses.

Many commenters pointed out that any action that might reduce the income of any Bank to any extent would necessarily reduce the amount of funds available for those Banks' Affordable Housing Programs (AHP), because the statute requires 10 percent of a Bank's earnings to be dedicated to its AHP. But increasing AHP contributions is not a legitimate reason to enhance Banks' earnings by allowing access to Bank advances by ineligible entities. In any event, expanding Banks' income through the admission of members who should be regarded as ineligible under the Bank Act is a very low-leverage way of increasing the availability of AHP funds, because the statute requires only 10 percent of Bank earnings to be dedicated to the AHP.

Finally, some commenters questioned why FHFA cannot address its concerns regarding the use of captives as funding conduits by adopting more narrowly tailored restrictions, such as by excluding from membership only captives that are owned by ineligible entities or, even more narrowly, only those that FHFA has determined are actually being used as a funding conduit for an ineligible parent. In developing the final rule, FHFA fully considered a number of narrower options, but ultimately concluded that

each those options either raised legal concerns, would not adequately address the Agency's policy concerns, or were not workable from a practical perspective.

For example, the Agency considered whether it would be possible to adopt a final rule allowing captives to be members, but including provisions restricting the extent to which the captive could pass advance proceeds on to an ineligible parent such as by establishing a specified percentage of a captive's assets that may be funded by advances or by requiring that all collateral be kept on the books of the captive. FHFA concluded that, while either of these options could be justified from a legal perspective, neither would be likely to be effective, given the fungibility of advance proceeds and the legal and other expert resources available to the captive's parent companies that would enable them to develop methods of effectively circumventing any such restrictions.[82]

FHFA also considered adopting a final rule that would have continued to allow membership for captives owned by entities eligible to become members. This option raises a legal question whether the statutory membership framework contemplates conditioning eligibility for membership on the activities or investments of a particular institution's parent company. Apart from that, however, this option would still allow institutions that are themselves eligible for membership to use captive subsidiaries to enable inexpensive access to multiple Banks. Like the use of captives by ineligible parents, this potential use by eligible parents raises substantial questions of policy and legitimacy under the Bank Act, in light of the statute's provision that a member may join

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[82] Some representatives of captive members represented to FHFA that their captive subsidiaries directly support residential housing finance and do not act as conduits to ineligible parents. However, as stated above, FHFA has been unable to develop an administratively feasible way to assure that this is the case or remains so, and in the great majority of instances that FHFA has reviewed, it is not. Also, in these cases, the captive is not engaged primarily in the business of insurance, meaning the business of shifting and spreading risk to unaffiliated parties, and, therefore, would not be an insurance company as Congress would have understood that concept in 1932.

only the Bank in the district in which its principal place of business is located.[83]

III. Section-by-Section Analysis of the Final Rule

A. Definitions—§ 1263.1

The final rule adds several new definitions to § 1263.1, as well as revises or deletes the definitions of a number of terms that appear in the existing regulation. Although most of these changes are non-substantive, newly added definitions for the terms “insurance company” and “captive” are intended to implement the main policy goal of the final rule—preventing circumvention of the Bank Act’s membership categories by excluding captive insurers from Bank membership. The final rule defines “insurance company” as “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.” The rule defines “captive” as “an entity that holds an insurance license or charter under the laws of a State, but that does not meet the definition of ‘insurance company’ set forth in this section or fall within any other category of institution that may be eligible for membership.” The purpose of defining those terms is to distinguish, as among entities that are deemed to be an insurance company under state law, between those that may be eligible for Bank membership as an “insurance company” and those that are not eligible. An entity that is chartered or licensed under a state’s insurance statutes but that neither meets the definition of “insurance company” nor falls within any of the other categories of institutions that may be eligible for membership under the statute or regulations, is ineligible for membership.

[83] See 12 U.S.C. 1424(b). If a depository institution were to establish a captive insurer in a state in another Bank district, structured so that its books, records, and personnel were located there, the regulation, as revised by the final rule, would recognize that other state as the principal place of business of the captive for Bank membership purposes.

Both the terms "insurance company" and "captive" were defined in the proposed rule and the final definitions are similar to those that were proposed. The proposed rule would have defined "insurance company" to mean "a company whose primary business is the underwriting of insurance for nonaffiliated persons or entities." It would have defined "captive" to mean "a company that is authorized under state law to conduct an insurance business, but that does not meet the definition of 'insurance company' . . . or fall within any other category of institution eligible for membership." In the final rule, the latter part of the definition of "captive" remains as proposed, while the initial phrase has been revised to refer more precisely to "an entity that holds an insurance license or charter under the laws of a State." The final rule adds that same initial phrase to the definition of "insurance company," substituting it for the generic term "a company" that was used in the proposed definition. This was done to make clearer that these two definitions are meant to be read in conjunction with each other. In addition, in the final rule, the definition of "insurance company" now refers to an entity "whose primary business is the underwriting of insurance for persons or entities that are not its affiliates," instead of one "whose primary business is the underwriting of insurance for nonaffiliated persons or entities." The sole reason for this change in nomenclature is because, in response to the requests of a number of commenters, FHFA has added a definition of the word "affiliate" to the final rule.

Several commenters asserted that the term "nonaffiliated persons or entities" was too vague and could be read in a way that would exclude from the definition of "insurance company" (and therefore from eligibility for Bank membership) entities that, because of diffuse ownership or other factors, cannot be easily used as financing

conduits. The types of entities identified were: mutual insurance companies, which are owned by their policyholders; "association captives," which may be incorporated as a mutual insurer under state captive statutes to insure a group of policyholders engaged in a related trade; and risk retention groups (RRGs), which are liability insurance companies that may be chartered as either captives or as traditional insurers under state law and that are authorized as RRGs under federal law.[84] FHFA has concluded that these types of insurance companies would in almost all cases be within the definition of "insurance company" adopted in the final rule and therefore would remain eligible for membership.

Two commenters provided specific recommendations as to how the term "nonaffiliated persons or entities" could be clarified so as to preclude the possibility that the definition of "insurance company" could be read to exclude entities that are not the intended targets of the proposal. One commenter, a Bank, suggested that FHFA define the term "nonaffiliated persons or entities" in the final rule to mean "one or more persons or entities holding less than 50% equity ownership or voting control of the insurance company."

Another commenter suggested that FHFA take an approach similar to that reflected in the Bank Holding Company Act ("BHCA"), which defines "affiliate" to mean "any company that controls, is controlled by, or is under common control with another company."[85] In turn, the BHCA states that one company is considered to have "control" over another thereunder if it: (A) "directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company"; (B) "controls in any manner the

[84] See Federal Liability Risk Retention Act, 15 U.S.C. 3901, et seq.
[85] 12 U.S.C. 1841(k).

election of a majority of the directors or trustees of the bank or company"; or (C) the Board of Governors of the Federal Reserve System (FRB) "determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company."[86] The commenter suggested that FHFA also adopt a "safe harbor" provision similar to one that applies to determinations made by the FRB under clause (C) of the foregoing which establishes a presumption that "any company which directly or indirectly owns, controls, or has power to vote less than 5 per centum of any class of voting securities of a given . . . company does not have control over that . . . company."[87]

FHFA has decided to follow that commenter's basic suggestion by adopting the concepts of "affiliate" and "control" that are reflected in the BHCA because those terms have well established meanings, as illustrated by their being used also in the Safety and Soundness Act with respect to affiliates of Fannie Mae and Freddie Mac.[88] While the final definition of "affiliate" is taken from the BHCA, the text defining the scope of the word "control" (which in the final rule appears within the definition of "affiliate") is based not on the language of the BHCA itself, but on the somewhat more specific definition of that word that the FRB used in its implementing regulations.[89]

The final rule defines "affiliate" to mean "any entity that controls, is controlled by, or is under common control with another entity." The new definition of "affiliate" also specifies that, for purposes of that definition, one entity "controls" another if it: (1) owns or controls 25 percent or more of the outstanding voting stock, limited partnership

[86] 12 U.S.C. 1841(a)(2).
[87] 12 U.S.C. 1841(a)(3).
[88] See 12 U.S.C. 4502(1).
[89] See 12 CFR 225.2(e).

shares, or similar interests of the other entity; (2) controls in any manner the election of a majority of the directors, trustees, or general partners of the other entity; or (3) has the power to exercise a controlling influence over the management or policies of the other entity through a management agreement, common directors or management officials, or by any other means.

The final rule definition of "control" does not include an equivalent of clause (C) in the BHCA definition of that term, which contemplates the possibility that the FRB may be required to hold hearings to determine whether one company exercises a controlling influence over another company. In other words, the rule does not contemplate that FHFA will under any circumstances hold a hearing to determine whether one entity "controls" another or to determine whether an entity falls within the definition of "insurance company." Instead, a Bank may need to inquire into the facts of a particular case and apply its reasoned judgment in some circumstances. In applying the definition of "control," a Bank should first make the relatively straightforward determination as to whether one entity exerts a controlling influence over another in the manner described in paragraphs (1) or (2) of the definition. If the answer to that question is "yes," then the inquiry need go no further—one entity "controls" the other, and they are thus considered to be affiliates under the rule. If the answer to that question is "no," then the Bank must consider, under paragraph (3), whether one entity has the power to exercise a controlling influence over the management or policies of the other entity by any other means, such as through a management agreement, common directors, or common management officials.

FHFA has also declined to include in the definition of "control" an equivalent to

the BHCA provision establishing a presumption of non-control in cases where one company controls less than 5 percent of the voting stock of another. FHFA believes that including such a provision will only further complicate the definition by appearing to require extensive inquiry into arrangements where one entity may control more than 5 percent, but less than 25 percent of the voting stock of another entity. To be clear, if a Bank determines that control does not exist in the manner described in paragraphs (1) or (2) and determines after reasonable inquiry that no alternative means of control exist as provided in paragraph (3), then it may presume that one entity does not control the other and, therefore, that they need not be considered affiliates under the rule.

Several commenters argued that the proposed rule also left unclear how a Bank would determine whether the "underwriting of insurance for nonaffiliated persons or entities" constitutes a company's "primary business," in determining whether a particular entity fell within the definition of "insurance company." One Bank suggested that FHFA define "primary business" to mean "a business line (such as selling policies, including reinsurance policies or contracts of reinsurance) that constitutes more than half of the insurance company's business." However, the concept of half of a company's business invokes measurement questions more complex and protean than are easily susceptible of being addressed in regulation language of general applicability. FHFA believes that close interpretive questions are unlikely to arise with any frequency, but is prepared to provide interpretive guidance as needed in any appropriate cases.

Determinations regarding whether an institution meets the definition of "insurance company," including determinations about what constitutes an "affiliate" and "control," as well as the manner in which Banks should memorialize their conclusions

with respect to those determinations in an applicant's membership application file, are addressed further in the discussion of final § 1263.2(b) below.

The one other substantive definitional change is to finalize the proposed expansion of the definition of "home mortgage loan" to include all types of MBS backed by qualifying loans and securities. Existing § 1263.1 generally defines "home mortgage loan" to include a loan that is secured by a first lien mortgage on one-to-four- or multi-family property, as well as a mortgage pass-through security that represents an undivided ownership interest in the underlying pool of mortgage loans. As proposed, the final rule replaces the existing reference to a pass-through security with a more general reference to a security representing either: (i) a right to receive a portion of the cash flows from a pool of qualifying loans; or (ii) an interest in other securities representing such a right. The reference to a right to receive a portion of the cash flows is intended to encompass both the rights of a holder of a mortgage pass-through security to an undivided ownership interest in the underlying loans and their principal and interest payments, as well as the rights of a holder "debt-type" instruments that grant the holder the right to a specified portion of the cash flows from the pooled mortgage loans. Thus, the revision is intended to bring within the definition of "home mortgage loan" all types of MBS—including pass-through securities, CMOs, REMICs, and principal-only and interest-only strips—that are fully backed by whole loans that meet the definition of "home mortgage loan" or by other MBS that are fully backed by such loans. The revised definition is not intended to include a bond or other debt security that is a general obligation of the issuer, even if it is collateralized by qualifying mortgage loans.

FHFA is making this revision in recognition of the fact that the capital markets do

not distinguish between MBS structured as pass-through vehicles and those structured as debt instruments. In adopting the existing definition in 1993, the Finance Board codified the approach of its predecessor agency, the Federal Home Loan Bank Board (FHLBB), which had held that a mortgage-backed security must provide its holder with a pro rata ownership interest in each of the loans in the underlying pool of mortgage loans in order for the purchase of that MBS to constitute the equivalent of making or purchasing those underlying loans. Thus, while the Finance Board permitted mortgage pass-through securities, which are structured to give the holder a theoretical undivided ownership interest in each of the underlying loans, to be counted toward satisfaction of the "makes long-term home mortgage loans" requirement, it did not permit other types of MBS to be used for that purpose.

However, as explained in the **Supplementary Information** to the proposed rule, investors in today's financial markets recognize that the economic interest in the loans underlying such instruments is essentially the same for all types of MBS, regardless of their legal structure. Indeed, the availability of the many types of MBS with different characteristics that have evolved to meet investors' needs over the past several decades has made the secondary mortgage market much more liquid. In recognition of this, FHFA believes that it is appropriate to expand the definition of "home mortgage loan" to include all types of MBS backed by qualifying whole loans and eliminate the distinction that the regulations have historically drawn between pass-through securities and other types of MBS.

This revision was originally proposed in connection with FHFA's proposal to require an institution to hold at least one percent of its total assets in home mortgage

loans in order to be deemed to comply with the "makes long-term home mortgage loans" eligibility requirement. The change was intended in part to ease the burden on members that would have been imposed by that new quantitative requirement by allowing them to satisfy the requirement with a wider range of first lien mortgage-related assets than would have been the case if the existing definition were retained. It was also intended in part to make it easier for the Banks to obtain the information necessary to confirm members' compliance with the one percent requirement from their regulatory financial reports. Notwithstanding that FHFA will not be finalizing the one percent requirement at this time, the Agency has decided to include the revised definition in the final rule for the reasons stated above.

In conjunction with the revision of the definition of "home mortgage loan," the final rule also revises the definition of "residential mortgage loan" by replacing paragraph (5) (referring to "mortgage pass-through securities") and paragraph (6) (referring to "mortgage debt securities") with a new paragraph (5), which is intended to include both types of securities. The new provision is similar to paragraph (2) of the definition of "home mortgage loan," referring generally to a security representing either: (i) a right to receive a portion of the cash flows from a pool of whole "residential mortgage loans"; or (ii) an interest in other securities representing such a right. This revision is not intended to effect any substantive change, but merely to streamline the definition in light of the fact that the revisions to the definition of "home mortgage loan" make it unnecessary to distinguish between pass-through securities and other types of MBS in the definition of "residential mortgage loan."

Each of the remaining revisions to the definitions within § 1263.1 is intended

either to remove a duplicative definition or to shorten or otherwise clarify the definition itself or the regulatory text in which the defined term appears. Each of these revisions appeared in the proposed rule and each is being finalized essentially as proposed. None of the revisions is intended to alter the meaning of any defined term or substantive provision.

B. Membership Application Process—§§ 1263.2–1263.5

The final rule makes several revisions to subpart B of part 1263, which governs the membership application process.

As proposed, the final rule relocates to § 1263.2(a) from § 1263.6(a) language prohibiting any institution from becoming a member of a Bank unless it has submitted to that Bank a membership application that satisfies the requirements of part 1263, except as otherwise specified in part 1263 (such as in the case of transfers or certain consolidations). While existing § 1263.2(a) requires that an applicant submit an application that complies with the requirements of part 1263, it does not state explicitly that an institution may not become a member unless it has done so. FHFA believes that this statement is more appropriately situated in its new location, which addresses the membership application process, rather than its current location, which addresses the substantive membership eligibility requirements.

Existing § 1263.2(b) requires a Bank to prepare a written digest for each applicant stating whether or not the applicant meets each of the applicable membership eligibility requirements and providing support for its conclusions with respect to each requirement. The final rule revises this subsection to add a specific requirement that, in any digest prepared for an applicant whose eligibility for membership is contingent upon its meeting

the new definition of “insurance company,” the Bank must state whether the applicant meets that definition and summarize the facts and identify the sources on which it relied in reaching that conclusion. In such cases, the digest should support the Bank’s determination that an applicant qualifies as an “insurance company” by summarizing the bases for the Bank’s conclusion that the applicant’s primary business is the underwriting of insurance for persons or entities that are not its affiliates. In the case of a traditional life or casualty insurance company, for example, it may be sufficient to indicate that a majority of the company’s premium income is derived from policies sold to unaffiliated parties. In the case of a mutual insurance company, for example, it may be sufficient to indicate that the company is organized in mutual form and that none of its policyholders has the power to control the election of persons to its board of directors. For a risk retention group, a Bank may be required to obtain additional information establishing that none of the owners control more than 25 percent of its voting shares. In a very few cases, a Bank may be required to conduct a more detailed analysis about whether any one or more policy holders can be said to have “control” over the applicant or related companies that may cause it to be considered an “affiliate,” as defined in § 1263.1.

Section 1263.2(c) of the existing regulation requires that a Bank create and maintain a membership file for each applicant. Paragraph (2) of that subsection requires that the Bank include in that file, as an attachment to the application digest, all materials required to document the applicant’s eligibility for membership. Paragraph (2) further provides that the Bank “may retain in the file only the relevant portions of the regulatory financial reports required by [part 1263].” This provision is intended merely to allow a Bank the option of omitting from an applicant’s file the portions of the applicant’s

regulatory financial report that are not relevant to its eligibility for membership. However, as currently phrased, the provision could be read as *prohibiting* the Bank from including the non-relevant portions. To eliminate the possibility of such a misreading, the final rule revises this provision to state, instead, that the Bank "is not required to retain in the file" portions of the reports "that are not relevant to its decision on the membership application."

Section 1263.3(c) of the existing regulation also addresses the timing and notice requirements applicable to a Bank's decision on an institution's application for membership. As proposed, the final rule makes a number of non-substantive revisions to that provision to state the requirements as to the timing of the Bank's decision more precisely. No change in meaning is intended.

Section 1263.4 of the existing regulation addresses the circumstances under which an institution may be admitted to membership in a Bank "automatically"—that is, without the need to apply for membership. As proposed, the rule makes two minor wording changes to § 1263.4(a), which governs automatic membership for certain charter conversions, to make the provision read more clearly. No change in meaning is intended.

Existing § 1263.4(b) provides that any member whose membership is transferred pursuant to § 1263.18(d) shall automatically become a member of the Bank to which it transfers. However, while the cross-referenced provision—existing § 1263.18(d)—requires that the Banks involved agree on a "method of orderly transfer" before a "transfer of membership" takes effect, neither that provision nor § 1263.4(b) specifies the types of events that constitute a "transfer" of membership. As a result, FHFA has occasionally received questions about how § 1263.4(b) is to be applied.

FHFA proposed to revise § 1263.4(b) to remove the reference to a "transfer" and, instead, specify that a new membership application is not required when a member either physically relocates its principal place of business to another Bank district (such as through a consolidation) or redesignates its principal place of business to another Bank district as provided under § 1263.18(c). FHFA believes that both of these situations should be treated in the same manner because they are simply different means of bringing about the same result—*i.e.,* a change in the location of a member's principal place of business from one Bank district to another. No commenters objected to the proposed revisions, and FHFA is adopting them as proposed. FHFA has also added language to clarify that the automatic membership at the new Bank commences upon the purchase of the minimum amount of stock needed under the new Bank's capital structure plan.

Section 1263.5 of the existing regulation gives an institution whose membership application has been denied by a Bank the right to appeal the denial to FHFA. FHFA did not propose any substantive revisions to this section, but requested comments on whether the regulations needed to continue to afford applicants this right of appeal, given that no applicants have ever requested an appeal. The Agency received relatively few comments in response to this request, but those that did respond—mostly CDFIs and credit unions, but also a few of the Banks—were uniformly opposed to removal of the appeal provision. One representative letter from a CDFI cited the right of a CDFI applicant under existing § 1263.16(b)(1)(iii) to present to a Bank as part of its application any information it believes demonstrates that is satisfies the "financial condition" eligibility requirement. The commenter stated that the adoption of that provision, as well as FHFA's discussion of the provision in the **Supplementary Information** to the final rule in which it was

included, demonstrates that the Agency understands that Banks "make judgments in their assessment of CDFI eligibility that could require additional review." The commenter concluded that, in light of "the inconsistent experience with CDFI membership across the System . . . the option for an appeal process should be maintained." Because of the concerns expressed by commenters, FHFA has decided to retain the appeal provision in the regulation.

C. Membership Eligibility Requirements—§§ 1263.6–1263.18

Subpart C of the existing regulation, which includes §§ 1263.6 through 1263.18, addresses the requirements that an institution must meet in order to be eligible for Bank membership. Section 1263.6 sets forth all of the eligibility requirements, while the remaining sections of subpart C address more specifically the manner in which a Bank is to determine compliance with those requirements for the different types of institutions that may be eligible for membership.

The proposed rule would have revised §§ 1263.6, 1263.9 and 1263.10, and would have added a new § 1263.11 (thereby requiring the re-numbering of existing §§ 1263.11-1263.18), to require that an institution hold at least one percent of its assets in "home mortgage loans" to be deemed to satisfy the statutory eligibility requirement that it make long-term home mortgage loans, and that each member comply on an ongoing basis with that one percent requirement and, where applicable, with the statutory eligibility requirement that it have at least 10 percent of its total assets in "residential mortgage loans" as a condition of remaining a Bank member. Because, as discussed above, FHFA has decided not to implement those proposed ongoing asset ratio requirements at this time, the proposed revisions to subpart C that were meant to implement the new

requirements are not included in the final rule. Nonetheless, the final rule makes some fairly extensive changes to subpart C in that it: adds to § 1263.6 a provision addressing the treatment of captive insurers that were admitted to Bank membership prior to the effective date of the rule; finalizes a proposed new provision in § 1263.16 requiring insurance companies to provide audited financial statements as part of the membership application process; finalizes a proposed new provision in § 1263.18 addressing the manner in which a Bank is to determine the "principal place of business" for insurance companies and CDFIs; and makes non-substantive clarifying revisions to the texts of §§ 1263.14, 1263.15, 1263.17 and 1263.18.

1. General eligibility requirements—§ 1263.6

Section 1263.6 sets forth the general eligibility requirements for Bank membership and provides that entities that do not meet the requirements of part 1263 shall be ineligible for Bank membership. With respect to the manner in which this section is to be applied, the most significant change the final rule makes is in defining "insurance company," as discussed in detail above. The introductory paragraph to § 1263.6(a) enumerates the types of institutions that are eligible under the Bank Act for membership. Entities of a type not listed in § 1263.6(a) and those, regardless of type, that do not meet the applicable requirements of part 1263, are not eligible for Bank membership. By defining the term "insurance company" in § 1263.1 to include only those entities "whose primary business is the underwriting of insurance for persons or entities that are not its affiliates," the final rule makes clear that a captive, as defined in the regulation, is not an "insurance company" for purposes of section 4(a) of the Bank Act and § 1263.6(a) of the membership regulation. Thus, captives are not eligible for

Bank membership, and those that the Bank had previously admitted to membership must wind down their relationships with the Banks in accordance with this final rule.

With respect to the text of § 1263.6(a) itself, the rule finalizes one proposed revision to the introductory paragraph. As discussed above, the final rule removes from this section and relocates to § 1263.2(a) language requiring all applicants to submit an application meeting all of the requirements of the Bank Act and FHFA regulations before it may become a member. FHFA believes that it is more appropriate for that requirement to be included with other material addressing the membership application process than in § 1263.6, which addresses the substantive membership eligibility requirements.

In conjunction with the implementation of the ongoing asset ratio requirements, the proposed rule also would have revised the introductory paragraph, which currently states that an institution meeting the requirements of paragraphs (a)(1) through (a)(6) of that subsection shall be "eligible to *become* a member" of a Bank, to provide that an institution shall be "eligible to *be* a member" if it meets those requirements. The final rule makes a slightly different change, by revising that paragraph to provide that an institution shall be "eligible for Bank membership" if it meets the listed requirements. Despite the fact that the final rule does not require the Banks to determine members' compliance with the "makes long-term home mortgage loans" and "10 percent" requirements on an ongoing periodic basis as would have been required under the proposed rule, FHFA is nonetheless making this revision to dispel any notion that the eligibility requirements of § 1263.6(a) are no longer of any relevance to a member once it

has been approved for membership.[90]

The final rule makes one additional change to § 1263.6(a) that was not reflected in the proposed rule by adding a new paragraph (7) providing that, in addition to meeting the requirements listed in paragraphs (1) through (6), an institution must have complied with any applicable requirement of § 1263.6(b) or § 1263.6(c) to be eligible for membership. This revision is not meant to effect any substantive change, but is intended merely to provide clarity by ensuring that § 1263.6(a) contains a comprehensive list of all of the requirements an institution is, or may be, required to meet to be eligible for membership. Section 1263.6(b) refers to the "10 percent" requirement that applies to insured depository institutions that are not CFIs, while § 1263.6(c) refers to the requirement that an applicant that is not an insured depository institution have a level of mortgage-related assets that reflect a commitment to housing finance. The final rule makes no changes to subsections (b) or (c), which both refer to what an "applicant" must do to "become" a member. To make clear that compliance with those requirements will continue to be assessed only at the time of application, new § 1263.6(a)(7) states that an institution to which either of those requirements apply shall be eligible for Bank

[90] As explained in the proposed rule, the existing regulations already reflect the necessarily ongoing nature of several of the eligibility requirements, although they employ various enforcement mechanisms short of the ultimate sanction of termination to ensure continuing compliance with those requirements. For example, under the existing membership regulation, an applicant for Bank membership must in most cases satisfy the "home financing policy" requirement by demonstrating that it has achieved a rating of "Satisfactory" or better on its most recent CRA evaluation. While the regulations do not require a member to maintain a "Satisfactory" or better CRA rating in order to retain its Bank membership, they do mandate restrictions on access to advances for failure to maintain such a rating. See 12 CFR 1290.5(b). FHFA's advances regulation effectively enforces the "financial condition" requirement by permitting a Bank to limit a member's access to advances if its credit underwriting indicates that it is advisable to do so and requires a Bank to limit or restrict access to advances in the case of a member that lacks positive tangible capital, but that has not yet reached the point of insolvency. See 12 CFR 1266.4. The "duly organized" and "subject to inspection and regulation" eligibility requirements are essentially self-enforcing in that any member that fell out of compliance with either of those requirements could not continue to operate as a financial institution.

membership if it "has complied" with the applicable requirement.

Existing § 1263.6(d) states that "[e]xcept as otherwise provided in this part, if an applicant does not satisfy the requirements of this part, the applicant is ineligible for membership." The proposed rule would have redesignated this provision as § 1263.6(c)(1) and revised it to read, "Except as provided in paragraph (c)(2) of this section, an institution that does not satisfy the requirements of this part shall be ineligible to be a member of a Bank." In the final rule, the provision remains as § 1263.6(d), but is revised to read, "Except as provided in paragraph (e) of this section, an institution that does not satisfy the requirements of this part shall be ineligible for membership." This revised language is similar to that which was proposed. As proposed, the final rule removes the initial qualifier "[e]xcept as otherwise provided in this part," which is redundant in that the reference to satisfying the "requirements of this part" is most logically read to take into account any exceptions to the general requirements. At the same time, the final rule adds a new qualifier—"[e]xcept as provided in paragraph (e)"—which is a new provision, described immediately below, that specifies the manner in which the Banks are to wind down their business with existing captive members before terminating the membership of those captives.

Because FHFA has amended the regulation to make captives ineligible for membership, the final rule adds a new provision, § 1263.6(e), to govern the treatment of captives that were admitted to membership prior to the effective date of the final rule. Like the proposed rule, the final rule treats captives that had been admitted to membership before the date of publication of the proposed rule (September 12, 2014) (hereinafter referred to as "pre-NPR captives") differently from those that were admitted

to membership on or after that date (hereinafter referred to as "post-NPR captives").

The final rule treats pre-NPR captives in essentially the same manner as would have been the case under the proposed rule. Section 1263.6(e)(1)(i) of the final rule permits a Bank five years from the effective date of the final rule to wind down its relationship with a pre-NPR captive. As proposed, the final rule also permits a Bank to continue to make or renew advances to such captives during that five year transition period, but only if: (A) after making or renewing an advance, the Bank's total outstanding advances to that captive would not exceed 40 percent of the captive's total assets; and (B) the maturity date of any new or renewed advance does not extend beyond the end of the five-year transition period. In the case of a captive that already has advances that exceed 40 percent of its assets, the final rule does not require a Bank to call those advances prior to their maturity date, but it does prevent the Bank from making or renewing any further advances to that captive until total outstanding advances have been reduced to below 40 percent of the captive's assets. Similarly, a Bank that already has made advances to captives that mature beyond five years from the effective date of the final rule may allow those to roll off in accordance with their terms, but may not renew them.

Section 1263.6(e)(1)(ii) of the final rule requires a Bank to terminate the membership of any pre-NPR captive no later than five years after the effective date of the rule. The Bank is to carry out the terminations as provided under § 1263.27, which is not amended by this final rule and which provides each Bank's board with the necessary authority to terminate the membership of any captive for failing to comply with a requirement of the Bank Act, as implemented by a regulation adopted by FHFA. The

requirements of § 1263.27(b), regarding stock redemption periods, and § 1263.27(c), regarding post-termination membership rights, shall apply without exception to any terminated captive.

Final § 1263.6(e)(1)(ii) further requires a Bank, after terminating the membership of a pre-NPR captive, to liquidate outstanding advances to, settle other business transactions with, and repurchase or redeem Bank stock held by that captive in accordance with § 1263.29, which also is not revised by the final rule. This provision also makes clear that in terminating a pre-NPR captive's membership a Bank may nonetheless allow the captive to repay any existing advances in accordance with their contractual terms, regardless of whether their maturity dates occur after the date of the termination of membership, so long as the advances had been made in conformity with the regulations in effect at the time the advance was made. In such cases, the Bank would also delay the repurchase of Bank stock held by the captive in support of any such advance until after the advance has been repaid, in accordance with the Bank's capital plan. The five-year transition period for these pre-NPR captives is intended to mitigate to a reasonable extent the burden that the termination of membership might otherwise have on any such captive that became a Bank member in reliance on the previous membership regulations. The limitations on advances that may be made during this period are intended to permit a pre-NPR captive to continue to borrow at its existing levels for a reasonable period of time, while also limiting its ability to provide increased financing to affiliates that are ineligible for Bank membership.

The text of the proposed rule did not explicitly address the treatment of post-NPR captives, but, in the **Supplementary Information**, FHFA stated that it would interpret

the rule to require the immediate termination of such captives' membership and the prompt liquidation of any outstanding advances, and that it would consider making those requirements explicit in the final rule if any Bank were to admit a captive to membership subsequent to the date of publication of the proposed rule. Notwithstanding that notice of the proposed consequences to captives admitted to membership after the date of the proposed rule, several Banks have continued to admit captives to membership, although at least some have obtained from such captives written acknowledgements of the possible immediate termination of their memberships. Because of those developments, FHFA has decided that it should address the treatment of those post-NPR captives explicitly in the final rule. In order to avoid the disruption to the Banks and those captives that could result from an immediate termination of membership and repayment of all advances, FHFA has reconsidered the position it took in the proposed rule and has decided to provide the Banks with a one-year transition period within which to wind down their affairs with any post-NPR captives they have admitted.

Accordingly, § 1263.6(e)(2)(i) of the final rule provides the Banks with a one-year transition period from the effective date of the final rule within which to wind down its relationships with any captives that had been admitted to membership on or after September 12, 2014. The final rule prohibits a Bank from making or renewing an advance to a post-NPR captive during that transition period, but does not require the immediate liquidation of any advances that may already be outstanding on the effective date of the rule.

Section 1263.6(e)(2)(ii) of the final rule requires a Bank to terminate the membership of any post-NPR captive as provided under § 1263.27 no later than one year

from the effective date of the final rule. It also requires generally that upon the termination of membership the Bank must liquidate all outstanding advances to the post-NPR captives, settle all other business transactions, and repurchase or redeem all Bank stock held by the terminated captive in accordance with § 1263.29. Thus, in contrast to pre-NPR captives, post-NPR captives must completely wind down all business relationships with the Banks, including the full repayment of all outstanding advances, prior to or simultaneously with the termination of membership.

2. Treatment of de novo insured depository institution applicants—§ 1263.14

Section 1263.14 of the existing membership regulation sets forth special standards by which a Bank is to assess the compliance of a "de novo applicant"—*i.e.*, an insured depository institution chartered less than three years prior to the date it applies for Bank membership—with the membership eligibility requirements. It deems each de novo applicant to be in compliance with the "duly organized," "subject to inspection and regulation," "financial condition," and "character of management" eligibility requirements and provides an alternative means for such an applicant to meet the "makes long-term home mortgage loans requirement" if it cannot meet the general standard set forth in § 1263.9. With respect to both the "10 percent" and "home financing policy" requirements, it provides standards pursuant to which an applicant may be "conditionally approved" for membership at the time of application and then achieve full membership if additional criteria are met within a certain timeframe.

Although the proposed rule would have made no substantive changes to the existing standards, it would have significantly revised the text of this section (which would have been redesignated at § 1263.15) to provide greater clarity, primarily with

respect to the standards for conditional approval and subsequent full membership. The proposed rule would, however, have added two new paragraphs to provide alternative standards by which a member that had been admitted as a de novo applicant could be deemed to comply with the proposed ongoing asset ratio requirements for a period of time before being required to meet the standards that would have applied to all other members.

Like the proposed rule, the final rule significantly revises the text of this section (which remains as § 1263.14 in the final rule), but organizes the material differently than was proposed. Again, these changes are intended primarily to state the requirements regarding conditional approval and subsequent full membership more clearly and are not meant to implement any substantive change. Because FHFA is not implementing the proposed ongoing asset ratio requirements at this time, the proposed provisions relating to those requirements are not included in final § 1263.14.

In the existing regulation, the term "de novo applicant" is defined in § 1263.14(a) and is used throughout the remainder of § 1263.14 to refer to an insured depository institution that was chartered less than three years prior to the date it applies for Bank membership. As proposed, the final rule substitutes "de novo insured depository institution" for "de novo applicant" to make clear that the time-limited exceptions for entities formed within the preceding three years apply only to insured depository institutions and not to insurance companies or non-depository CDFIs. In addition, the rule moves that definition from § 1263.14(a) to § 1263.1, where the definitions of other terms that are used in part 1263 are located. As is the case with the existing membership regulation, the final rule does not provide any special standards for measuring the

compliance of recently formed insurance company or non-depository CDFI applicants with the membership eligibility requirements.

While the final rule also revises the text of § 1263.14(a) to reflect the new nomenclature, it retains the substance of the existing subsection by deeming each de novo insured depository institution applicant to be in compliance with the "duly organized," "subject to inspection and regulation," "financial condition," and "character of management" eligibility requirements. This reflects the fact that the chartering entity and the federal deposit insurer would have evaluated those areas in connection with granting the charter and approving the institution for deposit insurance.[91]

Existing § 1263.14(b) allows a de novo insured depository institution to satisfy the "makes long-term home mortgage loans" requirement by providing a written justification acceptable to the Bank of how its home financing credit policy and lending practices will include originating or purchasing long-term home mortgage loans. The final rule makes minor revisions to the text of this subsection, but retains the substance of the existing provision.

Existing § 1263.14(c) deems a de novo insured depository institution to which the "10 percent" requirement applies and that has been in operation for less than one year to be "conditionally . . . in compliance" with that requirement at the time of application, and grants the institution "conditional membership approval" until the institution reaches the one-year anniversary of its commencement of operations. At that point, if the institution provides evidence acceptable to the Bank that it holds at least 10 percent of its assets in residential mortgage loans, it is deemed to be "in compliance" with the "10 percent"

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[91] See 61 FR 42531, 42538 (Aug. 16, 1996) (discussing reasoning behind adoption of streamlined requirements for de novo insured depository institutions).

requirement. If the institution is unable to provide such evidence within that time frame, it is deemed to be "in noncompliance" with the "10 percent" requirement, its "conditional membership approval is deemed null and void," is terminated, and its membership stock must be redeemed in accordance with § 1263.29.

The final rule revises the structure of § 1263.14(c) (condensing it from five paragraphs to three) and to its nomenclature, but makes only one minor change to the substance of that subsection. That substantive change is reflected in final § 1263.14(c)(1). As currently written, that paragraph appears to deem any de novo insured depository institution applicant to which it applies to be in mere conditional compliance with the "10 percent" requirement, without allowing for the possibility (perhaps slight) that the applicant may be able to demonstrate that it is already in full compliance with that requirement as provided in § 1263.10. The final rule remedies this oversight by specifying, in § 1263.14(c)(1), that the subsection applies to "a de novo insured depository institution applicant that commenced its initial business operations less than one year before applying for Bank membership [that] is subject to, but cannot yet meet, the 10 percent requirement . . . as provided in § 1263.10." If an institution already complies with § 1263.10 at the time it applies for membership, it is not subject to the procedures set forth in § 1263.14(c) under the final rule. With respect to applicants to which § 1263.14(c) does apply, final § 1263.14(c)(1) provides that a Bank shall conditionally approve such an applicant for membership if it meets all other applicable requirements (which include the other membership eligibility requirements as modified for de novo insured depository institutions under this section).

Final § 1263.14(c)(2) provides that if an institution that was conditionally

approved for membership demonstrates to the satisfaction of its Bank that it satisfies the "10 percent" requirement as provided under § 1263.10 within one year after it begins its business operations, its membership approval shall become final—*i.e.*, it shall be considered to be fully approved for membership (unless it also remains subject to conditional approval under § 1263.14(d)). Conversely, final § 1263.14(c)(3) provides that if such an institution fails to demonstrate its full compliance with the "10 percent" requirement within one year after it begins its business operations, its conditional membership approval shall become void.

Existing § 1263.14(d) deems any de novo insured depository institution that has not yet received its first CRA performance evaluation to be in conditional compliance with the "home financing policy" requirement if it provides a written justification acceptable to the Bank of how and why its home financing credit policy and lending practices will meet the credit needs of its community. The existing regulation allows a Bank to conditionally approve an applicant for membership on this basis until it receives its first CRA evaluation. If the institution receives a "Satisfactory" or better rating on its first CRA evaluation, it is deemed to be in full compliance with the "home financing policy" requirement and its membership approval shall become final (unless it also remains subject to conditional approval under § 1263.14(c)). If it fails to achieve a "Satisfactory" rating on that evaluation, it is considered to be out of compliance (unless that presumption is rebutted as specified in the regulation) and its conditional membership approval becomes void. The final rule revises the structure and nomenclature of § 1263.14(d) that parallel the revisions made to § 1263.14(c), but makes no substantive changes to that subsection.

The final rule adds a new subsection (e) to § 1263.14 to consolidate existing requirements that apply to conditional membership approvals under subsections (c) and (d). Final § 1263.14(e) provides that a de novo insured depository institution that has been conditionally approved for membership under § 1263.14(c)(1) or § 1263.14(d)(1) is subject to all regulations applicable to members generally, including those relating to stock purchase requirements and advances or collateral, notwithstanding that its membership may be merely conditional for some period of time. Final § 1263.14(e) also provides that if an institution's conditional membership approval becomes void as provided in § 1263.14(c)(3) or § 1263.14(d)(3), then the Bank must liquidate any outstanding indebtedness and redeem or repurchase its capital stock as it would for any other terminated member under § 1263.29.

3. Recently consolidated applicants—§ 1263.15

Section 1263.15 provides guidance to the Banks about how to assess a membership application submitted by an institution that recently has undergone a merger or other business combination with another institution. The existing provision specifies the manner in which the Banks must apply the "financial condition," "home financing policy," "makes long-term home mortgage loans," and "10 percent" requirements to such applicants. The final rule makes numerous non-substantive revisions to that section so as to provide greater clarity, but makes no substantive changes.

With respect to the "financial condition" requirement, final § 1263.15(a) requires a recently consolidated applicant that has not filed consolidated financial reports with its regulator for at least six quarters or three calendar years to provide the Bank with whatever regulatory reports it has filed as a consolidated institution, plus pro forma

financial statements for any quarters for which actual combined financial reports are not available. With respect to the "home financing policy" requirement, final § 1263.15(b) requires a recently consolidated applicant that has not yet received its first CRA performance evaluation as a consolidated entity to provide a written justification acceptable to the Bank of how and why its home financing credit policy and lending practices will meet the credit needs of its community. With respect to the "makes long-term home mortgage loans" and "10 percent" requirements, final § 1263.15(c) allows a recently consolidated applicant that has not yet filed a regulatory financial report as a consolidated entity to provide the Bank instead with the pro forma financial statements that it had provided to the regulator that approved the consolidation.

4. Financial condition of CDFIs and insurance companies—§ 1263.16

Existing § 1263.16 governs the application of the "financial condition" requirement to insurance company and certain CDFI applicants. By regulation, in order for such an institution to be eligible for membership its financial condition must be "such that advances may be safely made to it."[92] The Bank Act applies this "financial condition" requirement only to certain insured depository institutions,[93] but both FHFA and the Finance Board have applied this requirement by regulation to all institutions, including insurance companies, as a matter of safety and soundness.[94] The final rule does not alter this approach.

Under existing § 1263.16(a), an insurance company applicant is deemed to meet

[92] 12 CFR 1263.6(a)(4).
[93] See 12 U.S.C. 1424(a)(2)(B).
[94] See 58 FR 43522, 43531-34 (1993) (discussion in **Supplementary Information** to Finance Board's first post-FIRREA final rule on Bank Membership of the agency's decision to apply the requirements of section 4(a)(2)(B) of the Bank Act to insurance companies, as well as insured depository institutions).

the "financial condition" requirement if the Bank determines, based on the information contained in the applicant's most recent regulatory financial report, that it meets all of its minimum statutory and regulatory capital requirements and, in addition, meets all applicable capital standards established by the NAIC, regardless of whether those NAIC standards have been adopted by the state in which the company is subject to regulation. As proposed, the final rule carries forward those requirements, but also adds a new provision that requires a Bank to review an insurance company applicant's most recent audited financial statements and to determine that its financial condition is such that the Bank can safely make advances to it before that applicant may be deemed to meet the "financial condition" requirement. The final rule requires that the Bank make the latter determination based upon audited financial statements prepared in accordance with generally accepted accounting principles (GAAP), if they are available, but allows the use of financial statements prepared in accordance with statutory accounting principles if GAAP statements are not available.

5. Determination of appropriate district for Bank membership—§ 1263.18

The Bank Act provides that an eligible institution may become a member only of the Bank of the district in which the institution's "principal place of business" (PPOB) is located, but does not define that term.[95] The existing membership regulation includes both a general provision for determining the location of an institution's PPOB, as well as an alternative provision that allows an institution to request that the Bank designate a different state for the PPOB if certain requirements are met. Under the general provision,

[95] 12 U.S.C. 1424(b). An institution may, in the alternative, become a member of the Bank of an adjoining district, if that is demanded by convenience and the Director of FHFA approves that arrangement. There is no record of this statutory alternative ever having been used.

the PPOB is deemed to be the state in which an institution "maintains its home office established as such in conformity with the laws under which the institution is organized."[96] The alternative provision allows an institution to designate a different state as its PPOB if it meets a three-part test for establishing that it has a sufficient connection to that other state.[97]

a. Proposed PPOB provisions

The proposed rule would have redesignated § 1263.18 as § 1263.19, but retained the basic structure of that section (while adding additional paragraphs, as noted below). That section remains as § 1263.18 under the final rule. In the discussion of the substantive revisions to that section below, the existing, proposed, and final provisions are all referred to as being located in § 1263.18 in order to avoid confusion.

The proposed rule would have made three substantive revisions to § 1263.18 that were intended to address how the Banks designate the PPOB for certain insurance company and community development financial institution (CDFI) members. As more insurance companies and CDFIs have become Bank members, they have revealed shortcomings in the current regulation's application to some situations that these institutions can present that do not arise with depository institutions, such as being domiciled in one state but conducting all business operations from a different state. As noted in the **Supplementary Information** to the proposed rule, FHFA had previously declined a request to allow the Banks to look solely to the state of domicile for an

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[96] See 12 CFR 1263.18(b).
[97] The regulation allows an institution to have a state other than the one in which it maintains its home office designated as its PPOB, provided that: (i) at least 80 percent of the institution's accounting books, records, and ledgers are maintained in that state; (ii) a majority of the institution's board of director and board committee meetings are held in that state; and (iii) a majority of the institution's five highest paid officers have their places of employment located in that state. See 12 CFR 1263.18(c).

insurance company or the state of incorporation for a CDFI to identify the PPOB, because that approach would allow for the possibility of an institution having its "principal" place of business for membership purposes at a location from which it actually conducts no business activities. Such an arrangement is not consistent with the statute.

To address these issues, FHFA first proposed to amend the general PPOB provision by adding a requirement that an institution also must actually conduct business activities from its home office location in order for the home office to be designated as the PPOB. The intent was to make clear that a mere legal presence, such as a statutory home office or a registered agent's office at which no business is conducted, is not sufficient by itself to constitute a company's PPOB. FHFA was prompted to make this revision by learning of instances in which insurance companies and CDFIs had sought to become members of the Bank whose district included the state under whose laws those entities had been domiciled or incorporated, even though they conducted all of their business activities elsewhere.

FHFA also proposed to add a new section that would be specific to insurance companies and CDFIs, which would apply only in those cases in which an institution could not satisfy the general requirements for determining its PPOB. Thus, the new provision would apply only to an institution that did not have an actual "home office" established under the laws of its chartering statute, or that had such a "home office" but did not conduct business operations from that location, and that could not satisfy the existing three-part test for designating an alternative location for its PPOB. Under the proposed provision, a Bank would be required to designate as the institution's PPOB "the

geographic location from which the institution actually conducts the predominant portion of its business activities." The proposed rule further required that a Bank make these PPOB determinations based on the totality of the circumstances related to a particular institution and using "objective factors" for making the decision. The proposal included three examples of such objective factors, which were the location of the institution's senior executives, the locations of the offices from which it conducts business, and the locations from which its non-executive officers and employees carry out the institution's business activities.

Lastly, the proposed rule included a separate provision for designating the PPOB for those insurance companies that maintain no physical business presence in any state. As more insurance companies have become Bank members, FHFA has learned that certain insurance companies, such as those that are part of a holding company, may not maintain any physical office premises of their own that might be designated as their PPOB. Moreover, such companies may not have their own dedicated officers or employees, but instead may have joint employees or officers who are primarily employed by a separate affiliated insurance company. Those persons also may be situated at different geographic locations, *i.e.*, the locations of the business offices of the affiliated companies, rather than at one central location. Such companies also may contract with unaffiliated service providers to perform the services that ordinarily would be performed by a company's employees. For such companies, where it is not possible to identify a single physical location from which the insurance company can be said to actually conduct the predominant portion of its business activities, the proposed rule would have allowed the Banks to designate the insurance company's state of domicile as its PPOB.

b. Comment letters on proposed PPOB provisions

Approximately 80 comment letters addressed some aspect of these proposed PPOB amendments. Many of the comment letters were substantively identical and contended that using the state of domicile or incorporation would be the most logical way to determine the PPOB for CDFI and insurance company members. They also noted that the existing three-part test for redesignating a member's PPOB already provided an adequate alternative means for members to designate a place other than the state of domicile or incorporation. These commenters also criticized creating a separate PPOB provision for insurance company and CDFI members, saying that it would promote district shopping by such members and would create an unfair advantage for insurance companies over depository institution members.

Many other comment letters also urged FHFA to look solely to the state of domicile as the PPOB for insurance companies. Their principal reasons included: the simplicity of the approach; it would allow Banks to focus only on the insurance laws of the states in their districts; it would defer to state regulators on what constitutes a "home office"; it would avoid the inconsistent results that would likely occur if each Bank made its own decisions about what constituted the "predominant portion" of an institution's business; and it would recognize the realities of the marketplace, in which the concept of large institutions having a single physical location from which they conduct their business is no longer the norm.

Nine Banks submitted separate letters that were nearly identical in substance and generally opposed the revisions to the PPOB regulation. These letters also suggested certain revisions, one of which FHFA has decided to incorporate into the final rule, as

described below. The Banks also favored using the state of domicile as the PPOB for insurance companies, urging FHFA to recognize the central importance of the domicile to the operation and regulation of any insurance company, and to defer to state insurance regulators' determination of what constitutes an insurance company's "home office." The Banks further contended that principles of safety and soundness favor using the state of domicile, as that would avoid requiring each Bank to become familiar with the insurance regulators and laws for states outside of its district. A number of commenters other than the Banks also raised these same points in favor of using the state of domicile as the PPOB.

The Banks recommended substantive revisions to the proposed rule. For the general PPOB provision—which would allow the home office to be designated as the PPOB only if the institution also conducted some "business operations" from that office—the Banks recommended that FHFA specify what activities would constitute "business operations." Specifically, the Banks asked that FHFA define the term "business operations" to include an institution having any business, operations, or sales office in the domiciliary state, having any officer's place of employment located in the domiciliary state, or conducting any business in the domiciliary state, including the sale of insurance policies. The Banks contended that the addition of such requirements would ensure that an institution had more than a "mere legal presence" in its domiciliary state.

The Banks recommended similar revisions to the provision that would have applied solely to certain insurance companies and CDFI members, and which would have required a Bank to identify "the geographic location from which the institution actually conducts the predominant portion of its business activities." The Banks recommended

that FHFA add specific metrics to that provision that would provide clear guidance about what factors would constitute "the predominant portion" of a company's business activities. Specifically, the Banks recommended that the final rule allow the PPOB to be determined based on any two of the following factors: (1) the location of a plurality of the institution's employees; (2) the location of the places of employment of a plurality of certain specified senior executives; or (3) the location of the company's largest office (as measured by number of employees). Each of the Banks' proposed metrics is similar to the more generally phrased "objective factors" that FHFA had included as examples in the proposed rule, *i.e.*, "the location from which the institution's senior officers direct, control, and coordinate" an institution's activities, the "locations of the offices from which the institution conducts its business," and "the location from which its other officers and employees carry out the business activities." As discussed below, FHFA is persuaded that the final rule would be improved by the addition of the specific metrics suggested by the Banks and has incorporated them into the final rule.

All of the Banks that submitted similar comment letters also supported the third substantive revision in the proposed rule, which would have allowed the Banks to designate the state of domicile as the PPOB for any insurance company that maintains no physical offices of its own and has no employees of its own (*i.e.*, they are shared with other affiliates or the employee functions are performed by contractors), or whose executives may be situated at multiple locations. In addition to the matters discussed above, all of the Banks submitted supplemental comment letters in July 2015 that expressed their views on how to determine the PPOB for a captive insurance company. Certain Banks favored using the state of domicile for captives, while others favored other

approaches, such as the location of the parent company or the location of any affiliated company that is already a member of a Bank. Several of the Banks expressed concerns that allowing captives to use the state of domicile as their PPOB would encourage "district shopping" among the Banks by the parent companies of prospective captive members, which could undermine the cooperative nature of the Bank System. Because FHFA has defined the term "insurance company" to exclude captives and has required the termination of membership for existing captives members, FHFA has not addressed this issue in the final rule.

c. Overview of final PPOB provisions

In the final rule, FHFA has decided to adopt certain of the substantive amendments largely as they were proposed, and to modify the other provisions by incorporating the revisions recommended by the Banks. All of these provisions are to be applied prospectively, and thus will not affect current members. In addition, FHFA is adopting as proposed clarifying amendments to the "transfer of membership" provisions of § 1263.18(d)(1), which deals with transfers of membership from one Bank to another. The proposed rule would have revised this provision to make clear that it applies to instances where a member of one Bank either redesignates or relocates its PPOB to a state located in another Bank district. A "redesignation" of a PPOB can occur if a member satisfies the three-part test set out in § 1263.18(c), which remains unchanged in the final rule. A "relocation" of a member's PPOB would occur if it were to physically relocate its home office, as identified in its charter, to another state, such as in connection with a corporate reorganization, merger, or acquisition, and continued to conduct business from that new location. This revision is intended to reflect the two methods by

which transfers of membership can occur—which had previously not been described by the regulation—and is related to revisions made to § 1263.4(b), regarding "automatic membership" that can occur as a result of such changes in a member's principal place of business. No commenters opposed these revisions to § 1263.18(d)(1).

d. General PPOB/home office test

The final rule adopts the amendment to the general PPOB provision, § 1263.18(b), as it was proposed. Thus, the general approach for designating the PPOB for any member is to identify the state within which the institution maintains its home office, as the home office is established in accordance with the laws under which the institution is organized, and to confirm that the institution also conducts business operations from that office. As noted previously, as increasing numbers of insurance companies and CDFIs have become members, FHFA has learned that it is possible for them to conduct all of their business activities in states other than those under whose laws they are domiciled or incorporated. Moreover, although the law of most states may require an insurance company to maintain a "home office" within the domicile state, FHFA is also aware of instances in which the statutory "home office" claimed to be the PPOB for membership purposes has been nothing more than the address of an in-state registered agent, such as a law firm, whose sole function may be to accept service of process on behalf of the insurance company. FHFA has received inquiries from the Banks about how to determine the PPOB for such institutions, and is aware of instances in which Banks have agreed between themselves that in such cases the appropriate Bank for membership purposes is the Bank from whose district the insurance company or CDFI actually conducts its business operations, not the state of domicile.

As noted in the proposed rule, FHFA believes that the term "principal place of business" must be read to require that some material amount of business activities be conducted at that location, and that a mere legal presence – such as being domiciled or incorporated under the laws of a particular state, without more – is not sufficient to establish an institution's PPOB. Accordingly, in order to be consistent with Section 4(b) of the Bank Act, FHFA believes that it must amend the existing "home office" provision to address the above-described situations by requiring that the institution also conduct some business operations from its home office in order for that home office to be designated as its PPOB. The final rule retains the requirement of the existing rule, which requires that the "home office" be established as such under state law. FHFA has not accepted the Banks' suggested revisions to this paragraph—which would specify certain activities that could constitute conducting business operations from the home office—principally because the examples provided were too attenuated to be consistent with FHFA's concept of a "principal" place of business. The amendment made by the final rule should have no effect on depository institution applicants. The charters for depository institutions typically designate a location within a state as the institution's "home office," which location also will be a branch office at which the institution conducts some portion of its lending and deposit taking business, which is sufficient to meet the new standard. The amendment also should not adversely affect insurance company applicants because, as was pointed out by some commenters, most insurance companies in fact conduct some or all of their business operations from offices located within their state of domicile, and because the final rule includes a new provision, § 1263.18(f), that specifically addresses insurance companies and CDFIs that cannot

satisfy the general PPOB provision.

A significant number of commenters urged FHFA not to amend § 1263.18(b) and to "retain" what they believed to be its current regulatory approach, which they characterized as a "state of domicile" test for insurance companies. Neither FHFA nor any of its predecessor agencies has ever adopted a regulation that established a state of domicile approach for insurance companies or that otherwise specifically addressed insurance companies. The most likely reason is that the Bank System regulators had not previously seen any need to address those issues because insurance companies have, until relatively recently, been a very small portion of the membership base. Although the Bank Act has authorized insurance companies to become members since 1932, only in recent years has the number of insurance companies grown significantly. For example, as recently as 1996, the Bank System had no more than 31 insurance company members, out of a total membership base of 6,146.[98] By the end of 2014, the number of insurance company members had grown to 304, out of 7,367 total members.[99] Also, FHFA has become aware of the need to provide more specific guidance for identifying the PPOB for insurance companies and to first consider whether the state of domicile, by itself, is sufficient under the statute to constitute an insurance company's PPOB.

Moreover, although the language of the current regulation, which refers to the "home office established as such in conformity with the laws under which the institution is organized," could arguably be read as tantamount to a "state of domicile" test, neither

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[98] See Federal Home Loan Bank System, 1996 Financial Report at 10-11.
[99] See Federal Home Loan Banks, 2014 Combined Financial Report at 32. The same was true in the early years of the Bank System, as the annual reports for the Federal Home Loan Bank Board indicate that: as of June 30, 1935, there were three insurance companies among 3,324 total members; as of June 30, 1937, there were twelve insurance companies among 3,886 total members; and as of December 31, 1952 there were five insurance companies among 4,056 total members.

FHFA nor its predecessors has ever adopted that interpretation. Indeed, the history of this regulation indicates that it is unlikely that the predecessor agencies ever considered the concept of an insurance company's domicile when they adopted this language. The current language appears to date to 1958, when the FHLBB adopted a definition of "principal office" as part of its regulations that applied to savings associations that were insured by the Federal Savings and Loan Insurance Corporation (FSLIC). The 1981 regulations of the FSLIC defined "principal office" in much the same way as FHFA currently defines "principal place of business,"[100] but the context makes clear that the term could not have applied to insurance companies because it appeared within the regulations of the FSLIC, which applied only to federally insured savings and loan associations.[101] Through the more recent revisions to the membership regulations, neither FHFA nor the Finance Board has ever addressed whether it intended the term to be synonymous with an insurance company's state of domicile or a CDFI's state of incorporation. Moreover, although certain commenters contended that the Agency has used a "state of domicile" test for insurance companies, the fact is that some Banks

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[100] See 12 CFR 561.7 (1981). That provision defined "principal office" to mean "the home office of an institution established as such in conformity with the laws under which the insured institution is organized." The term "insured institution" was defined to mean a savings and loan association the deposits of which were insured by the FSLIC. 12 CFR 561.1 (1981). The 1981 Code of Federal Regulation citation indicates that that definition of "principal office" was adopted as part of the FSLIC regulations in 1958 and had not subsequently been amended.

[101] The definition of "principal office" at 12 CFR 561.7 (1981) was located within definitional sections of the regulations of the FSLIC, which applied only to federally insured savings and loan associations. Thus, there would have been no reason for the FSLIC to have considered anything having to do with insurance companies because they were not eligible for FSLIC insurance. The FHLBB did have separate regulations in 1981 governing the Bank System, but those regulations did not define "principal office" or "principal place of business." It was not until 1987 that the FHLBB incorporated this long-standing FSLIC definition of "principal office" into its membership regulations, which it did by cross-referencing the FSLIC definition. See 12 CFR 523.3-2 (1988) (PPOB for membership purposes is the state in which an institution maintains its "principal office" as defined in 12 CFR 561.7). In 1993, the Finance Board eliminated the cross-reference and provided that for membership purposes an institution's PPOB is the state in which it maintains its home office, established as such under the laws under which the institution is organized. See 12 CFR 933.5(b) (1994).

currently have as members insurance companies that are domiciled outside of the Bank's district. That suggests that even the Banks have not viewed FHFA's regulations as mandating the use of the state of domicile for making PPOB determinations.

The comment letters also raised other reasons for using a state of domicile approach, which include: (1) the belief that a separate PPOB provision for insurance companies would be unfair to depository institution members; (2) the need to recognize the primacy of state law with regard to matters of insurance company regulation; and (3) the belief that Banks should not be required to become familiar with the insurance laws for states outside of their districts. FHFA does not believe that any of those arguments are sufficient to overcome the Bank Act's requirement of more than a mere legal presence to constitute an institution's "principal" place of business. As to the unfairness issue, FHFA reiterates that it has adopted the amendments to address a specific concern—*i.e.,* the possibility that insurance companies and CDFIs can conduct business entirely outside of the state in which they are domiciled or incorporated, that is not presented by depository institutions. Adopting a regulation that addresses specific situations that are unique to insurance companies and CDFIs is a proper exercise of FHFA's regulatory authority and does not confer any advantage on insurance company or CDFI members.

As to the concern about not recognizing the primacy of state law on matters relating to the regulation of insurance companies, FHFA notes that the final rule does not purport to regulate in any way the operation of insurance companies. Rather, it implements a provision of the Bank Act, the interpretation of which Congress has vested solely in FHFA. The fact that a state insurance regulator may deem a simple legal

presence to be sufficient to constitute an institution's "home office" for purposes of the state insurance code does not mean that FHFA must construe the Bank Act in the same manner or that FHFA must defer to the interpretations of fifty different state insurance commissioners on that point. At its core, the final rule simply indicates the Bank to which an insurance company may apply for membership; it does not in any way interfere with the ability of a state insurance regulator to oversee the operations of the insurance companies domiciled in its state.

A number of the comment letters noted that FHFA has issued guidance stressing the importance of the Banks understanding the laws under which their insurance company members are chartered and developing relationships with the state insurance regulators. These commenters also have reasoned that it would be most consistent with that guidance for FHFA to adopt a state of domicile PPOB standard because doing so would allow the Banks to concentrate their resources on the insurance laws and insurance regulators for the states in their own districts. They have also contended that requiring them to develop such knowledge and relationships with the insurance regulators of other states would impose a significant burden. While FHFA acknowledges that developing a level of expertise about the insurance laws of any state and developing a relationship with the state insurance commissioners does require a commitment of time and resources, it does not believe that doing so would constitute an undue burden for any Bank. As noted previously, some Banks already have insurance company members that are domiciled in states outside of their districts. FHFA is not aware of any difficulties arising at those Banks from the fact that the state of domicile is outside of the Banks' districts. Indeed, FHFA has been told in at least one instance that Bank staff was fully committed to

developing the same level of expertise and communication regarding insurance company members domiciled outside of their district as they had done for those domiciled within the district.

e. PPOB for certain insurance companies and CDFIs

As proposed, § 1263.18(f) included two separate components—one dealing with certain CDFIs and insurance companies, and one dealing with insurance companies lacking any distinct physical presence. The first provision would have established a separate PPOB standard for insurance companies and CDFIs for which the Banks could not determine the PPOB under either the general provision of § 1263.18(b) (either because they lack a home office designated as such under state law or did not conduct business from their home office) or the alternative three-part test provision of § 1263.18(c). For those institutions, the proposed rule would have required the Banks to determine the geographic location from which the institutions actually conduct the predominant portion of their business activities, using "objective factors" to make that determination. The proposal included three examples of such objective factors. The second provision would have required the Banks to designate the state of domicile as the PPOB for an insurance company that did not have a physical presence in any state.

The Banks and others criticized the first provision, contending that the term "predominant portion of its business activities" was too vague and would result in different Banks reaching different conclusions as to what facts constitute the predominant portion of a company's business activities. As noted previously, the Banks recommended adding specific metrics to this provision, which FHFA agrees would make the final rule clearer and easier to administer. Accordingly, FHFA has incorporated the Banks'

suggested revisions into the final rule.

In the final rule, FHFA has modified proposed § 1263.18(f) in two respects, by adding language based on the comment letters from the Banks, and by replacing the proposed language that had dealt with insurance companies that maintain no physical offices of their own. Subsection (f) addresses only those insurance companies and CDFIs for which a Bank cannot designate the PPOB under the general provision of § 1263.18(b) or the existing three-part test of § 1263.18(c). The final rule retains the core concept of the proposed rule, which requires the Banks to designate as the PPOB for these institutions the geographic location from which the institutions actually conduct the predominant portion of their business activities.

To address the concerns of the commenters, FHFA has deleted the language of the proposal that would have required the Banks to make these determinations based on the totality of the circumstances and objective factors. In place of that language FHFA has added new language that closely follows the language recommended by the Banks. FHFA agrees that the three factors recommended by the Banks will provide a reasonable proxy for ascertaining the location from which an institution can be said to conduct the predominant portion of its business. Thus, the final rule will allow the Banks to deem an institution to conduct the predominant portion of its business in the state in which any two of three specified factors are present. The three factors are: (i) the state in which the institution's largest office (as measured by the number of employees) is located; (ii) the state in which a plurality of the institution's employees are located; and (iii) the state in which a plurality of the institution's senior executives are located. In the event that there is an institution for which this test does not work because each of the three factors would

identify a different state, then the Bank would be required to analyze the matter under the general standard of paragraph (f)(1), meaning that it should look to these and other factors of the Bank's choosing to determine from which of those three possible states the institution actually conducts the predominant portion of its business activities.

FHFA expects that there will be very few instances in which an institution would be unable to use this test, but because it is possible that each of these factors may point to a different state FHFA has decided to retain the general "predominant portion of its business activities" standard in the final rule to address such possibilities. The final rule adds new language, located in paragraph (f)(3) providing that if a Bank determines that it is unable to determine from which of those geographic locations the institution actually conducts the predominant portion of its business, then it shall designate the state of domicile as the PPOB. In considering the number of employees and senior executives for a particular insurance company or CDFI subject to this paragraph, the Banks should consider all such persons, regardless of whether those persons may also serve as joint employees or senior executives for affiliated companies. For purposes of this provision, the term "senior executives" is defined to include all officers at or above the level of senior vice president, and the final rule includes a non-exclusive list of examples of titles of the positions that would qualify as senior executives for this purpose.

f. PPOB for Insurance Companies with no Physical Offices

The proposed rule included one provision that dealt with insurance companies that have no physical offices of their own—*i.e.*, they neither own nor rent any office space. That provision would have permitted a Bank to designate the state of domicile as the PPOB for such insurance companies, provided that the insurance company also had

no employees of its own or whose senior officers are situated at multiple locations. The intent of this provision was to address situations that some Banks have brought to FHFA's attention in the case of insurance company applicants that are part of a holding company structure and that use employees and executives of their affiliated insurance companies as joint employees, or that use third party service providers to perform the services that otherwise would be performed by an institution's own employees. Most of the Banks supported this amendment and no commenters affirmatively opposed it, except to the extent that it was thought that it could be used by captives to "district shop" among the Banks.

In the final rule, however, FHFA has removed this provision because the situation that it was designed to address is now adequately covered under the revised provisions of the final rule, as described immediately above, which allow for the state of domicile to be designated as the PPOB if the Bank cannot use the two-factor test or otherwise identify a particular geographic location from which the predominant portion of the business is conducted. Thus, under this provision an insurance company that neither owns nor rents office space in its own name can use its state of domicile as its PPOB so long as a plurality of its employees and a plurality of its senior executives are not located in the same state.

The final rule also has relocated into a new § 1263.18(g) language from the proposed rule pertaining to the Banks' recordkeeping obligations with respect to their designation of their members' PPOBs. The substance of this provision is unchanged from the proposed rule. The final rule also carries over without substantive change the amendments to § 1263.18(d), pertaining to transfers of Bank membership resulting from

the relocation or redesignation of an institution's PPOB.

D. Bank Stock Requirements—§§ 1263.20–1263.23

Subpart D of part 1263 currently sets forth certain requirements regarding the purchase and disposition of Bank stock. As proposed, the final rule repeals several provisions within this subpart that relate to the purchase and disposition of Bank stock in accordance with the law in effect prior to the enactment of the Financial Services Modernization Act of 1999[102] (hereinafter, the "GLB Act"). Among other things, the GLB Act amended the Bank Act to require each Bank to establish and operate under its own capital structure plan.[103] The provisions being repealed no longer have any effect because all of the Banks are now operating under GLB Act capital plans. The provisions being repealed are: (1) § 1263.19, which generally requires Bank capital stock to be sold at par (because this requirement is now addressed in FHFA's regulations governing Bank capital); (2) portions of § 1263.20 that relate to the pre-GLB Act subscription capital requirements; (3) § 1263.21, pertaining to the issuance and form of Bank stock, primarily under the pre-GLB Act regime; and (4) portions of § 1261.22 relating to the redemption of excess shares of pre-GLB Act capital stock. The final rule retains the substance of the remaining provisions of existing subpart D, although those provisions have been reorganized to reflect the GLB Act capital provisions more explicitly.

As proposed, § 1263.20(a) of the final rule provides that an institution becomes a member only upon the purchase of the amount of membership stock required under the Bank's capital plan. This further requires an approved applicant to purchase the required stock within 60 days, or else its membership approval becomes void. This carries over

[102] Pub. L. No. 106-102, § 608, 113 Stat. 1338, 1458-61 (Nov. 12, 1999).
[103] See 12 U.S.C. 1426.

much of the substance of existing provisions that now appear, respectively, in paragraphs (a)(2) and (d) of existing § 1263.20.

Final § 1263.20(b) requires a Bank to issue its capital stock to a new member only after it has approved the institution for membership and received payment in full for the par value of the Bank stock. This replaces a similar provision, which had appeared in § 1263.21(a) of the existing regulation. Section 1263.20(c) of the final rule carries over the substance of existing § 1263.20(e) , and requires that each Bank report to FHFA information regarding each new member's minimum investment in Bank capital stock, in accordance with the instructions provided in FHFA's Data Reporting Manual.

The final rule also retains the substance of existing § 1263.22(b)(1), which requires each Bank to calculate annually each member's required minimum stock holdings for purposes of determining the number of votes that the member may cast in that year's election of directors, and sets forth the procedures and timing that each Bank must follow with regard to that calculation. That material is carried over with some minor textual edits to provide greater clarity, as the sole provision of proposed § 1263.22. Existing § 1263.23, which governs excess Bank stock, is retained without change.

E. Withdrawal, Termination, and Readmission—§§ 1263.24–1263.30

As proposed, the final rule implements a non-substantive structural change to part 1263 by consolidating sections that are currently dispersed among subparts E through H into subpart E.

Existing § 1263.24 governs the effects that a merger or other consolidation of members has on their membership status. The final rule would retain nearly all of the existing text of that section without change, but would revise § 1263.24(b)(5) to remove

references to Banks that have not yet converted to a GLB Act capital structure. The final rule also deletes existing § 1263.24(d), which addresses FHFA approval for transfers of Bank stock that occur in a merger of members, because it too implements a provision of the Bank Act that was repealed by the GLB Act.

Section 1263.26 of the existing regulation governs voluntary withdrawal from Bank membership. Paragraph (d) of that section conditioned the ability of a member to withdraw on FHFA having certified that the withdrawal will not cause the Bank system to fail to contribute the amounts required to fund the interest payments owed on obligations issued by the Resolution Funding Corporation (REFCorp).[104] Because the Banks satisfied their obligation to contribute to the debt service on the REFCorp bonds as of July 2011, this provision has become moot. The final rule deletes that provision but leaves the remainder of § 1263.26 unchanged.

Section 1263.27 of the existing regulation establishes the grounds and procedures for the involuntary termination of an institution's Bank membership, as well as the rights of an institution whose membership is terminated. The final rule retains that section without change.

F. Other Membership Provisions—§§ 1263.31–1263.32

As proposed, the final rule consolidates sections of part 1263 that are currently contained in subparts I and J—§§ 1263.31 and 1263.32—into subpart F. The final rule retains these remaining provisions of the existing membership regulation without change, except that the cross-reference to § 1263.22(b)(1) found in § 1263.31(d) (which requires each member to provide its Bank annually with the data necessary to calculate its

[104] See 12 U.S.C. 1441b(f)(2)(C).

minimum required holdings of Bank stock) would be revised to reflect its redesignation as § 1263.22.

IV. Consideration of Differences Between the Banks and the Enterprises

Section 1313(f) of the Safety and Soundness Act requires the Director of FHFA, when promulgating regulations relating to the Banks, to consider the differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac) as they relate to: the Banks' cooperative ownership structure; the mission of providing liquidity to members; the affordable housing and community development mission; their capital structure; and their joint and several liability on consolidated obligations.[105] The Director also may consider any other differences that are deemed appropriate. In preparing this final rule, the Director considered the differences between the Banks and the Enterprises as they relate to the above factors, and determined that the rule is appropriate.

V. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) requires that FHFA consider the impact of paperwork and other information collection burdens imposed on the public.[106] Under the PRA and the implementing regulations of the Office of Management and Budget (OMB), an agency may not collect or sponsor the collection of information, nor may it impose an information collection requirement unless it displays a currently valid control number assigned by OMB.[107] FHFA's regulation "Members of the Federal Home Loan Banks," located at 12 CFR part 1263, contains several collections of information that OMB has approved under control number 2590-0003, which is due to expire on

[105] 12 U.S.C. 4513(f).
[106] See 44 U.S.C. 3507(a) and (d).
[107] See 44 U.S.C. 3512(a); 5 CFR 1320.8(b)(3)(vi).

December 31, 2016.

The proposed rule would have added a new collection of information to part 1263 related to the proposal to require an institution to hold at least one percent of its assets in "home mortgage loans" in order to satisfy the statutory "makes long-term home mortgage loans" and to require members to meet both that one percent requirement and the statutory "10 percent" requirement (where applicable) on an ongoing basis as a condition of remaining a Bank member. Because these changes are not being implemented in the final rule, there will be no new collection of information under part 1263; in addition, the existing collections under part 1263 will remain the same as those that have been approved by OMB under the existing clearance. Therefore, FHFA has withdrawn its request to OMB to approve a revision to control number 2590-0003.

VI. Regulatory Flexibility Act

The Regulatory Flexibility Act[108] (RFA) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation will not have a significant economic impact on a substantial number of small entities.[109] FHFA has considered the impact of the final rule under the RFA. The General Counsel of FHFA certifies that the final rule is not likely to have a significant economic impact on a substantial number of small entities because the regulation applies only to the Banks, which are not small entities for purposes of the RFA.

[108] 5 U.S.C. 601, et seq.
[109] See 5 U.S.C. 605(b).

List of Subjects in

12 CFR Part 1263

Federal home loan banks, Reporting and recordkeeping requirements.

Authority and Issuance

For the reasons stated in the **SUPPLEMENTARY INFORMATION**, FHFA hereby amends part 1263 of subchapter D of chapter XII, of title 12 of the Code of Federal Regulations as follows:

1. Revise part 1263 to read as follows:

PART 1263—MEMBERS OF THE BANKS

Subpart A—Definitions

Sec.
1263.1 Definitions.

Subpart B—Membership Application Process

1263.2 Membership application requirements.
1263.3 Decision on application.
1263.4 Automatic membership.
1263.5 Appeals.

Subpart C—Eligibility Requirements

1263.6 General eligibility requirements.
1263.7 Duly organized requirement.
1263.8 Subject to inspection and regulation requirement.
1263.9 Makes long-term home mortgage loans requirement.
1263.10 Ten percent requirement for certain insured depository institution applicants.
1263.11 Financial condition requirement for depository institutions and CDFI credit unions.
1263.12 Character of management requirement.
1263.13 Home financing policy requirement.
1263.14 De novo insured depository institution applicants.
1263.15 Recently consolidated applicants.
1263.16 Financial condition requirement for insurance company and certain CDFI applicants.

1263.17 Rebuttable presumptions.
1263.18 Determination of appropriate Bank district for membership.

Subpart D—Stock Requirements

1263.19 [Reserved].
1263.20 Stock purchase.
1263.21 [Reserved].
1263.22 Annual calculation of stock holdings.
1263.23 Excess stock.

Subpart E—Withdrawal, Termination, and Readmission

1263.24 Consolidations involving members.
1263.25 [Reserved].
1263.26 Voluntary withdrawal from membership.
1263.27 Involuntary termination of membership.
1263.28 [Reserved].
1263.29 Disposition of claims.
1263.30 Readmission to membership.

Subpart F—Other Membership Provisions

1263.31 Reports and examinations.
1263.32 Official membership insignia.

Authority: 12 U.S.C. 1422, 1423, 1424, 1426, 1430, 1442, 4511, 4513.

Subpart A—Definitions

§ 1263.1 Definitions.

For purposes of this part:

Adjusted net income means net income, excluding extraordinary items such as income received from, or expense incurred in, sales of securities or fixed assets, reported on a regulatory financial report.

Affiliate means any entity that controls, is controlled by, or is under common control with another entity. For purposes of this definition, one entity controls another if it:

(1) Directly or indirectly, or acting through one or more other persons, owns, controls, or has the power to vote twenty-five (25) percent or more of the outstanding shares of any class of voting securities of the other entity, including shares of common or preferred stock, general or limited partnership shares or interests, or similar interests that entitle the holder:

(i) To vote for or to select directors, trustees, or partners (or individuals exercising similar functions) of that entity; or

(ii) To vote on or to direct the conduct of the operations or other significant policies of that entity;

(2) Controls in any manner the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the other entity; or

(3) Otherwise has the power to exercise, directly or indirectly, a controlling influence over the management or policies of the other entity through a management agreement, common directors or management officials, or by any other means.

Aggregate unpaid loan principal means the aggregate unpaid principal of a subscriber's or member's home mortgage loans, home-purchase contracts and similar obligations.

Allowance for loan and lease losses means a specified balance-sheet account held to fund potential losses on loans or leases, which is reported on a regulatory financial report.

Appropriate regulator means:

(1) In the case of an insured depository institution or a CDFI credit union, an appropriate Federal banking agency or appropriate State regulator, as applicable; or

(2) In the case of an insurance company, an appropriate State regulator accredited by the NAIC.

Captive means an entity that holds an insurance license or charter under the laws of a State, but that does not meet the definition of "insurance company" set forth in this section or fall within any other category of institution that may be eligible for membership.

CDFI credit union means a State-chartered credit union that has been certified as a CDFI by the CDFI Fund and that does not have federal share insurance.

CDFI Fund means the Community Development Financial Institutions Fund established under section 104(a) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4703(a)).

CFI asset cap means $1 billion, as adjusted annually by FHFA, beginning in 2009, to reflect any percentage increase in the preceding year's Consumer Price Index (CPI) for all urban consumers, as published by the U.S. Department of Labor.

Class A stock means capital stock issued by a Bank, including subclasses, that has the characteristics specified in section 6(a)(4)(A)(i) of the Bank Act (12 U.S.C. 1426(a)(4)(A)(i)) and applicable FHFA regulations.

Class B stock means capital stock issued by a Bank, including subclasses, that has the characteristics specified in section 6(a)(4)(A)(ii) of the Bank Act (12 U.S.C. 1426(a)(4)(A)(ii)) and applicable FHFA regulations.

Combination business or farm property means real property for which the total appraised value is attributable to residential, and business or farm uses.

Community development financial institution or CDFI means an institution that is

certified as a community development financial institution by the CDFI Fund under the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4701 et seq.), other than a bank or savings association insured under the Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.), a holding company for such a bank or savings association, or a credit union insured under the Federal Credit Union Act (12 U.S.C. 1751 et seq.).

Community financial institution or CFI means an institution:

(1) The deposits of which are insured under the Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.); and

(2) The total assets of which, as of the date of a particular transaction, are less than the CFI asset cap, with total assets being calculated as an average of total assets over three years, with such average being based on the institution's regulatory financial reports filed with its appropriate regulator for the most recent calendar quarter and the immediately preceding 11 calendar quarters.

Composite regulatory examination rating means a composite rating assigned to an institution following the guidelines of the Uniform Financial Institutions Rating System (issued by the Federal Financial Institutions Examination Council), including a CAMELS rating or other similar rating, contained in a written regulatory examination report.

Consolidation means a combination of two or more business entities, and includes a consolidation of two or more entities into a new entity, a merger of one or more entities into another entity, or a purchase of substantially all of the assets and assumption of substantially all of the liabilities of an entity by another entity.

CRA means the Community Reinvestment Act of 1977 (12 U.S.C. 2901 et seq.).

CRA performance evaluation means, unless otherwise specified, a formal performance evaluation of an institution prepared by its appropriate regulator as required by the CRA or, if such a formal evaluation is unavailable for a particular institution, an informal or preliminary evaluation.

De novo insured depository institution means an insured depository institution with a charter approved by its appropriate regulator within the three years prior to the date the institution applies for Bank membership.

Dwelling unit means a single room or a unified combination of rooms designed for residential use.

Enforcement action means any written notice, directive, order, or agreement initiated by an applicant for Bank membership or by its appropriate regulator to address any operational, financial, managerial, or other deficiencies of the applicant identified by such regulator. An "enforcement action" does not include a board of directors' resolution adopted by the applicant in response to examination weaknesses identified by such regulator.

Funded residential construction loan means the portion of a loan secured by real property made to finance the on-site construction of dwelling units on one-to-four family property or multifamily property disbursed to the borrower.

Gross revenues means, in the case of a CDFI applicant, total revenues received from all sources, including grants and other donor contributions and earnings from operations.

Home mortgage loan means:

(1) A loan, whether or not fully amortizing, or an interest in such a loan, which is

secured by a mortgage, deed of trust, or other security agreement that creates a first lien on one of the following interests in property:

(i) One-to-four family property or multifamily property, in fee simple;

(ii) A leasehold on one-to-four family property or multifamily property under a lease of not less than 99 years that is renewable, or under a lease having a period of not less than 50 years to run from the date the mortgage was executed; or

(iii) Combination business or farm property where at least fifty (50) percent of the total appraised value of the combined property is attributable to the residential portion of the property, or in the case of any community financial institution, combination business or farm property, on which is located a permanent structure actually used as a residence (other than for temporary or seasonal housing), where the residence constitutes an integral part of the property; or

(2) A security representing:

(i) A right to receive a portion of the cash flows from a pool of long-term loans, provided that, at the time of issuance of the security, all of the loans meet the requirements of paragraph (1) of this definition; or

(ii) An interest in other securities, all of which meet the requirements of paragraph (2)(i) of this definition.

Insurance company means 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.

Insured depository institution means an insured depository institution as defined in section 2(9) of the Bank Act, as amended (12 U.S.C. 1422(9)).

Long-term means a term to maturity of five years or greater at the time of origination.

Manufactured housing means a manufactured home as defined in section 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974, as amended (42 U.S.C. 5402(6)).

Multifamily property means:

(1) Real property that is solely residential and includes five or more dwelling units;

(2) Real property that includes five or more dwelling units combined with commercial units, provided that the property is primarily residential; or

(3) Nursing homes, dormitories, or homes for the elderly.

NAIC means the National Association of Insurance Commissioners.

Nonperforming loans and leases means the sum of the following, reported on a regulatory financial report:

(1) Loans and leases that have been past due for 90 days (60 days, in the case of credit union applicants) or longer but are still accruing;

(2) Loans and leases on a nonaccrual basis; and

(3) Restructured loans and leases (not already reported as nonperforming).

Nonresidential real property means real property that is not used for residential purposes, including business or industrial property, hotels, motels, churches, hospitals, educational and charitable institution buildings or facilities, clubs, lodges, association buildings, golf courses, recreational facilities, farm property not containing a dwelling unit, or similar types of property.

One-to-four family property means:

(1) Real property that is solely residential, including one-to-four family dwelling units or more than four family dwelling units if each dwelling unit is separated from the other dwelling units by dividing walls that extend from ground to roof, such as row houses, townhouses, or similar types of property;

(2) Manufactured housing if applicable State law defines the purchase or holding of manufactured housing as the purchase or holding of real property;

(3) Individual condominium dwelling units or interests in individual cooperative housing dwelling units that are part of a condominium or cooperative building without regard to the number of total dwelling units therein; or

(4) Real property which includes one-to-four family dwelling units combined with commercial units, provided the property is primarily residential.

Operating expenses means, in the case of a CDFI applicant, expenses for business operations, including, but not limited to, staff salaries and benefits, professional fees, interest, loan loss provision, and depreciation, contained in the applicant’s audited financial statements.

Other real estate owned means all other real estate owned (*i.e.*, foreclosed and repossessed real estate), reported on a regulatory financial report, and does not include direct and indirect investments in real estate ventures.

Regulatory examination report means a written report of examination prepared by the applicant's appropriate regulator, containing, in the case of insured depository institution applicants, a composite rating assigned to the institution following the guidelines of the Uniform Financial Institutions Rating System, including a CAMELS

rating or other similar rating.

Regulatory financial report means a financial report that an applicant is required to file with its appropriate regulator on a specific periodic basis, including the quarterly call report for commercial banks and savings associations, quarterly or semi-annual call report for credit unions, NAIC's annual or quarterly statement for insurance companies, or other similar report, including such report maintained by the appropriate regulator in an electronic database.

Residential mortgage loan means any one of the following types of loans, whether or not fully amortizing:

(1) A home mortgage loan;

(2) A funded residential construction loan;

(3) A loan secured by manufactured housing whether or not defined by State law as secured by an interest in real property;

(4) A loan secured by a junior lien on one-to-four family property or multifamily property;

(5) A security representing:

(i) A right to receive a portion of the cash flows from a pool of loans, provided that, at the time of issuance of the security, all of the loans meet the requirements of one of paragraphs (1) through (4) of this definition; or

(ii) An interest in other securities that meet the requirements of paragraph (5)(i) of this definition;

(6) A home mortgage loan secured by a leasehold interest, as defined in paragraph (1)(ii) of the definition of "home mortgage loan," except that the period of the lease term

may be for any duration; or

(7) A loan that finances one or more properties or activities that, if made by a member, would satisfy the statutory requirements for the Community Investment Program established under section 10(i) of the Bank Act (12 U.S.C. 1430(i)), or the regulatory requirements established for any Community Investment Cash Advance program.

Restricted assets means both permanently restricted assets and temporarily restricted assets, as those terms are used in Financial Accounting Standard No. 117, or any successor publication.

Total assets means the total assets reported on a regulatory financial report or, in the case of a CDFI applicant, the total assets contained in the applicant's audited financial statements.

Unrestricted cash and cash equivalents means, in the case of a CDFI applicant, cash and highly liquid assets that can be easily converted into cash that are not restricted in a manner that prevents their use in paying expenses, as contained in the applicant's audited financial statements.

Subpart B—Membership Application Process

§ 1263.2 Membership application requirements.

(a) Application. Except as otherwise specified in this part, no institution may become a member of a Bank unless it has submitted to that Bank an application that satisfies the requirements of this part. The application shall include a written resolution or certification duly adopted by the applicant's board of directors, or by an individual with authority to act on behalf of the applicant's board of directors, of the following:

(1) Applicant review. The applicant has reviewed the requirements of this part and, as required by this part, has provided to the best of its knowledge the most recent, accurate, and complete information available; and

(2) Duty to supplement. The applicant will promptly supplement the application with any relevant information that comes to its attention prior to the Bank's decision on whether to approve or deny the application, and if the Bank's decision is appealed pursuant to § 1263.5, prior to resolution of any appeal by FHFA.

(b) Digest. The Bank shall prepare a written digest for each applicant stating whether or not the applicant meets each of the requirements in §§ 1263.6 to 1263.18, the Bank's findings, and the reasons therefor. In preparing a digest for an applicant whose satisfaction of the membership eligibility requirements of § 1263.6(a) is contingent upon its meeting the definition of "insurance company" set forth in § 1263.1, the Bank shall state its conclusion as to whether the applicant meets that definition and summarize the bases for that conclusion.

(c) File. The Bank shall maintain a membership file for each applicant for at least three years after the Bank decides whether to approve or deny membership or, in the case of an appeal to FHFA, for three years after the resolution of the appeal. The membership file shall contain at a minimum:

(1) Digest. The digest required by paragraph (b) of this section.

(2) Required documents. All documents required by §§ 1263.6 to 1263.18, including documents required to establish or rebut a presumption under this part, shall be described in and attached to the digest. The Bank is not required to retain in the file portions of regulatory financial reports that are not relevant to its decision on the

membership application. If an applicant's appropriate regulator requires return or destruction of a regulatory examination report, the date that the report is returned or destroyed shall be noted in the file.

(3) Additional documents. Any additional document submitted by the applicant, or otherwise obtained or generated by the Bank, concerning the applicant.

(4) Decision resolution. The decision resolution described in § 1263.3(b).

§ 1263.3 Decision on application.

(a) Authority. FHFA hereby authorizes the Banks to approve or deny all applications for membership, subject to the requirements of this part. The authority to approve membership applications may be exercised only by a committee of the Bank's board of directors, the Bank president, or a senior officer who reports directly to the Bank president, other than an officer with responsibility for business development.

(b) Decision resolution. For each applicant, the Bank shall prepare a written resolution duly adopted by the Bank's board of directors, by a committee of the board of directors, or by an officer with delegated authority to approve membership applications. The decision resolution shall state:

(1) That the statements in the digest are accurate to the best of the Bank's knowledge, and are based on a diligent and comprehensive review of all available information identified in the digest; and

(2) The Bank's decision and the reasons therefor. Decisions to approve an application should state specifically that:

(i) The applicant is authorized under the laws of the United States and the laws of the appropriate State to become a member of, purchase stock in, do business with, and

maintain deposits in, the Bank to which the applicant has applied; and

(ii) The applicant meets all of the membership eligibility criteria of the Bank Act and this part.

(c) Action on applications. The Bank shall act on an application within 60 calendar days of the date the Bank deems the application to be complete. An application is "complete" when a Bank has obtained all the information required by this part, and any other information the Bank deems necessary, to process the application. If an application that was deemed complete subsequently is deemed incomplete because the Bank determines during the review process that additional information is necessary to process the application, the Bank may suspend the 60-day processing period until the Bank again deems the application to be complete, at which time the processing period shall resume. The Bank shall notify an applicant in writing when it deems the applicant's application to be complete, and shall maintain a copy of the notice in the applicant's membership file. The Bank shall notify an applicant whenever it suspends or resumes the 60-day processing period, and shall maintain a written record of those notifications in the applicant's membership file. Within three business days of a Bank's decision on an application, the Bank shall provide the applicant and FHFA with a copy of the Bank's decision resolution.

§ 1263.4 Automatic membership.

(a) Automatic membership for certain charter conversions. An insured depository institution member that converts from one charter type to another automatically shall become a member of the Bank of which the converting institution was a member on the effective date of the conversion, provided that the converted institution continues to be an

insured depository institution and the assets of the institution immediately before and immediately after the conversion are not materially different. In such case, all relationships existing between the member and the Bank at the time of such conversion may continue.

(b) Automatic membership for transfers. Any member that relocates its principal place of business to another Bank district or that redesignates its principal place of business to another Bank district pursuant to § 1263.18(c) automatically shall become a member of the Bank of that district upon the purchase of the minimum amount of Bank stock required for membership in that Bank, as required by § 1263.20.

(c) Automatic membership, in the Bank's discretion, for certain consolidations.—(1) If a member institution (or institutions) and a nonmember institution are consolidated, and the consolidated institution has its principal place of business in a State in the same Bank district as the disappearing institution (or institutions), and the consolidated institution will operate under the charter of the nonmember institution, on the effective date of the consolidation, the consolidated institution may, in the discretion of the Bank of which the disappearing institution (or institutions) was a member immediately prior to the effective date of the consolidation, automatically become a member of such Bank upon the purchase of the minimum amount of Bank stock required for membership in that Bank, as required by § 1263.20, provided that:

(i) 90 percent or more of the consolidated institution's total assets are derived from the total assets of the disappearing member institution (or institutions); and

(ii) The consolidated institution provides written notice to such Bank, within 60 calendar days after the effective date of the consolidation, that it desires to be a member

of the Bank.

(2) The provisions of § 1263.24(b)(4)(i) shall apply, and upon approval of automatic membership by the Bank, the provisions of § 1263.24(c) shall apply.

§ 1263.5 Appeals.

(a) Appeals by applicants.—(1) Filing procedure. Within 90 calendar days of the date of a Bank's decision to deny an application for membership, the applicant may file a written appeal of the decision with FHFA.

(2) Documents. The applicant's appeal shall be addressed to the Deputy Director for Federal Home Loan Bank Regulation, Federal Housing Finance Agency, 400 Seventh Street, SW., Washington, DC 20219, with a copy to the Bank, and shall include the following documents:

(i) Bank's decision resolution. A copy of the Bank's decision resolution; and

(ii) Basis for appeal. An applicant must provide a statement of the basis for the appeal with sufficient facts, information, analysis, and explanation to rebut any applicable presumptions, or otherwise to support the applicant's position.

(b) Record for appeal.—(1) Copy of membership file. Upon receiving a copy of an appeal, the Bank whose action has been appealed (appellee Bank) shall provide FHFA with a copy of the applicant's complete membership file. Until FHFA resolves the appeal, the appellee Bank shall supplement the materials provided to FHFA as any new materials are received.

(2) Additional information. FHFA may request additional information or further supporting arguments from the appellant, the appellee Bank, or any other party that FHFA deems appropriate.

(c) Deciding appeals. FHFA shall consider the record for appeal described in paragraph (b) of this section and shall resolve the appeal based on the requirements of the Bank Act and this part within 90 calendar days of the date the appeal is filed with FHFA. In deciding the appeal, FHFA shall apply the presumptions in this part, unless the appellant or appellee Bank presents evidence to rebut a presumption as provided in § 1263.17.

Subpart C—Eligibility Requirements

§ 1263.6 General eligibility requirements.

(a) Requirements. Any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, community development financial institution (including a CDFI credit union), or insured depository institution shall be eligible for Bank membership if:

(1) It is duly organized under tribal law, or under the laws of any State or of the United States;

(2) It is subject to inspection and regulation under the banking laws, or under similar laws, of any State or of the United States or, in the case of a CDFI, is certified by the CDFI Fund;

(3) It makes long-term home mortgage loans;

(4) Its financial condition is such that advances may be safely made to it;

(5) The character of its management is consistent with sound and economical home financing;

(6) Its home financing policy is consistent with sound and economical home financing; and

(7) It has complied with any applicable requirement of paragraphs (b) and (c) of this section.

(b) Additional eligibility requirement for insured depository institutions other than community financial institutions. In order to be eligible to become a member of a Bank, an insured depository institution applicant other than a community financial institution also must have at least 10 percent of its total assets in residential mortgage loans.

(c) Additional eligibility requirement for applicants that are not insured depository institutions. In order to be eligible to become a member of a Bank, an applicant that is not an insured depository institution also must have mortgage-related assets that reflect a commitment to housing finance, as determined by the Bank in its discretion.

(d) Ineligibility. Except as provided in paragraph (e) of this section, an institution that does not satisfy the requirements of this part shall be ineligible for membership.

(e) Treatment of captives previously admitted to membership. A Bank that admitted one or more captives to membership prior to [INSERT THE EFFECTIVE DATE OF THE FINAL RULE] shall wind down its relationship with, and terminate the membership of, each of those captives as provided in this paragraph (e).

(1) Captives admitted prior to September 12, 2014.—(i) A Bank shall have until [INSERT DATE FIVE (5) YEARS AFTER THE EFFECTIVE DATE OF THE FINAL RULE] to wind down its business transactions with any captive that it had admitted to membership prior to September 12, 2014, notwithstanding the captive's ineligibility for Bank membership. The Bank may make or renew an advance to such a captive only if:

(A) After making or renewing the advance, its total outstanding advances to that captive would not exceed 40 percent of the captive's total assets; and

(B) The new or renewed advance has a maturity date no later than [INSERT DATE FIVE (5) YEARS AFTER THE EFFECTIVE DATE OF THE FINAL RULE].

(ii) A Bank shall terminate the membership of any captive described in paragraph (e)(1)(i) of this section no later than [INSERT DATE FIVE (5) YEARS AFTER THE EFFECTIVE DATE OF THE FINAL RULE], as provided under § 1263.27. After termination, the Bank shall require the liquidation of any outstanding indebtedness owed by, and the settlement of all other outstanding business transactions with, such terminated captive, and shall redeem or repurchase the Bank stock owned by the captive in accordance with § 1263.29; provided that the Bank may allow the captive to repay any outstanding advance made or last renewed in accordance with the applicable requirements then in effect and having a maturity date later than its date of termination in accordance with its terms and delay the repurchase of any Bank stock held in support of that advance until after the advance has been repaid, in accordance with the Bank's capital plan.

(2) Captives admitted on or after September 12, 2014.—(i) A Bank shall have until [INSERT DATE ONE (1) YEAR AFTER THE EFFECTIVE DATE OF THE FINAL RULE] to wind down its business transactions with any captive that it had admitted to membership on or after September 12, 2014, notwithstanding the captive's ineligibility for Bank membership. The Bank shall not make or renew any advance to such a captive.

(ii) A Bank shall terminate the membership of any captive described in paragraph (e)(2)(i) of this section no later than [INSERT DATE ONE (1) YEAR AFTER THE EFFECTIVE DATE OF THE FINAL RULE], as provided under § 1263.27. Upon

termination, the Bank shall require the liquidation of any outstanding indebtedness owed by, and the settlement of all other outstanding business transactions with, such terminated captive, and shall redeem or repurchase the Bank stock owned by the captive in accordance with § 1263.29; provided that all advances outstanding to that member must be repaid in full by the termination date.

§ 1263.7 Duly organized requirement.

An applicant shall be deemed to be duly organized, as required by section 4(a)(1)(A) of the Bank Act (12 U.S.C. 1424(a)(1)(A)) and § 1263.6(a)(1), if it is chartered by a State or federal agency as a building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, or insured depository institution or, in the case of a CDFI applicant, is incorporated under State or tribal law.

§ 1263.8 Subject to inspection and regulation requirement.

An applicant shall be deemed to be subject to inspection and regulation, as required by section 4(a)(1)(B) of the Bank Act (12 U.S.C. 1424 (a)(1)(B)) and § 1263.6(a)(2) if, in the case of an insured depository institution or insurance company applicant, it is subject to inspection and regulation by its appropriate regulator. A CDFI applicant that is certified by the CDFI Fund is not subject to this requirement.

§ 1263.9 Makes long-term home mortgage loans requirement.

An applicant shall be deemed to make long-term home mortgage loans, as required by section 4(a)(1)(C) of the Bank Act (12 U.S.C. 1424(a)(1)(C)) and § 1263.6(a)(3), if, based on the applicant's most recent regulatory financial report filed with its appropriate regulator, or other documentation provided to the Bank, in the case of

a CDFI applicant that does not file such reports, the applicant originates or purchases long-term home mortgage loans.

§ 1263.10 Ten percent requirement for certain insured depository institution applicants.

An insured depository institution applicant that is subject to the 10 percent requirement of section 4(a)(2)(A) of the Bank Act (12 U.S.C. 1424(a)(2)(A)) and § 1263.6(b) shall be deemed to comply with that requirement if, based on the applicant's most recent regulatory financial report filed with its appropriate regulator, the applicant has at least 10 percent of its total assets in residential mortgage loans, except that any assets used to secure mortgage-backed securities as described in paragraph (5) of the definition of "residential mortgage loan" set forth in § 1263.1 shall not be used to meet this requirement.

§ 1263.11 Financial condition requirement for depository institutions and CDFI credit unions.

(a) Review requirement. In determining whether a building and loan association, savings and loan association, cooperative bank, homestead association, savings bank, insured depository institution, or CDFI credit union has complied with the financial condition requirements of section 4(a)(2)(B) of the Bank Act (12 U.S.C. 1424(a)(2)(B)) and § 1263.6(a)(4), the Bank shall obtain as a part of the membership application and review each of the following documents:

(1) Regulatory financial reports. The regulatory financial reports filed by the applicant with its appropriate regulator for the last six calendar quarters and three year-ends preceding the date the Bank receives the application;

(2) Financial statement. In order of preference—

(i) The most recent independent audit of the applicant conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the applicant;

(ii) The most recent independent audit of the applicant's parent holding company conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the consolidated holding company but not on the applicant separately;

(iii) The most recent directors' examination of the applicant conducted in accordance with generally accepted auditing standards by a certified public accounting firm;

(iv) The most recent directors' examination of the applicant performed by other external auditors;

(v) The most recent review of the applicant's financial statements by external auditors;

(vi) The most recent compilation of the applicant's financial statements by external auditors; or

(vii) The most recent audit of other procedures of the applicant.

(3) Regulatory examination report. The applicant's most recent available regulatory examination report prepared by its appropriate regulator, a summary prepared by the Bank of the applicant's strengths and weaknesses as cited in the regulatory examination report, and a summary prepared by the Bank or applicant of actions taken by the applicant to respond to examination weaknesses;

(4) Enforcement actions. A description prepared by the Bank or applicant of any outstanding enforcement actions against the applicant, responses by the applicant, reports as required by the enforcement action, and verbal or written indications, if available, from the appropriate regulator of how the applicant is complying with the terms of the enforcement action; and

(5) Additional information. Any other relevant document or information concerning the applicant that comes to the Bank's attention in reviewing the applicant's financial condition.

(b) Standards. An applicant of the type described in paragraph (a) of this section shall be deemed to be in compliance with the financial condition requirement of section 4(a)(2)(B) of the Bank Act (12 U.S.C. 1424(a)(2)(B)) and § 1263.6(a)(4), if:

(1) Recent composite regulatory examination rating. The applicant has received a composite regulatory examination rating from its appropriate regulator within two years preceding the date the Bank receives the application;

(2) Capital requirement. The applicant meets all of its minimum statutory and regulatory capital requirements as reported in its most recent quarter-end regulatory financial report filed with its appropriate regulator; and

(3) Minimum performance standard—(i) Except as provided in paragraph (b)(3)(iii) of this section, the applicant's most recent composite regulatory examination rating from its appropriate regulator within the past two years was "1", or the most recent rating was "2" or "3" and, based on the applicant's most recent regulatory financial report filed with its appropriate regulator, the applicant satisfied all of the following performance trend criteria—

(A) Earnings. The applicant's adjusted net income was positive in four of the six most recent calendar quarters;

(B) Nonperforming assets. The applicant's nonperforming loans and leases plus other real estate owned, did not exceed 10 percent of its total loans and leases plus other real estate owned, in the most recent calendar quarter; and

(C) Allowance for loan and lease losses. The applicant's ratio of its allowance for loan and lease losses plus the allocated transfer risk reserve to nonperforming loans and leases was 60 percent or greater during four of the six most recent calendar quarters.

(ii) For applicants that are not required to report financial data to their appropriate regulator on a quarterly basis, the information required in paragraph (b)(3)(i) of this section may be reported on a semi-annual basis.

(iii) A CDFI credit union applicant must meet the performance trend criteria in paragraph (b)(3)(i) of this section irrespective of its composite regulatory examination rating.

(c) Eligible collateral not considered. The availability of sufficient eligible collateral to secure advances to the applicant is presumed and shall not be considered in determining whether an applicant is in the financial condition required by section 4(a)(2)(B) of the Bank Act (12 U.S.C. 1424(a)(2)(B)) and § 1263.6(a)(4).

§ 1263.12 Character of management requirement.

(a) General. A building and loan association, savings and loan association, cooperative bank, homestead association, savings bank, insured depository institution, insurance company, and CDFI credit union shall be deemed to be in compliance with the character of management requirements of section 4(a)(2)(C) of the Bank Act (12 U.S.C.

1424(a)(2)(C)) and § 1263.6(a)(5) if the applicant provides to the Bank an unqualified written certification duly adopted by the applicant's board of directors, or by an individual with authority to act on behalf of the applicant's board of directors, that:

(1) Enforcement actions. Neither the applicant nor any of its directors or senior officers is subject to, or operating under, any enforcement action instituted by its appropriate regulator;

(2) Criminal, civil or administrative proceedings. Neither the applicant nor any of its directors or senior officers has been the subject of any criminal, civil or administrative proceedings reflecting upon creditworthiness, business judgment, or moral turpitude since the most recent regulatory examination report; and

(3) Criminal, civil or administrative monetary liabilities, lawsuits or judgments. There are no known potential criminal, civil or administrative monetary liabilities, material pending lawsuits, or unsatisfied judgments against the applicant or any of its directors or senior officers since the most recent regulatory examination report, that are significant to the applicant's operations.

(b) CDFIs other than CDFI credit unions. A CDFI applicant, other than a CDFI credit union, shall be deemed to be in compliance with the character of management requirement of § 1263.6(a)(5), if the applicant provides an unqualified written certification duly adopted by the applicant's board of directors, or by an individual with authority to act on behalf of the applicant's board of directors, that:

(1) Criminal, civil or administrative proceedings. Neither the applicant nor any of its directors or senior officers has been the subject of any criminal, civil or administrative proceedings reflecting upon creditworthiness, business judgment, or moral turpitude in

the past three years; and

(2) Criminal, civil or administrative monetary liabilities, lawsuits or judgments. There are no known potential criminal, civil or administrative monetary liabilities, material pending lawsuits, or unsatisfied judgments against the applicant or any of its directors or senior officers arising within the past three years that are significant to the applicant's operations.

§ 1263.13 Home financing policy requirement.

(a) Standard. An applicant shall be deemed to be in compliance with the home financing policy requirements of section 4(a)(2)(C) of the Bank Act (12 U.S.C. 1424(a)(2)(C)) and § 1263.6(a)(6), if the applicant has received a CRA rating of "Satisfactory" or better on its most recent CRA performance evaluation.

(b) Written justification required. An applicant that is not subject to the CRA shall file, as part of its application for membership, a written justification acceptable to the Bank of how and why the applicant's home financing policy is consistent with the Bank System's housing finance mission.

§ 1263.14 De novo insured depository institution applicants.

(a) Presumptive compliance. A de novo insured depository institution applicant shall be deemed to meet the duly organized, subject to inspection and regulation, financial condition, and character of management requirements of §§ 1263.7, 1263.8, 1263.11 and 1263.12, respectively.

(b) Makes long-term home mortgage loans requirement. A de novo insured depository institution applicant shall be deemed to make long-term home mortgage loans, as required by section 4(a)(1)(C) of the Bank Act (12 U.S.C. 1424(a)(1)(C)) and §

1263.6(a)(3), if it has filed as part of its application for membership a written justification acceptable to the Bank of how its home financing credit policy and lending practices will include originating or purchasing long-term home mortgage loans.

(c) 10 percent requirement.—(1) Conditional approval. If a de novo insured depository institution applicant that commenced its initial business operations less than one year before applying for Bank membership is subject to, but cannot yet meet, the 10 percent requirement of section 4(a)(2)(A) of the Bank Act (12 U.S.C. 1424(a)(2)(A)) and § 1263.6(b) as provided in § 1263.10, a Bank may conditionally approve that applicant for membership if it meets all other applicable requirements.

(2) Approval may become final. If, within one year after commencement of its initial business operations, an institution that was conditionally approved for membership under paragraph (c)(1) of this section supplies evidence acceptable to the Bank that it satisfies the 10 percent requirement as provided under § 1263.10, its membership approval shall become final.

(3) Approval may become void. If an institution that was conditionally approved for membership under paragraph (c)(1) does not satisfy the requirements of paragraph (c)(2) of this section, it shall be deemed to be out of compliance with the 10 percent requirement, and its conditional membership approval shall become void.

(d) Home financing policy requirement.—(1) Conditional approval. If a de novo insured depository institution applicant cannot meet the home financing policy requirement of section 4(a)(2)(C) of the Bank Act (12 U.S.C. 1424(a)(2)(C)) and § 1263.6(a)(6) as provided under § 1263.13 because it has not received its first CRA performance evaluation, a Bank may conditionally approve that applicant for

membership if it meets all other applicable requirements and has included in its application a written justification acceptable to the Bank of how and why its home financing credit policy and lending practices will meet the credit needs of its community.

(2) Approval may become final. If an institution that was conditionally approved for membership under paragraph (d)(1) of this section supplies evidence acceptable to the Bank that it has satisfied the home financing policy requirement as provided under § 1263.13 by receiving a CRA rating of "Satisfactory" or better on its first CRA performance evaluation, its membership approval shall cease to be conditional.

(3) Approval may become void. If an institution that was conditionally approved for membership under paragraph (d)(1) of this section receives a rating of "Needs to Improve" or "Substantial Non-Compliance" on its first CRA performance evaluation, and fails to rebut the presumption of non-compliance with the home financing policy requirement as provided under § 1263.17(f), it shall be deemed to be out of compliance with that requirement and its conditional membership approval shall become void.

(e) Other rules. An institution that has been conditionally approved for membership under paragraph (c)(1) or (d)(1) of this section shall be subject to all regulations applicable to members generally, including those relating to stock purchase requirements and or collateral, notwithstanding that its membership may be conditional for some period of time. If an institution's conditional membership approval becomes void as provided in paragraphs (c)(3) or (d)(3) of this section, then the Bank shall liquidate any outstanding indebtedness owed by the institution to the Bank and redeem or repurchase its capital stock in accordance with § 1263.29.

§ 1263.15 Recently consolidated applicants.

An applicant that has recently consolidated with another institution is subject to the requirements of §§ 1263.7 to 1263.13 except as provided in this section.

(a) Financial condition requirement. For purposes of § 1263.11(a)(1) and 1263.11(b)(3)(i)(A), a recently consolidated applicant that has not yet filed regulatory financial reports as a consolidated entity for six quarters or three calendar year-ends shall provide to the Bank:

(1) All regulatory financial reports that the applicant has filed as a consolidated entity; and

(2) Pro forma combined financial statements for those quarters for which actual combined regulatory financial reports are unavailable.

(b) Home financing policy requirement. For purposes of § 1263.13, a recently consolidated applicant that has not yet received its first CRA performance evaluation as a consolidated entity shall file as part of its application a written justification acceptable to the Bank of how and why the applicant's home financing credit policy and lending practices will meet the credit needs of its community.

(c) Makes long-term home mortgage loans requirement; 10 percent requirement. For purposes of determining compliance with §§ 1263.9 and 1263.10, a Bank may, in its discretion, permit a recently consolidated applicant that has not yet filed a regulatory financial report as a consolidated entity to provide the pro forma financial statement for the consolidated entity that the consolidating entities filed with the regulator that approved the consolidation.

§ 1263.16 Financial condition requirement for insurance company and certain CDFI applicants.

(a) Insurance companies.—(1) An insurance company applicant shall be deemed to meet the financial condition requirement of § 1263.6(a)(4) if the Bank determines:

(i) Based on the information contained in the applicant's most recent regulatory financial report filed with its appropriate regulator, that the applicant meets all of its minimum statutory and regulatory capital requirements and the capital standards established by the NAIC; and

(ii) Based on the applicant's most recent audited financial statements, that the applicant's financial condition is such that the Bank can safely make advances to it.

(2) In making the determination required under paragraph (a)(1)(ii) of this section, the Bank shall use audited financial statements that have been prepared in accordance with generally accepted accounting principles, if they are available. If they are not available, the Bank may use audited financial statements prepared in accordance with statutory accounting principles.

(b) CDFIs other than CDFI credit unions.—(1) Review requirement. In order for a Bank to determine whether a CDFI applicant, other than a CDFI credit union, has complied with the financial condition requirement of § 1263.6(a)(4), the applicant shall submit, as a part of its membership application, each of the following documents, and the Bank shall consider all such information prior to acting on the application for membership:

(i) Financial statements. An independent audit conducted within the prior year in accordance with generally accepted auditing standards by a certified public accounting firm, plus more recent quarterly statements, if available, and financial statements for the two years prior to the most recent audited financial statement. At a minimum, all such

financial statements must include income and expense statements, statements of activities, statements of financial position, and statements of cash flows. The financial statement for the most recent year must include separate schedules or disclosures of the financial position of each of the applicant's affiliates, descriptions of their lines of business, detailed financial disclosures of the relationship between the applicant and its affiliates (such as indebtedness or subordinate debt obligations), disclosures of interlocking directorships with each affiliate, and identification of temporary and permanently restricted funds and the requirements of these restrictions;

(ii) CDFI Fund certification. The certification that the applicant has received from the CDFI Fund. If the certification is more than three years old, the applicant must also submit a written statement attesting that there have been no material events or occurrences since the date of certification that would adversely affect its strategic direction, mission, or business operations; and

(iii) Additional information. Any other relevant document or information a Bank requests concerning the applicant's financial condition that is not contained in the applicant's financial statements, as well as any other information that the applicant believes demonstrates that it satisfies the financial condition requirement of § 1263.6(a)(4), notwithstanding its failure to meet any of the financial condition standards of paragraph (b)(2) of this section.

(2) Standards. A CDFI applicant, other than a CDFI credit union, shall be deemed to be in compliance with the financial condition requirement of § 1263.6(a)(4) if it meets all of the following minimum financial standards─

(i) Net asset ratio. The applicant's ratio of net assets to total assets is at least 20

percent, with net and total assets including restricted assets, where net assets is calculated as the residual value of assets over liabilities and is based on information derived from the applicant's most recent financial statements;

(ii) Earnings. The applicant has shown positive net income, where net income is calculated as gross revenues less total expenses, is based on information derived from the applicant's most recent financial statements, and is measured as a rolling three-year average;

(iii) Loan loss reserves. The applicant's ratio of loan loss reserves to loans and leases 90 days or more delinquent (including loans sold with full recourse) is at least 30 percent, where loan loss reserves are a specified balance sheet account that reflects the amount reserved for loans expected to be uncollectible and are based on information derived from the applicant's most recent financial statements;

(iv) Liquidity. The applicant has an operating liquidity ratio of at least 1.0 for the four most recent quarters, and for one or both of the two preceding years, where the numerator of the ratio includes unrestricted cash and cash equivalents and the denominator of the ratio is the average quarterly operating expense.

§ 1263.17 Rebuttable presumptions.

(a) Rebutting presumptive compliance. The presumption that an applicant meeting the requirements of §§ 1263.7 to 1263.16 is in compliance with the corresponding eligibility requirements of section 4(a) of the Bank Act (12 U.S.C. 1424(a)) and § 1263.6(a) and (b), may be rebutted, and the Bank may deny membership to an applicant, if the Bank obtains substantial evidence to overcome the presumption of compliance.

(b) Rebutting presumptive noncompliance. The presumption that an applicant not

meeting a particular requirement of §§ 1263.8, 1263.11, 1263.12, 1263.13, or 1263.16, is not in compliance with the corresponding eligibility requirement of section 4(a) of the Bank Act (12 U.S.C. 1424(a)) and § 1263.6(a) may be rebutted and the applicant shall be deemed to be in compliance with an eligibility requirement, if it satisfies the applicable requirements in this section.

(c) Presumptive noncompliance by insurance company applicant with "subject to inspection and regulation" requirement of § 1263.8. If an insurance company applicant is not subject to inspection and regulation by an appropriate State regulator accredited by the NAIC, as required by § 1263.8, the applicant or the Bank shall prepare a written justification that provides substantial evidence acceptable to the Bank that the applicant is subject to inspection and regulation as required by § 1263.6(a)(2), notwithstanding the regulator's lack of NAIC accreditation.

(d) Presumptive noncompliance with financial condition requirements of §§ 1263.11 and 1263.16.—(1) Applicants subject to § 1263.11. For applicants subject to §1263.11, in the case of an applicant's lack of a composite regulatory examination rating within the two-year period required by § 1263.11(b)(1), a variance from the rating required by § 1263.11(b)(3)(i), or a variance from a performance trend criterion required by § 1263.11(b)(3)(i), the applicant or the Bank shall prepare a written justification pertaining to such requirement that provides substantial evidence acceptable to the Bank that the applicant is in the financial condition required by § 1263.6(a)(4), notwithstanding the lack of rating or variance.

(2) Applicants subject to § 1263.16. For applicants subject to § 1263.16, in the case of an insurance company applicant's variance from a capital requirement or standard

of § 1263.16(a) or, in the case of a CDFI applicant's variance from the standards of § 1263.16(b), the applicant or the Bank shall prepare a written justification pertaining to such requirement or standard that provides substantial evidence acceptable to the Bank that the applicant is in the financial condition required by § 1263.6(a)(4), notwithstanding the variance.

(e) Presumptive noncompliance with character of management requirement of § 1263.12.—(1) Enforcement actions. If an applicant or any of its directors or senior officers is subject to, or operating under, any enforcement action instituted by its appropriate regulator, the applicant shall provide or the Bank shall obtain:

(i) Regulator confirmation. Written or verbal confirmation from the applicant's appropriate regulator that the applicant or its directors or senior officers are in substantial compliance with all aspects of the enforcement action; or

(ii) Written analysis. A written analysis acceptable to the Bank indicating that the applicant or its directors or senior officers are in substantial compliance with all aspects of the enforcement action. The written analysis shall state each action the applicant or its directors or senior officers are required to take by the enforcement action, the actions actually taken by the applicant or its directors or senior officers, and whether the applicant regards this as substantial compliance with all aspects of the enforcement action.

(2) Criminal, civil or administrative proceedings. If an applicant or any of its directors or senior officers has been the subject of any criminal, civil or administrative proceedings reflecting upon creditworthiness, business judgment, or moral turpitude since the most recent regulatory examination report or, in the case of a CDFI applicant,

during the past three years, the applicant shall provide or the Bank shall obtain—

(i) Regulator confirmation. Written or verbal confirmation from the applicant's appropriate regulator that the proceedings will not likely result in an enforcement action; or

(ii) Written analysis. A written analysis acceptable to the Bank indicating that the proceedings will not likely result in an enforcement action or, in the case of a CDFI applicant, that the proceedings will not likely have a significantly deleterious effect on the applicant's operations. The written analysis shall state the severity of the charges, and any mitigating action taken by the applicant or its directors or senior officers.

(3) Criminal, civil or administrative monetary liabilities, lawsuits or judgments. If there are any known potential criminal, civil or administrative monetary liabilities, material pending lawsuits, or unsatisfied judgments against the applicant or any of its directors or senior officers since the most recent regulatory examination report or, in the case of a CDFI applicant, occurring within the past three years, that are significant to the applicant's operations, the applicant shall provide or the Bank shall obtain—

(i) Regulator confirmation. Written or verbal confirmation from the applicant's appropriate regulator that the liabilities, lawsuits or judgments will not likely cause the applicant to fall below its applicable capital requirements set forth in §§ 1263.11(b)(2) and 1263.16(a); or

(ii) Written analysis. A written analysis acceptable to the Bank indicating that the liabilities, lawsuits or judgments will not likely cause the applicant to fall below its applicable capital requirements set forth in § 1263.11(b)(2) or § 1263.16(a), or the net asset ratio set forth in § 1263.16(b)(2)(i). The written analysis shall state the likelihood

of the applicant or its directors or senior officers prevailing, and the financial consequences if the applicant or its directors or senior officers do not prevail.

(f) Presumptive noncompliance with home financing policy requirements of §§ 1263.13 and 1263.14(d). If an applicant received a "Substantial Non-Compliance" rating on its most recent CRA performance evaluation, or a "Needs to Improve" CRA rating on its most recent CRA performance evaluation and a CRA rating of "Needs to Improve" or better on any immediately preceding formal CRA performance evaluation, the applicant shall provide or the Bank shall obtain:

(1) Regulator confirmation. Written or verbal confirmation from the applicant's appropriate regulator of the applicant's recent satisfactory CRA performance, including any corrective action that substantially improved upon the deficiencies cited in the most recent CRA performance evaluation(s); or

(2) Written analysis. A written analysis acceptable to the Bank demonstrating that the CRA rating is unrelated to home financing, and providing substantial evidence of how and why the applicant's home financing credit policy and lending practices meet the credit needs of its community.

§ 1263.18 Determination of appropriate Bank district for membership.

(a) Eligibility.—(1) An institution eligible to be a member of a Bank under the Bank Act and this part may be a member only of the Bank of the district in which the institution's principal place of business is located, except as provided in paragraph (a)(2) of this section. A member shall promptly notify its Bank in writing whenever it relocates its principal place of business to another State and the Bank shall inform FHFA in writing of any such relocation.

(2) An institution eligible to become a member of a Bank under the Bank Act and this part may be a member of the Bank of a district adjoining the district in which the institution's principal place of business is located, if demanded by convenience and then only with the approval of FHFA.

(b) Principal place of business. Except as otherwise designated in accordance with this section, the principal place of business of an institution is the State in which the institution maintains its home office established as such in conformity with the laws under which the institution is organized and from which the institution conducts business operations.

(c) Designation of principal place of business.—(1) A member or an applicant for membership may request in writing to the Bank in the district where the institution maintains its home office that a State other than the State in which it maintains its home office be designated as its principal place of business. Within 90 calendar days of receipt of such written request, the board of directors of the Bank in the district where the institution maintains its home office shall designate a State other than the State where the institution maintains its home office as the institution's principal place of business, provided that, all of the following criteria are satisfied:

(i) At least 80 percent of the institution's accounting books, records, and ledgers are maintained, located or held in such designated State;

(ii) A majority of meetings of the institution's board of directors and constituent committees are conducted in such designated State; and

(iii) A majority of the institution's five highest paid officers have their place of employment located in such designated State.

(2) Written notice of a designation made pursuant to paragraph (c)(1) of this section shall be sent to the Bank in the district containing the designated State, FHFA, and the institution.

(3) The notice of designation made pursuant to paragraph (c)(1) of this section shall include the State designated as the principal place of business and the Bank of which the subject institution is eligible to be a member.

(4) If the board of directors of the Bank in the district where the institution maintains its home office fails to make the designation requested by the member or applicant pursuant to paragraph (c)(1) of this section, then the member or applicant may request in writing that FHFA make the designation.

(d) Transfer of membership.—(1) In the case of a member whose principal place of business has been designated as a State located in another Bank district in accordance with paragraph (c) of this section, or in the case of a member that has relocated its principal place of business to a State in another Bank district, the transfer of membership from one Bank to another Bank shall not take effect until the Banks involved reach an agreement on a method of orderly transfer.

(2) In the event that the Banks involved fail to agree on a method of orderly transfer, FHFA shall determine the conditions under which the transfer shall take place.

(e) Effect of transfer. A transfer of membership pursuant to this section shall be effective for all purposes, but shall not affect voting rights in the year of the transfer and shall not be subject to the provisions on termination of membership set forth in section 6 of the Bank Act (12 U.S.C. 1426) or §§ 1263.26 and 1263.27, nor the restriction on reacquiring Bank membership set forth in § 1263.30.

(f) Insurance companies and CDFIs.—(1) For an insurance company or CDFI that cannot satisfy the requirements of paragraphs (b) or (c) of this section for designating its principal place of business, a Bank shall designate as the principal place of business the geographic location from which the institution actually conducts the predominant portion of its business activities.

(2) A Bank may deem an institution to conduct the predominant portion of its business activities in a particular State if any two of the following three factors are present:

(i) The institution's largest office, as measured by the number of employees, is located in that State;

(ii) A plurality of the institution's employees are located in that State; or

(iii) The places of employment for a plurality of the institution's senior executives are located in that State.

(3) If a Bank cannot designate a State as the principal place of business under paragraph (1) of this section, and cannot otherwise identify a geographic location from which the institution actually conducts the predominant portion of its business activities, it shall designate the State of domicile or incorporation as the principal place of business for that institution.

(4) For purposes of paragraph (f)(2) of this section, the term "senior executive" means all officers at or above the level of "senior vice president" and includes the positions of president, executive vice president, chief executive officer, chief financial officer, chief operating officer, general counsel, as well as any individuals who perform functions similar to those positions whether or not the individual has an official title.

(g) Records. A Bank designating the principal place of business for a member under this section shall document the bases for its determination in writing and shall include that documentation in the membership digest and application file for the institution that are required under § 1263.2.

Subpart D—Stock Requirements

§ 1263.19 [Reserved].

§ 1263.20 Stock purchase.

(a) Minimum purchase requirement. An institution that has been approved for membership in a Bank as provided in this part shall become a member of that Bank upon purchasing the amount of stock required under the membership stock purchase provisions of that Bank's capital structure plan. If an institution fails to purchase the minimum amount of stock required for membership within 60 calendar days after the date on which it is approved for membership, the membership approval shall become void and that institution may not become a member of that Bank until after it has filed a new application and the Bank has approved that application pursuant to the requirements of this part.

(b) Issuance of stock. After approving an institution for membership, and in return for payment in full of the par value, a Bank shall issue to that institution the amount of capital stock required to be purchased under the Bank's capital structure plan.

(c) Reports. Each Bank shall report to FHFA information regarding the minimum investment in Bank capital stock made by each new member referred to in paragraph (a) of this section, in accordance with the instructions provided in the Data Reporting Manual.

§ 1263.21 [Reserved].

§ 1263.22 Annual calculation of stock holdings.

A Bank shall calculate annually each member's required minimum holdings of Bank stock using calendar year-end financial data provided by the member to the Bank, pursuant to § 1263.31(d), and shall notify each member of the result. The notice shall clearly state that the Bank's calculation of each member's minimum stock holdings is to be used to determine the number of votes that the member may cast in that year's election of directors and shall identify the State within the district in which the member will vote. A member that does not agree with the Bank's calculation of the minimum stock purchase requirement or with the identification of its voting State may request FHFA to review the Bank's determination. FHFA shall promptly determine the member's minimum required holdings and its proper voting State, which determination shall be final.

§ 1263.23 Excess stock.

(a) Sale of excess stock. Subject to the restriction in paragraph (b) of this section, a member may purchase excess stock as long as the purchase is approved by the member's Bank and is permitted by the laws under which the member operates.

(b) Restriction. Any Bank with excess stock greater than one percent of its total assets shall not declare or pay any dividends in the form of additional shares of Bank stock or otherwise issue any excess stock. A Bank shall not issue excess stock, as a dividend or otherwise, if after the issuance, the outstanding excess stock at the Bank would be greater than one percent of its total assets.

Subpart E—Withdrawal, Termination and Readmission

§ 1263.24 Consolidations involving members.

(a) Consolidation of members. 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 each disappearing institution shall terminate on the cancellation of its charter. Upon the consolidation of two or more institutions, at least two of which are members of different Banks, 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 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 that 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.

(b) Consolidation into nonmember.—(1) In general. 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.

(2) Notification. If a member has consolidated into a nonmember that has its principal place of business in a State in the same Bank district as the former member, the consolidated institution shall have 60 calendar days after the cancellation of the charter of the former member within which to notify the Bank of the former member that the

consolidated institution intends to apply for membership in such Bank. If the consolidated institution does not so notify the Bank by the end of the period, the Bank shall require the liquidation of any outstanding indebtedness owed by the former member, shall settle all outstanding business transactions with the former member, and shall redeem or repurchase the Bank stock owned by the former member in accordance with § 1263.29.

(3) Application. If such a consolidated institution has notified the appropriate Bank of its intent to apply for membership, the consolidated institution shall submit an application for membership within 60 calendar days of so notifying the Bank. If the consolidated institution does not submit an application for membership by the end of the period, the Bank shall require the liquidation of any outstanding indebtedness owed by the former member, shall settle all outstanding business transactions with the former member, and shall redeem or repurchase the Bank stock owned by the former member in accordance with § 1263.29.

(4) Outstanding indebtedness. If a member has consolidated into a nonmember institution, the Bank need not require the former member or its successor to liquidate any outstanding indebtedness owed to the Bank or to redeem its Bank stock, as otherwise may be required under § 1263.29, during:

(i) The initial 60 calendar-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.

(5) Approval of membership. If the application of such a consolidated institution is approved, the consolidated institution shall become a member of that Bank upon the purchase of the amount of Bank stock necessary, when combined with any Bank stock acquired from the disappearing member, to satisfy the minimum stock purchase requirements established by the Bank's capital structure plan.

(6) Disapproval of membership. If the Bank disapproves the application for membership of the consolidated institution, the Bank shall require the liquidation of any outstanding indebtedness owed by, and the settlement of all other outstanding business transactions with, the former member, and shall redeem or repurchase the Bank stock owned by the former member in accordance with § 1263.29.

(c) Dividends on acquired Bank stock. A consolidated institution shall be entitled to receive dividends on the Bank stock that it acquires as a result of a consolidation with a member in accordance with applicable FHFA regulations.

§ 1263.25 [Reserved].

§ 1263.26 Voluntary withdrawal from membership.

(a) In general.—(1) Any institution may withdraw from 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. The Bank need not commit to providing any further services, including advances, to a withdrawing member that would mature or otherwise terminate subsequent to the effective date of the withdrawal. A 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 on a

member that cancels a notice of withdrawal, provided that the fee or the manner of its calculation is specified in the Bank's capital plan.

(2) A Bank shall notify FHFA within 10 calendar days of receipt of any notice of withdrawal or notice of cancellation of withdrawal from membership.

(b) Effective date of withdrawal. The membership of an institution that has submitted a notice of withdrawal shall terminate as of the date on which the last of the applicable stock redemption periods ends for the stock that the member is required to hold, as of the date that the notice of withdrawal is submitted, under the terms of a Bank's capital plan as a condition of membership, unless the institution has cancelled its notice of withdrawal prior to the effective date of the termination of its membership.

(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, respectively, for all of the Class A and Class B stock held by that member that is not already subject to a pending request for 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 for any stock that is not subject to a pending notice of redemption shall be deemed to commence on the date on which the charter of the former member is cancelled.

§ 1263.27 Involuntary termination of membership.

(a) Grounds. The board of directors of a Bank may terminate the membership of any institution that:

(1) Fails to comply with any requirement of the Bank Act, any regulation adopted

by FHFA, or any requirement of the Bank's capital plan;

(2) Becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under federal or State law; or

(3) Would jeopardize the safety or soundness of the Bank if it were to remain a member.

(b) Stock redemption periods. The applicable 6-month and 5-year stock redemption periods, respectively, for all of the Class A and Class B stock owned by a member and not already subject to a pending request for redemption, shall commence on the date that the Bank terminates the institution's membership.

(c) Membership rights. An institution whose membership is terminated involuntarily under this section shall cease being a member as of the date on which the board of directors of the Bank acts to terminate the membership, and the institution shall have no right to obtain any of the benefits of membership after that date, but shall be entitled to receive any dividends declared on its stock until the stock is redeemed or repurchased by the Bank.

§ 1263.28 [Reserved].

§ 1263.29 Disposition of claims.

(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 outstanding indebtedness owed by that member to the Bank and for settling all other claims against the member. After all such obligations and claims have been extinguished or settled, the Bank shall return to the member all collateral pledged by the member to the Bank to secure its obligations to the Bank.

(b) Bank stock. If an institution that has withdrawn from membership or that otherwise has had its membership terminated remains indebted to the Bank or has outstanding any business transactions with the Bank after the effective date of its termination of membership, the Bank shall not redeem or repurchase any Bank stock that is required to support the indebtedness or the business transactions until after all such indebtedness and business transactions have been extinguished or settled.

§ 1263.30 Readmission to membership.

(a) In general. An institution that has withdrawn from membership or otherwise has had its membership terminated and which has divested all of its shares of Bank stock, may not be readmitted to membership in any Bank, or acquire any capital stock of any Bank, for a period of five years from the date on which its membership terminated and it divested all of its shares of Bank stock.

(b) Exceptions. An institution that transfers membership between two Banks without interruption shall not be deemed to have withdrawn from Bank membership or had its membership terminated.

Subpart F—Other Membership Provisions

§ 1263.31 Reports and examinations.

As a condition precedent to Bank membership, each member:

(a) Consents to such examinations as the Bank or FHFA may require for purposes of the Bank Act;

(b) Agrees that reports of examination by local, State or federal agencies or institutions may be furnished by such authorities to the Bank or FHFA upon request;

(c) Agrees to give the Bank or the appropriate Federal banking agency, upon

request, such information as the Bank or the appropriate Federal banking agency may need to compile and publish cost of funds indices and to publish other reports or statistical summaries pertaining to the activities of Bank members;

(d) Agrees to provide the Bank with calendar year-end financial data each year, for purposes of making the calculation described in § 1263.22; and

(e) Agrees to provide the Bank with copies of reports of condition and operations required to be filed with the member's appropriate Federal banking agency, if applicable, within 20 calendar days of filing, as well as copies of any annual report of condition and operations required to be filed.

§ 1263.32 Official membership insignia.

Members may display the approved insignia of membership on their documents, advertising and quarters, and likewise use the words "Member Federal Home Loan Bank System."

/s/ Dated: January 11, 2016
Melvin L. Watt,
Director, Federal Housing Finance Agency.