



# Federal Register

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**Tuesday,  
January 30, 2001**

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**Part II**

**Federal Housing  
Finance Board**

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**12 CFR Part 915, et al.  
Capital Requirements for Federal Home  
Loan Banks; Final Rule**

**FEDERAL HOUSING FINANCE BOARD****12 CFR Parts 915, 917, 925, 930, 931, 932, 933, 956, 966**

[No. 2000-46]

RIN 3069-AB01

**Capital Requirements for Federal Home Loan Banks****AGENCY:** Federal Housing Finance Board.**ACTION:** Final rule.

**SUMMARY:** The Federal Housing Finance Board (Finance Board) is amending its regulations to implement a new capital structure for the Federal Home Loan Banks (Banks), as required by the Gramm-Leach-Bliley Act. The final rule establishes risk-based and leverage capital requirements for the Banks. It also addresses the different classes of stock that a Bank may issue, the rights and preferences that may be associated with each class of stock, and the capital plans that each Bank must submit for Finance Board approval.

**EFFECTIVE DATE:** The final rule is effective on March 1, 2001.

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**SUPPLEMENTARY INFORMATION:****I. Statutory and Regulatory Background***A. The Bank System*

The twelve Banks are instrumentalities of the United States organized under the authority of the Federal Home Loan Bank Act (Bank Act). 12 U.S.C. 1423, 1432(a), *as amended*. The Banks are "government sponsored enterprises" (GSE), *i.e.*, federally chartered but privately owned institutions created by Congress to support the financing of housing and community lending by their members. See 12 U.S.C. 1422a(a)(3)(B)(ii), 1430(i), (j)(10) (1994). By virtue of their GSE status, the Banks are able to borrow in the capital markets at favorable rates.

The Banks then pass along that funding advantage to their members—and ultimately to consumers—by providing advances (secured loans) and other financial services to their members (principally, depository institutions) at rates that the members generally could not obtain elsewhere.

The Banks also are cooperatives, meaning that only their members may own the capital stock and share in the profits of the Banks and only their members, and certain eligible associates (such as state housing finance agencies), may borrow from or use the other products and services provided by the Banks. 12 U.S.C. 1426, 1430(a), 1430b, *as amended*. An institution that is eligible may become a member of a Bank if it satisfies certain statutory criteria and purchases a specified amount of the Bank's capital stock. 12 U.S.C. 1424, 1426 (1994). Together with the Office of Finance, the twelve Banks comprise the Bank System, which operates under the supervision of the Finance Board, an independent agency in the executive branch of the U.S. government. The primary duty of the Finance Board is to ensure that the Banks operate in a financially safe and sound manner; consistent with that duty the Finance Board is required to supervise the Banks, ensure that they carry out their housing finance mission, and ensure that they remain adequately capitalized and able to raise funds in the capital markets. 12 U.S.C. 1422a(a)(3)(A), (B) (1994).

*B. Federal Home Loan Bank Capital Structure*

Since its enactment in 1932, section 6 of the Bank Act has provided for a "subscription" capital structure for the Banks. Under that structure, the amount of capital stock that each Bank issued was determined by a statutory formula that dictated how much Bank stock each member must purchase. In accordance with that formula, each member was required to purchase Bank stock in an amount equal to one percent of the member's total mortgage assets or five percent of the advances outstanding to the member, whichever was greater. A principal shortcoming of the subscription capital structure was that the amount of capital maintained by each Bank bore little relation to the risks inherent in the assets and liabilities of the Bank.

With the enactment of the Gramm-Leach-Bliley Act, Pub. Law No. 106-102, 133 Stat. 1338 (Nov. 12, 1999) (GLB Act), the Congress amended section 6 of the Bank Act in its entirety, replacing the subscription capital provisions with risk-based and leverage capital

requirements that are similar to those applicable to depository institutions and to the other housing GSEs. The GLB Act mandated that the Finance Board issue regulations prescribing uniform capital standards applicable to each Bank in accordance with the provisions of the GLB Act. When the Finance Board's regulations are implemented, each Bank will be required to maintain permanent capital and total capital in amounts that are sufficient for the Bank to comply with the minimum risk-based and leverage capital requirements, respectively, established by the GLB Act.

The GLB Act requires each Bank to maintain "permanent capital" in an amount that is sufficient to meet the credit risk and market risk to which the Bank is subject, with the market risk being based on a stress test established by the Finance Board that tests for changes in certain specified market variables. Permanent capital is defined by statute to include the amounts paid-in for Class B stock plus the retained earnings of the Bank, with retained earnings being determined in accordance with generally accepted accounting principles (GAAP).

The GLB Act also requires each Bank to maintain "total capital" in amounts that are sufficient to comply with a minimum leverage requirement. Total capital is defined by the GLB Act to include a Bank's permanent capital, plus the amounts paid-in by the members for Class A stock, any general loss allowance (if consistent with GAAP and not established for specific assets), and other amounts from sources determined by the Finance Board as available to absorb losses. When measured by weighting the amount paid-in for Class B stock and the retained earnings by a factor of 1.5, each Bank must maintain a ratio of total capital to total assets of at least 5 percent. When measured on an unweighted basis, each Bank must maintain a ratio of total capital to total assets of at least 4 percent.

The GLB Act further requires the capital regulations issued by the Finance Board to address a number of other matters, such as the classes of stock that a Bank may issue, the rights, terms, and preferences that may be established for each class, the issuance, transfer, and redemption of Bank stock, and the liquidation of claims against a withdrawing member. The rules must permit each Bank to issue either Class A or Class B stock, or both, with the board of directors of each Bank to determine the rights, terms, and preferences for each class. Both Class A and Class B stock may be issued only to

and held only by members of the Bank, and the regulations are to provide the manner in which the stock may be sold, transferred, redeemed, or repurchased. The rules also must address the manner in which a Bank is to liquidate any claims against its members.

The GLB Act separately establishes a number of other capital-related requirements, which pertain to matters such as the termination of an institution's Bank membership, the ability of a Bank to repurchase excess stock held by a member (*i.e.*, stock that is in excess of the minimum stock investment that each member is required to hold), restrictions on the ability of a Bank to redeem stock when its capital is impaired, restrictions on readmission to membership after withdrawing, and the ownership of the retained earnings by the Class B stockholders.

Within 270 days after the publication of this final capital rule, the GLB Act requires the board of directors of each Bank to submit for Finance Board approval a capital plan that the board determines is best suited for the Bank and its members. Subsequent amendments to an approved capital plan also must be approved in advance by the Finance Board. The GLB Act requires the plan to include certain provisions, requires that it be consistent with the regulations adopted by the Finance Board, and that when implemented it must provide the Bank with sufficient capital to meet both the leverage and risk-based capital requirements. Each plan also must include certain provisions specified by the GLB Act. Those provisions relate to the minimum investment required of each member in order for the Bank to meet its regulatory capital requirements, the effective date of the plan and the length of any transition period, the classes of stock to be offered by the Bank and the rights, terms, and preferences associated with each class, the transferability of the Bank stock, the disposition of Bank stock held by institutions that withdraw from membership, and review of the plan by an independent accountant and a credit ratings agency. Those provisions are the minimum required by the GLB Act; the Finance Board may require that other provisions be included in each plan, and the Banks as well may include other provisions in their plans, provided they are consistent with the Bank Act and the regulations of the Finance Board.

### C. Federal Home Loan Bank Stock

Section 6 of the Bank Act, as in effect prior to the GLB Act, authorized the Banks to issue stock, specified the

characteristics of the stock, and addressed the manner in which the stock could be issued, transferred, and redeemed. 12 U.S.C. 1426 (1994). Since the establishment of the Bank System in 1932, each of the Banks has been authorized to issue a single class of stock, which could be issued and redeemed only at its statutory par value of \$100 per share. An institution becoming a Bank member was required to subscribe for a certain minimum amount of the Bank's stock, for which it was required to pay in full and in cash at the time of its application.<sup>1</sup>

The amount of the initial stock subscription required for membership was the greater of \$500, 1.0 percent of the member's mortgage assets, or 0.3 percent of the member's total assets.<sup>2</sup> 12 U.S.C. 1426(b), 1430(e) (1994). If a member were to borrow from its Bank, the amount of Bank stock it was required to own could not be less than 5.0 percent of the amount of Bank advances outstanding to the member. Each Bank was required to adjust the minimum stock investment required of each member, as of December 31st of each year, so that each member would own at least the required minimum amount of Bank stock, based on a percentage of either its assets or advances, whichever amount was higher. Each Bank had the discretion to retire any "excess" stock held by a member, *i.e.*, stock in excess of the minimum required for that member, upon the application of the member. Once issued, the stock of a Bank could be transferred only between the member and the Bank or, with the approval of the Finance Board, from one member to

<sup>1</sup> A member also was allowed to purchase the stock in installments, under which it would pay one-quarter of the full amount at the time of application, and the remainder in three installments over the following 12 months. 12 U.S.C. 1426(c) (1994).

<sup>2</sup> The Bank Act referred to a member's "aggregate unpaid loan principal," which the Finance Board has defined to include a variety of mortgage assets, such as home mortgage loans, combination loans, and mortgage pass-through securities. 12 U.S.C. 1426(b)(1) (1994); 65 FR 8253 (Feb. 18, 2000), 12 CFR 925.1. For purposes of applying the 1.0 percent of mortgage assets test, the Bank Act also established a statutory presumption that each member had at least 30 percent of its assets in mortgage related instruments. 12 U.S.C. 1430(e)(3) (1994). The effect of the presumption was that commercial banks (which typically have a lower percentage of their assets in mortgage related instruments than do savings associations) were required to maintain a minimum investment equal to the greater of 1.0 percent of mortgage assets, 0.3 percent of total assets, or 5.0 percent of outstanding advances. Separately, a member that was not a "qualified thrift lender" (QTL), *i.e.*, an institution with less than 65 percent of its assets in certain mortgage related instruments, was subject to a higher "percentage of advances" requirement, which varied inversely with its QTL ratio.

another member or to an institution in the process of becoming a member. The Bank Act required that all stock issued by a Bank share in dividends equally and without preference. The Bank Act also allowed any member, other than a federal savings and loan association, to withdraw from membership by providing six months written notice to the Finance Board. At the end of the six-month notice period, and provided that all indebtedness owed by the withdrawing member to the Bank had been liquidated, a Bank could redeem the stock of the withdrawing member, paying cash to the member equal to the par value of the stock. Any such withdrawing member could not rejoin the Bank system for 10 years, with only limited exceptions.

### D. Overview of the Proposed Rule

On July 13, 2000, the Finance Board published a Notice of Proposed Rulemaking to amend its regulations to implement the capital requirements of the GLB Act. The proposed rule initially included a 90-day comment period, which would have closed on October 11, 2000. See 65 FR 43408-43447 (July 13, 2000). On September 19, 2000, the Finance Board extended the comment period until November 20, 2000. See 65 FR 57748 (September 26, 2000).

The proposed rule contemplated a significantly different capital structure than that adopted in this final rule, which was due in large part to certain assumptions about how difficult it would be for the Banks to sell their new stock, particularly the Class B stock. For instance, it was initially envisioned that Class B stockholders would demand the ability to control the boards of directors of the Banks if they were to commit their capital for five years. In order to protect the interests of the Class A stockholders from possible manipulation by the Class B stockholders, the proposed rule would have required the Class A stock to pay a stated dividend that would have priority over the Class B dividends. The Finance Board also provided for maximum flexibility in the capital plans to allow for the Class B stock to have as many pure equity attributes as a Bank might wish to adopt. During the notice and comment period, the Finance Board's initial assumptions were challenged, and the concerns became less of an issue for the Banks and their members, and, therefore, less of a concern for the Finance Board.

Many provisions of the proposed rule paralleled the requirements of the GLB Act, such as authorizing each Bank to issue either or both Class A or Class B stock. The proposed rule also

authorized each Bank to issue subclasses of either Class A or Class B stock. The proposed rule would have established certain characteristics for the Class A stock, such as a stated dividend, a priority for payment of dividends, and a priority in liquidation. The Class A stock would be issued and redeemed at par value, but the Class B stock could be issued at par or at any other price. By statute, both classes of stock may be redeemed only at par value, but the proposed rule would have required the Banks to repurchase Class B stock at a negotiated price. The proposed rule required that a Bank issue stock only to its members and that the initial issuance of the Class A and/or Class B stock be done through any fair and equitable method of distribution. The Banks would have been permitted to require each member to invest in the Class A stock of the Bank as a condition of becoming a member of the Bank, though a member would have the option of investing a lesser amount in the Class B stock. The Banks also would have been permitted to require a member to invest in the Class A or Class B stock as a condition to doing business with the Bank. The proposed rule also would have required each Bank to specify "operating capital ratios," which would be somewhat greater than the Bank's minimum leverage and risk-based capital ratios. The proposed rule would have prohibited a Bank from requiring additional stock purchases by members if doing so would cause the Bank to exceed either its operating total capital ratio or its operating risk-based capital ratio, though it would have permitted a Bank to establish a membership fee in lieu of the minimum stock investment. Separately, the proposed rule would have prohibited any member (including its affiliates) from owning more than 40 percent of any class of Bank stock, or a lower limit established by the Bank.

Under the proposed rule, each Bank would have been authorized to determine the manner in which the members of the Bank were to elect directors and how the elected directorships were to be allocated, *i.e.*, among the several states in each district or otherwise. The voting rights also were to be determined by each Bank, subject to a regulatory cap that would have barred any member (including its affiliates) from casting more than 20 percent of the votes in any election of directors. Those provisions of the proposed rule were premised on an implicit repeal of section 7 of the Bank Act (which relates to the designation of directorships and the election of

directors) by the capital provisions of the GLB Act.

The proposed rule would have permitted a member to transfer Bank stock to another member, with such transfers being at a price to be agreed to by the members. It also would have barred any transfers of stock that would result in any member (including its affiliates) having more than 40 percent of any class of the Bank's outstanding stock, though it would have permitted a Bank to establish a lower percentage. In a similar fashion, the proposed rule would have allowed a Bank to repurchase its outstanding stock at any time, but at a negotiated price.

The proposed rule adopted the minimum total capital leverage requirement specified by the GLB Act. It also specified that a Bank must hold an amount of permanent capital at least equal to the sum of the Bank's credit, market, and operations risk charges, calculated as specified in the proposal. The Finance Board also proposed to reserve the right to require a Bank to hold amounts of total and permanent capital above the minimum specified levels, if such higher levels were warranted for reasons of safety or soundness.

The proposed rule set forth the methods to be used for calculating credit risk charges for all on-balance sheet assets and off-balance sheet items held by a Bank and established risk weightings for these assets and items based upon broad categories. In addition, for rated assets and off-balance sheet items and for mortgage assets, risk weightings were further differentiated by ratings and remaining maturity. The proposed rule also set forth broad standards that a Bank must meet in developing its internal risk model or cash-flow model to be used to calculate the Bank's market risk capital charge. The rule also required a Bank to receive Finance Board approval before the model could be used, and to undertake an annual validation of its model. The proposed rule also would have required a further capital charge equal to the amount by which the market value of the Bank's capital, calculated using the internal risk model, fell below 95 percent of the book value of the Bank's total capital, calculated using GAAP. The proposed rule also established an operations risk charge equal to 30 percent of a Bank's credit and market risk, but allowed a Bank to reduce this charge with Finance Board approval by providing an alternative method for calculating its operations risk or by obtaining insurance to cover it for such risk. The proposed rule, however, required that at no time could the

operations risk charge be less than ten percent of the Bank's credit and market risk charges. The proposed rule also required the Banks to calculate their capital levels and total risk-based capital charge as of the last business day of each month and report this information to the Finance Board by the fifteenth of the next month.

The proposed rule would have required a Bank to maintain sufficient liquidity to cover its needs for five days of inability to access the consolidated obligation debt markets. Separately, the proposed rule set forth limits on a Bank's extension of unsecured credit, both to a single counterparty and to affiliated counterparties, and established monthly reporting requirements based upon a Bank's extension of unsecured credit and combined secured and unsecured credit to a single counterparty and to affiliated counterparties. It also proposed incorporating into the rule, requirements from the Finance Board's Financial Management Policy (FMP) concerning a Bank's use of hedging instruments and proposed providing specific authority for the Banks to engage in certain off-balance sheet transactions.

#### *E. Overview of Comments Received*

The Finance Board received 143 comments on the proposed rule. Ten of those comments were submitted before the proposed rule was published. Of the 133 comments received after publication of the proposed rule, 25 comments came from the 12 Banks; 1 comment was received from a not-for-profit housing association; 73 comments were received from member institutions; 25 comments came from banking and other trade associations; 6 comments were received from other parties associated with the mortgage industry; 2 comments came from members of Congress, and 1 comment was submitted by the Department of the Treasury.

To the extent that the comments raised questions about particular aspects of the proposed rule, those comments and the Finance Board's response to them are discussed below as part of the explanation of the relevant provisions of the final rule.

In general, many commenters recommended that the Finance Board preserve the cooperative ownership structure of the Bank System by eliminating provisions of the proposed rule that were perceived to threaten the cooperative nature of the Bank System. In particular, a number of commenters believed that provisions in the proposed rule permitting the payment of

membership fees in lieu of a minimum stock investment, trading of Bank stock among the members, the repurchase of Bank stock at a negotiated price, and barring the Banks from requiring their members to retain Bank stock that was purchased to support a particular transaction with the Bank would undermine the cooperative structure of the Bank System because such provisions would tend to separate ownership of the Bank System from the use of its services.

Many commenters also recommended that the Finance Board pay close attention to the possible tax implications of provisions in the rule, principally as they relate to the members of the Banks. For example, commenters expressed concern that by establishing a stated dividend for the Class A stock and giving it a priority over payment of dividends on the Class B stock, the proposed rule might create a taxable event for certain members upon the conversion of some of their existing stock to Class A stock.

Commenters expressed other concerns about the capital structure provisions of the proposed rule. Nearly all commenters that addressed the issue of the operating capital ratios recommended that they be eliminated, principally because the manner in which the operating ratios would have worked would have resulted in members being treated unequally with regard to their stock purchase requirements, depending on when they purchased their stock. Many commenters asked, if the final regulation were to retain the operating ratio concept, that such limits should be more appropriately set as a range, rather than a fixed number. With respect to provisions related to the designation of directorships and the election of directors, many commenters believed that the GLB Act did not repeal by implication any provisions of section 7 of the Bank Act, as the Finance Board had proposed. With respect to the provision that would have barred any member or its affiliates from owning more than 40 percent of the stock of any Bank, nearly all commenters that addressed the issue recommended eliminating that provision, arguing that any concern about control of a Bank could be better addressed by limits on the amount of stock that a member may vote.

Many commenters addressed the risk-based capital provisions in the proposed rule. With respect to credit risk, many commenters argued that the capital charges assigned in the proposed rule to advances, as well as to mortgage assets rated BBB or lower, were too

conservative. With respect to market risk, many commenters indicated that the value-at-risk model is inappropriate for measuring the long-term market risk profile of a Bank. Many commenters also opposed applying a 95 percent of market value to book value test because they believe it fails to provide a Bank with sufficient flexibility to manage its entire portfolio of activities. Finally, with respect to operations risk, many commenters stated that a capital charge of 30 percent of the sum of credit and market risk was too high, and that there was no sound theoretical basis for linking operations risk to credit and market risk.

The Finance Board has made significant revisions in the final rule in response to the comments received, particularly with respect to matters of capital structure. The Finance Board also has retained much of the substance of the proposed rule with respect to the risk-based capital provisions. The changes from the proposed rule, as well as the provisions that have been retained, are described in more detail below in the discussion of specific provisions of the final rule.

## II. The Final Rule

### A. Part 915—Designation and Election of Directors

Certain provisions of part 931 of the proposed rule would have authorized each Bank to determine the allocation of the elected directorships among the states in the Bank's district, and to determine how the members would elect those directors. For the reasons stated below, the Finance Board has deleted those provisions from the final rule and, apart from the matter of allowing a Bank to establish voting preferences, part 931 no longer addresses these issues. Instead, the final rule includes a number of revisions to part 915 of the Finance Board's elections regulations that conform those regulations to the new capital structure required by the GLB Act. Those amendments are described below.

Section 7 of the Bank Act addresses, among other things, the manner in which the members of each Bank elect the directors of the Bank and the manner in which the Finance Board allocates elected directorships among the states in each Bank district. 12 U.S.C. 1427. Section 7(a) of the Bank Act establishes the basic size and composition of the boards of directors for the Banks, providing that each board shall consist of fourteen directors, with eight directors elected by the members and six directors appointed by the

Finance Board.<sup>3</sup> 12 U.S.C. 1427(a). Section 7(b) of the Bank Act requires the Finance Board to designate each elected directorship as representing the members located in a particular state within the Bank district, and section 7(c) directs the Finance Board to make those designations based on the approximate ratio of the number of shares of Bank stock "required to be held" by the members located in each of the respective states as of the end of each calendar year. 12 U.S.C. 1427(b), (c). Section 7(c) includes two exceptions, one of which requires that each state be allocated at least one directorship (but not more than six) and the other of which requires each state to be allocated no fewer directorships than were allocated to it in 1960. 12 U.S.C. 1427(c). Section 7(b) separately provides that in an election to fill a directorship each member may cast one vote for each share of Bank stock that it was "required to hold" as of the end of the prior calendar year, subject to a statutory cap. 12 U.S.C. 1427(b). Under that cap, the maximum number of votes that any member may cast in such an election is equal to the average number of shares of stock "required to be held" by all members located in the same state as of the end of the prior calendar year.

The GLB Act did not expressly amend section 7 as it relates to the designation of directorships or the election of directors. Section 931.3(b) of the proposed rule, however, would have deemed those provisions of section 7 to cease to apply after the new capital structure for the Banks had been established. In the **SUPPLEMENTARY INFORMATION** section of the proposed rule, the Finance Board explained that it had preliminarily determined to deem those provisions of section 7 to have been repealed by implication by the GLB Act amendments to section 6 of the Bank Act regarding the capital structure of the Bank System. During its initial consideration of the proposed rule, the Finance Board had been advised that the members of the Bank System would be unlikely to purchase Class B stock unless they received some assurance of being able to elect a majority of the directors to the board of each Bank. Because the ability to sell the Class B stock is an essential aspect of the new capital structure established by the GLB Act, the Finance Board had serious concerns that retention of the state-based directorship structure would

<sup>3</sup> As a practical matter, the boards of directors at most of the Banks have more than 14 directorships, which is due in part to the operation of a statutory grandfather provision, and in part to the creation of discretionary directorships by the Finance Board in certain Bank districts.

discourage the members from purchasing the Class B stock, thereby frustrating the intent of the Congress to establish a risk-based permanent capital structure for the Banks. Accordingly, the Finance Board preliminarily determined that the possibility that the state-based directorship structure would preclude the sale of sufficient amounts of Class B stock to capitalize the Banks created an irreconcilable conflict between section 6 and section 7 of the Bank Act. The Finance Board deemed that conflict to be sufficient to support an implied repeal of those provisions of section 7. In place of the directorship structure established by section 7, the Finance Board proposed to allow each Bank to specify the manner in which the members would elect members to the board of directors, to require each Bank to assign voting rights to the Class B stock and allow the Banks to assign voting rights to the Class A stock, and to limit the number of votes that any member and its affiliates could cast in an election to 20 percent of the votes eligible to be cast in the election.

The Finance Board received numerous comments criticizing its proposal to deem certain provisions of section 7 to have been implicitly repealed by the capital provisions of the GLB Act. Many of those comments questioned the factual premise underlying the implicit repeal, *i.e.*, that the members would not purchase Class B stock unless they had some assurance of being allowed to elect a majority of the board of directors for the Bank, and contended that the Finance Board could find alternative ways to reconcile the provisions of section 6 and section 7. A number of comments also noted that unless the Finance Board could identify a more demonstrable conflict between section 6 and section 7, a determination that provisions of the latter had been implicitly repealed by the former would be unlikely to withstand a legal challenge.

Since the Finance Board issued the proposed rule, the staff of the Finance Board has had numerous discussions with representatives of the Banks, as well as with members and other interested parties, about this and other aspects of the proposed rule, and has received prototype capital plans from several of the Banks. As a result of those comments and those discussions, the Finance Board has been persuaded that the retention of the state-based directorship structure would not be likely to discourage members from purchasing Class B stock. Indeed, a number of the Banks have indicated their intention to issue only Class B stock or to require the purchase of Class

B stock both as a condition of membership and as a condition of transacting business with and obtaining services from the Bank. Under any of those approaches, the Finance Board's prior concern about the Banks being unable to sell Class B stock would become moot. Accordingly, the final rule does not deem any provisions of section 7 of the Bank Act to have been implicitly repealed by the GLB Act. Because § 931.3 of the proposed rule, which would have authorized the boards of directors of each Bank to establish as part of the capital plan the manner in which the members would elect directors, was premised on an implied repeal of certain provisions of section 7, that section has been deleted from the final rule.

As stated in the proposed rule, the Finance Board is mindful of its obligation to give effect to the laws as written by the Congress unless two provisions are in such irreconcilable conflict that the Finance Board cannot as a practical matter give simultaneous effect to both provisions. Based on the information currently available, the Finance Board no longer perceives any such conflict between the capital provisions of section 6 and the directorship provisions of section 7. It remains possible, however, as the Banks develop their capital plans and offer the Class A and/or Class B stock to their members, that such a conflict may arise. If, while attempting to develop or to implement their capital plans, the Banks provide demonstrable evidence that they have been unable to sell the Class B stock (or have been unable to sell sufficient quantities of Class B stock) and that their inability to sell the Class B stock has been caused by the retention of the state-based directorship provisions in section 7, the Finance Board would be prepared to revisit the issue of an implied repeal. Absent such evidence, the directorship structure of the Banks will not be changed in the final rule.

Because the statutory provisions regarding the designation of directorships and the election of directors are linked to the capital provisions in section 6 of the Bank Act, however, the GLB Act amendments to section 6 do require the Finance Board to amend its directorship and elections regulations in certain respects. Accordingly, the final rule includes a number of conforming amendments to those regulations, including a provision that addresses the authority of the board of directors of a Bank to establish voting preferences, all of which are described below.

The first of the conforming amendments to part 915 relates to the manner in which the Finance Board designates elected directorships among the states of each Bank district. Section 7 of the Bank Act requires the Finance Board to designate elected directorships based on the amount of Bank stock that section 6 of the Bank Act requires the members in each state to hold as of the end of the prior calendar year. Under the present single-class capital structure, the determination of the number of shares required to be held is relatively straightforward. Because the GLB Act authorizes the Banks to issue two classes of stock, the final rule adds a new provision to § 915.3(b) to clarify that, for any Bank that has two classes of stock outstanding, the Finance Board shall conduct the designation of directorships based on the combined shares of each class of stock that the members are required to hold as of the end of the year.

Because the GLB Act repealed the statutory stock purchase requirements and replaced them with a provision requiring the capital plan for each Bank to specify the minimum stock investment required of each member, the Finance Board is further amending § 915.3(b) to address how the annual designation of directorships will be conducted both before and after the implementation of the capital plan. If a Bank's capital plan was not in effect on the immediately preceding December 31st, the number of shares of Bank stock required to be held by the members in each state will be determined pursuant to § 925.20 and § 925.22, which reflect the stock purchase requirements specified by section 6 of the Bank Act, as in effect immediately prior to the GLB Act. If a Bank's capital plan was in effect on the immediately preceding December 31st, the number of shares of Bank stock required to be held by the members in each state will be determined in accordance with the minimum investment established by the capital plan for that Bank. For any members whose investment in Bank stock is less than the minimum investment required by the capital plan (*i.e.*, during a transition period), the amount of stock to be used in the designation of directorships shall be the number of shares of Bank stock actually owned by those members as of December 31st.

Because the annual designation of directorships is keyed to the amount of stock required to be held as of the prior calendar year, the earliest possible date that the Finance Board could designate directorships under the new capital plans would be in 2002. With regard to

the designation of directorships that the Finance Board must conduct in 2001, those determinations must be based on the amount of Bank stock required to be held as of December 31, 2000, which means that the current capital structure will determine how those directorships will be allocated.

Under current law, the amount of Bank stock "required to be held" by a member as of the end of the calendar year is the greater of \$500, one percent of the member's mortgage assets, or five percent of the member's outstanding advances. As discussed above, once a Bank's capital plan has taken effect, the amount of Bank stock required to be held will be equal to the minimum investment in Bank stock for each member established in the Bank's capital plan. As discussed elsewhere in this **SUPPLEMENTARY INFORMATION** section, § 931.3 of the final rule requires a Bank to require each member to maintain a minimum investment in the capital stock of the Bank, both as a condition to becoming and remaining a member of the Bank and as a condition to transacting business with or obtaining advances and other services from the Bank. In all cases, both before and after the effective date of a Bank's capital plan, the Finance Board would use the information provided to it by the Banks in the annual capital stock report, as required by § 915.4, as the basis for calculating the relative amounts of stock held by the members in the respective states. The final rule also includes one technical correction to § 915.3(b)(3), which replaces the words "the Bank" with "that State".

Another conforming amendment relates to the annual reports submitted by the Banks regarding the stock holdings of their members. Under current law, § 915.4 requires each Bank to submit, by no later than April 10th of each year, a capital stock report that shows the amount of Bank stock required to be held by the members in each state as of the end of the prior calendar year. 12 CFR 915.4. The Finance Board uses that information to conduct the designation of directorships for the states in each Bank district. Because the amount of stock that each member must hold ultimately will be determined by the capital plan approved for each Bank, rather than in accordance with the current statutory formula, the final rule amends § 915.4 to address how the Banks are to determine the amount of Bank stock that each member is required to hold, both before and after the effective date of a Bank's capital plan. The final rule amends § 915.4(a) to provide that if a Bank has issued more than one class of stock, it

shall report to the Finance Board the combined number of shares of stock required to be held by the members, *i.e.*, the report will not distinguish between the required amounts of Class A and Class B stock. The final rule also provides that if a Bank's capital plan was not in effect as of the record date, the number of shares of Bank stock that the members are required to hold shall be determined in accordance with the existing stock purchase requirements, as stated in § 925.20 and § 925.22. For any record date occurring after the capital plan is in effect, the number of shares of required Bank stock will be the minimum investment established for each member by the capital plan, provided that, for any member whose Bank stock is less than the minimum investment during a transition period, the amount of Bank stock to be reported shall be the number of shares of Bank stock actually owned by the member as of the record date. Thus, if a Bank's capital plan were in effect as of December 31st of a given year, the capital stock report to be submitted before April 10th of the following year would be based on the amounts of Bank stock required to be held by the members as the "minimum investment" established by the capital plan. If a Bank's plan had not taken effect as of December 31st of a given year, then the capital stock report to be submitted the following April would be based on the amount of stock required to be held pursuant to § 925.20 and § 925.22. None of these amendments would affect the authority of a Bank to establish voting preferences in favor of either the Class A or the Class B stockholders, which it could do as part of its capital plan and which is addressed below.

Because the proposed rule would have deemed certain provision of section 7 to have been repealed by implication, the proposed rule would have authorized each Bank to determine the manner in which the members would elect the directors for each Bank. The proposed rule also would have capped the number of votes that any member or its affiliates could cast in an election at 20 percent of the number of eligible votes, though it would have allowed a Bank to establish a lower cap. As noted previously, the Finance Board has determined that there is no need at present to deem any provisions of section 7 to have been repealed by implication. For that reason, the Finance Board is not adopting the proposed amendments that would have allowed each Bank to determine the manner in which the members elect the directors of the Bank. Instead, the final

rule gives effect to the provisions of section 7(b) of the Bank Act by retaining the existing regulations regarding the election of directors, albeit with a number of revisions to conform them to the new two-class capital stock structure established by the GLB Act. A number of commenters criticized the Finance Board for proposing to determine that certain provisions of section 7 of the Bank Act had been implicitly repealed, but nonetheless argued that the matters of how the directorships should be allocated among the states and how the members should elect directors were best left for the individual Banks to determine. Because section 7 of the Bank Act addresses both of those issues, the Finance Board cannot allow the Banks to allocate the directorships or to determine the manner of electing directors without deeming section 7 to have been implicitly repealed, which the Finance Board has determined not to do.

As described previously, section 7(b) of the Bank Act provides that each member shall be entitled to cast one vote for each share of Bank stock it was required to hold as of the end of the prior year, subject to the statutory cap, *i.e.*, the average number of shares of Bank stock required to be held by the members in each state as of the end of the year. The final rule amends § 915.5(b) to restate those general provisions of section 7(b), *i.e.*, for each directorship that is to be filled in an election, each member that is located in the state to be represented by the directorship and that is eligible to vote in the election may cast one vote for each share of Bank stock that it was required to own as of the end of the prior calendar year, subject to the statutory cap.

For any Bank that has issued only one class of stock, the statutory voting cap will be calculated in the same manner as it is calculated at present, which is a simple average of the number of shares of Bank stock held by the members in each state as of the record date. For any Bank that has issued more than one class of stock, however, the final rule provides that the statutory cap will be applied separately for each class of stock. Thus, a Bank that has issued two classes of stock must determine, for each state, the average amount of Class A stock required to be held by the members in that state as of the end of the prior year, as well as the average amount of Class B stock required to be held by the members in that state as of the end of that year. As noted previously, once the capital plan is in effect, the amount of stock that each member is required to hold as of the end

of the year will be the "minimum investment" that each member is required to maintain in order to remain a member and to do business with the Bank. Thus, a member that has purchased both Class A and Class B stock would be entitled to cast one vote for each share of Class A stock it is required to own, up to the average holdings of the Class A stock, plus one vote for each share of Class B stock, up to the average holdings of the Class B stock by the members in that state, with the combined total being the number of votes that the member is entitled to cast in the election. The Finance Board considered, as an alternative to the separate caps for each class, using an average of the combined amounts of Class A and Class B stock that the members in a particular state were required to own as of the end of the year. Because it is possible that even in a two-class stock structure there may be members that own only one class of Bank stock, the Finance Board believes that the most equitable way of calculating the statutory voting cap is to do so separately for each class of stock outstanding.

As with the other conforming amendments, noted above, regarding the designation of directorships and the capital stock report, the final rule provides that if a Bank's capital plan was not in effect as of the record date, the number of shares of Bank stock that a member is required to hold as of the record date shall be determined in accordance with § 925.20 and § 925.22. If a Bank's capital plan was in effect as of the record date, the number of shares of Bank stock that a member is required to hold as of the record date shall be determined in accordance with the minimum investment established by the Bank's capital plan, provided, however, that for any members whose Bank stock is less than the minimum investment during a transition period, the amount of Bank stock to be counted shall be the number of shares of Bank stock actually owned by those members as of the record date.

As was discussed in the proposed rule, what appeared to be most in conflict between the directorship provisions of section 7 and the capital provisions of section 6 was the voting rights of the members. Specifically, section 6(c)(4)(B) of the Bank Act, as amended by the GLB Act, expressly authorizes the board of directors of a Bank to establish voting preferences for its capital stock. 12 U.S.C. 1426(c)(4)(b). Section 7(b) of the Bank Act, however, provides (subject to the statutory cap) that each share of Bank stock entitles the holder to cast one vote in an election

of directors. 12 U.S.C. 1427(b). Even though the Finance Board has determined not to deem any provisions of section 7(b) to have been repealed by implication by the GLB Act, the issue remains of how best to reconcile these two provisions. Based on the statutory language concerning voting preferences, the Finance Board has determined that the most appropriate way to strike a balance between and reconcile these two provisions is to consider the "one share, one vote" provisions of section 7(b) as the general rule for voting, subject to the statutory cap, but to recognize that the provisions of section 6(c)(4)(B) of the Bank Act, as amended, authorize the individual Banks to create an exception to the general rule by establishing a voting preference.

The language of section 6(c)(4)(B), as amended by the GLB Act, provides that each Bank "shall include in its capital structure plan provisions establishing terms, rights, and preferences, including \* \* \* voting \* \* \* preferences for each class of stock issued by the bank, consistent with Finance Board regulations and market requirements." 12 U.S.C. 1426(c)(4)(B). That language clearly authorizes the board of each Bank to establish voting preferences as part of its capital plan, but it does not mandate that a Bank must do so with regard to the election of directors. Under the statute, the question of whether to establish voting preferences is left to the board of directors of the Bank, subject to the regulatory oversight of the Finance Board. Because the creation of a voting preference is not mandatory, there is no immediate conflict between section 6(c)(4)(B) and section 7(b). Indeed, if a Bank declines to establish a voting preference for one class of stock over the other there will be no conflict at all. In that case, each share of Bank stock will entitle the holder to cast one vote in the election of directors, subject to the statutory cap, as implemented by the final rule. If, however, a Bank were to exercise the authority conferred by section 6(c)(4)(B) to confer a preference, for example, on the holders of the Class B stock as part of its capital plan, then the voting rights for the Class A and the Class B members would be governed by the preference established by that Bank. In effect, the voting preferences established by the Bank as part of its approved capital plan on the authority of section 6(c)(4)(B) would supercede the provisions of section 7(b), which otherwise would grant each member one vote for each share of stock that it was required to own as of the record date.

Because the concept of a voting preference relates principally to the relative distribution of voting power

between two or more classes of stockholders, the Finance Board believes that the authority to establish voting preferences should not extend to matters beyond that distribution of voting power. In other words, a Bank can invoke the authority of section 6(c)(4)(B), 12 U.S.C. 1426(c)(4)(B), to establish a preference structure that favors the Class B stock, but it should not be able to rely on that authority to override other provisions of section 7(b), 12 U.S.C. 1427(b), such as the statutory cap on voting, which, as noted above, will be applied separately to each class of Bank stock. For that reason, the final rule makes clear that, even if a Bank invokes its authority to establish voting preferences that vest the exclusive or predominant voting power in one class of stock, the holders of that class of stock will remain subject to the statutory cap. Accordingly, § 915.5(c) of the final rule provides that, notwithstanding the general rule for voting in an election of directors, a Bank may include as part of its capital plan voting preferences for any class of stock issued by the Bank, and that such preferences shall supercede the general provisions that otherwise would confer one vote for each share of Bank stock, subject to the statutory cap. The final rule includes a corresponding amendment to § 933.2, which addresses the contents of the capital plans.

Separately, the final rule includes two other amendments of a technical nature. The first amendment, to § 915.6(a)(3), makes a conforming change to a citation to another regulation within the text of the rule. The second technical amendment adds a sentence to § 915.7(b)(2) regarding the terms "appropriate federal regulator" and "appropriate State regulator" that was inadvertently deleted from the regulation as part of an earlier rulemaking.

#### *B. Part 917—Powers and Responsibilities of Board of Directors*

The Finance Board is amending § 917.3 to require the Banks to include as part of their risk management policies total and risk-based capital ratios at which the Banks intend to operate. The final rule also amends § 917.9 to conform the existing provisions, which require dividends to be paid without preference, to the requirements of the GLB Act and Part 931 of the final rule.

As described elsewhere in this **SUPPLEMENTARY INFORMATION** section, the Finance Board has responded to criticisms about the proposed operating capital ratios by deleting them from the final capital rule. Although the Finance Board agrees that the final capital rule



should not impose operating capital ratios, the Finance Board believes that the concept of operating capital ratios is useful as a risk management tool for the Banks, as well as a supervisory tool for the Finance Board. For that reason, the final rule amends § 917.3 to require each Bank to include, as part of its risk management policy, a provision that establishes the total and risk-based capital levels at which the Bank intends to operate. In addition, the Finance Board has considered comments suggesting that such operating ratios are better expressed as a range, rather than as a fixed number, and believes that this approach would provide additional flexibility to the Banks in managing their capital levels. Accordingly, the amendments to § 917.3 allow the Banks to set their own operating total capital and operating risk-based capital ratios as a range.

Separately, the Finance Board is amending § 917.9, which currently requires that dividends on Bank capital stock be computed without preference, to conform it to the GLB Act and to other provisions in the final rule. The GLB Act authorizes the board of directors of each Bank to determine the rights, terms, and preferences for each class of stock, consistent with section 6 of the Bank Act, the regulations of the Finance Board, and market requirements. Because § 931.4 of the final rule permits the board of directors of a Bank to establish in the Bank's capital plan different dividend rates or preferences for each class or subclass of stock, it is necessary to make a corresponding change to § 917.9, so that the current requirement that dividends be computed without preference not apply if a Bank has established any dividend preferences for one or more classes or subclasses of its capital stock. For any such Bank, once the capital plan takes effect, the requirement that dividends be computed without preference will cease to apply to that Bank.

### C. Part 925—Membership Amendments

**Minimum Stock Purchase Requirements.** The proposed rule would have removed from the existing membership regulation all provisions pertaining to the amount of Bank stock an institution must purchase upon becoming a member. See 12 CFR 925.19 through 925.23 (Subpart D); 925.25(d)(2)(ii), (iii). In the final rule, the Finance Board has retained all of those provisions because the GLB Act requires the existing stock purchase requirements to remain in effect for each Bank until the Bank has implemented its capital plan. Because of that

requirement, the Finance Board anticipates that it will remove those provisions from its regulations only after the capital plans for all of the Banks have been implemented. As each Bank implements its capital plan, the amount of stock that each member of that Bank would be required to purchase shall be the minimum investment established by that Bank's capital plan.

**Consolidations Involving Members.** Section 925.19 of the proposed rule would have consolidated existing §§ 925.24 and 925.25 into one provision addressing the consolidation of a member into another member or into a nonmember. In the final rule, the Finance Board has consolidated the substance of §§ 925.24 and 925.25 into an amended version of § 925.24. The substance of § 925.24 of the final rule is much the same as proposed § 925.19; because the final rule does not rescind the several provisions that the proposed rule would have rescinded, the numbering of the amended provisions in the final rule does not correspond to the numbering of the proposed amendments. As amended, § 925.24 retains much of the structure of the proposed rule, albeit with some technical, clarifying, and organizational changes.

Section 925.24(b)(5) of the final rule addresses the consolidation of a member into a nonmember and differs somewhat from the proposed rule with regard to the minimum amount of Bank stock that the consolidated institution must purchase if it is approved for membership. Thus, if the capital plan for the Bank has not taken effect when the consolidated institution has been approved for membership, the amount of Bank stock that such institution must own shall be as provided in § 925.20 and § 925.22, which are the stock purchase requirements in effect prior to the enactment of the GLB Act. See 12 CFR 925.20, 925.22. If the capital plan for the Bank is in effect when the consolidated institution has been approved for membership, the amount of stock that such institution is required to own shall be equal to the minimum investment established by the capital plan for that Bank. These provisions reflect the more general transition provisions in § 931.9 of the final rule.

**Voluntary Withdrawal.** Section 6(d)(1) of the Bank Act, as amended by the GLB Act, provides that any member may withdraw from its Bank by providing written notice of its intent to do so, provided that on the date of the withdrawal there is in effect a certification from the Finance Board that the withdrawal will not cause the

Bank System to fail to meet its required payment toward the debt service for the obligations issued by the Resolution Funding Corporation (RefCorp), in accordance with section 21B(f)(2)(C) of the Bank Act, 12 U.S.C. 1441b(f)(2)(C), *as amended*. (RefCorp Certification). 12 U.S.C. 1426(d)(1), *as amended*. The statute further provides that the receipt of the withdrawal notice by the Bank commences the applicable stock redemption periods for the stock owned by the member, *i.e.*, the 6-month and 5-year notice periods for Class A and Class B stock, respectively, after which the member may receive the par value of its stock in cash. During the notice period, the member remains entitled to receive any dividends declared on its stock. Section 925.20 of the proposed rule would have implemented these statutory provisions. Section 925.26 of the final rule retains these provisions, generally as proposed, but with several changes that are discussed below.

Section 925.26(a)(1) of the final rule provides that any member may voluntarily withdraw from membership by providing to the Bank written notice of its intent to do so. In response to comments, the Finance Board has revised the final rule to make clear that a Bank need not commit to providing any further services to a withdrawing member that would mature or otherwise terminate subsequent to the effective date of the withdrawal. Thus, a Bank could limit the maximum maturity of any new advances to a withdrawing member to the amount of time remaining until the date of withdrawal. Section 925.26(a)(1) also provides that 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, and further allows a Bank to impose a fee on any member that cancels its notice of withdrawal. Any such fee, or the manner of its calculation, must be specified in the capital plan. This provision of the final rule is in substance as it was proposed.

Section 925.26(a)(2) of the final rule requires the Banks to notify the Finance Board within 10 calendar days of receiving any notices of withdrawal or notices canceling a notice of withdrawal. Although notification to the Finance Board no longer is mandated by statute as a condition to withdrawal, retaining the requirement will allow the Finance Board to maintain an accurate membership database (which provides the official count of Bank System members), and to maintain historical records regarding Bank System membership, withdrawals, and cancellations of notices of withdrawal.

Being advised of member withdrawals also allows the Finance Board to anticipate changes in Bank System membership.

Because the Bank Act, as amended by the GLB Act, does not expressly link the withdrawal of membership to the redemption of stock, the proposed rule would have allowed a member to specify the date on which its membership would terminate, which date could be no later than the end of its last stock redemption period. The proposed rule provided further that if the notice did not indicate a withdrawal date, withdrawal would be deemed to take effect on the date that the last applicable stock redemption period ends.

Commenters criticizing this provision expressed concerns about whether a termination in membership prior to the end of the redemption periods would result in a nonmember owning Bank stock, which arguably would conflict with the provisions of the GLB Act that restrict ownership of Bank stock to members. Although the Finance Board believes that the appropriate time for determining whether Bank stock is lawfully held by a "member" of the Bank is the date on which the member acquires the Bank stock, the Finance Board is revising the final rule to make the date of termination coincide with the expiration of the longest stock redemption period, unless the institution cancels its notice of withdrawal prior to that date. That approach is consistent with current practice at the Banks. In part, the proposed rule was premised on the view that under the new capital regime a member that wanted to terminate its membership prior to the end of the stock redemption periods could simply sell the Bank stock to another member, at a price to be negotiated by the two members. Because the final rule does not permit the members to establish a trading market for Bank stock, the provisions of the proposed rule that would have "de-linked" the termination of membership from the ownership of stock are no longer appropriate, and thus have been deleted.

As was proposed, § 925.26(c) of the final rule provides that 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. Also as proposed, § 925.26(c) provides that 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. The final rule makes no substantive changes to this provision.

As was proposed and as discussed above, § 925.26(d) of the final rule implements the Bank Act, as amended by the GLB Act, by providing that no institution may withdraw from membership unless, on the date that the membership is to terminate, there is in effect a RefCorp Certification. This provision is not substantively changed from the proposed rule. The GLB Act amended the Bank Act to require each Bank to pay 20 percent of its net earnings each year toward the RefCorp debt service. 12 U.S.C. 1441b(f)(2)(C), *as amended*. The GLB Act further required that before a member can withdraw from Bank membership, the Finance Board must have in effect a certification that the withdrawal of the member will not cause the Bank System to fail to make its required payments toward the RefCorp debt service. The Finance Board has previously addressed this matter by certifying that the withdrawal of any member will not cause the Bank System to fail to meet its RefCorp payments. Finance Board Resolution No. 2000-32 (June 23, 2000). The certification remains in effect until rescinded or superseded by the Finance Board. Accordingly, there is no need to revisit the issue as part of this final rule, and Bank members may withdraw from membership without having to request individual certifications from the Finance Board.

*Involuntary Termination.* Section 6(d)(2) of the Bank Act, as amended by the GLB Act, provides the grounds on which a Bank may terminate the membership of an institution, such as in the case of violating the Bank Act or Finance Board regulations, or insolvency. Section 6(d)(2) also provides that the applicable notice period for each class of redeemable stock shall commence on the earlier of: (i) The date of such termination; or (ii) the date on which the member provided notice of its intent to redeem the stock.

Section 925.21 of the proposed rule implemented the above statutory provisions. Section 925.27 of the final rule retains these provisions as proposed, with several changes discussed below. As was proposed, § 925.27(a) of the final rule provides that the board of directors of a Bank may terminate the membership of any institution that fails to comply with any

requirement of the Bank Act, any Finance Board regulation, or any requirement of the Bank's capital plan, or becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under federal or state law. Section 925.27(a)(3) of the final rule also adds as an additional ground for termination any circumstances under which the retention of Bank membership would jeopardize the safety or soundness of the Bank, which is consistent with existing § 925.27(b)(4). *See* 12 CFR 925.27(b)(4). As was proposed, § 925.27(b) of the final rule provides that the applicable 6-month and 5-year stock redemption periods, respectively, for all Class A and Class B stock that is not already subject to a pending request for redemption, shall commence on the date that the Bank terminates the institution's membership. In response to a Bank commenter's suggestion, § 925.27(c) of the final rule adds language clarifying that an institution whose membership is terminated involuntarily shall cease being a member as of the date on which the board of directors of the Bank acts to terminate its membership. As was proposed, this section provides that the institution shall have no right to obtain any of the benefits of membership after that date. In response to one comment, the final rule clarifies that the institution shall be entitled to receive any dividends declared on its stock until the stock is redeemed by the Bank.

Prior to the GLB Act, section 6(e) of the Bank Act provided the Finance Board with the authority to terminate the membership of an institution that became insolvent. 12 U.S.C. 1426(e)(ii) (1994). Pursuant to that authority, the Finance Board adopted § 925.28(a), which provides that the membership of an institution placed in receivership (which in all likelihood would be insolvent) automatically terminates. 12 CFR 925.28(a). As discussed above, the GLB Act amended the Bank Act by vesting in the Banks, rather than the Finance Board, the authority to determine whether to terminate involuntarily the membership of an institution that is insolvent or placed into receivership. 12 U.S.C. 1426(d)(2)(A)(ii), *as amended*. One Bank suggested that the final rule retain the automatic termination provision in existing § 925.28 because that procedure has worked well and the proposed change would impose operational burdens on the Banks and receivers and conservators. The Finance Board has not implemented that recommendation in the final rule, because the GLB Act vests

the authority for making such decisions in the board of directors of each Bank, rather than in the Finance Board. Thus, if a member is placed into receivership or conservatorship or otherwise is determined to be insolvent, the board of directors of each Bank must determine whether it is most appropriate to allow that institution to remain a member of the Bank for some period of time or to terminate its membership under these provisions. The final rule also removes existing § 925.28(b) and (c) regarding the treatment of outstanding advances and Bank stock, and dividends on Bank stock, of a member placed into receivership, which are addressed generally in § 925.29 and § 931.4, respectively, of the final rule.

**Disposition of Claims.** The GLB Act did not amend section 10(c) of the Bank Act, which provides that a Bank shall have a lien upon and shall hold the stock of a member as further collateral security for all indebtedness of the member to the Bank. 12 U.S.C. 1430(c) (1994). The GLB Act did amend section 6(d)(3) of the Bank Act, which provides that upon the termination of membership for any reason, the outstanding indebtedness of the member to the Bank shall be liquidated in an orderly manner, as determined by the Bank, and upon the extinguishment of all such indebtedness the Bank shall return to the member all collateral pledged to secure the indebtedness. *Id.* § 1426(d)(3), *as amended*. Section 925.22 of the proposed rule would have implemented these two statutory provisions, and § 925.29 of the final rule retains these provisions, with several changes, as described below.

Section 925.29(a) of the final rule provides that 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.

Section 925.29(b) of the final rule provides that 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.

**Readmission to Membership.** Section 6(g)(1) of the Bank Act, as amended by the GLB Act, provides that an institution that divests all shares of Bank stock may not, after such divestiture, acquire Bank stock before the end of the 5-year period beginning on the date of the completion of such divestiture, unless the divestiture is a consequence of a transfer of membership on an uninterrupted basis between Banks. 12 U.S.C. 1426(g)(1), *as amended*. Section 6(g)(2) of the Bank Act, as amended by the GLB Act, provides for an exception that allows any institution that withdrew from membership in a Bank before December 31, 1997 to acquire Bank stock at any time after that date, subject to the approval of the Finance Board and the requirements of the Bank Act. *Id.* 1426(g)(2), *as amended*.

Section 925.23 of the proposed rule implemented these statutory provisions. Section 925.30 of the final rule retains these provisions as proposed, with some clarifying language, described below. Section 925.30(a) of the final rule provides that 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 5 years from the date on which its membership terminated and it divested all of its shares of Bank stock.

Section 925.30(b) of the final rule provides that 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. Section 925.30(b) further provides that any institution that withdrew from Bank membership prior to December 31, 1997, and for which the 5-year period has not expired, may apply for membership in a Bank at any time, subject to the approval of the Finance Board and the requirements of part 925.

#### *D. Part 930—Definitions*

As was proposed, § 930.1 of the final rule sets forth the definitions for the risk management and capital provisions of parts 931, 932 and 933. The Finance Board has adopted § 930.1 generally as proposed, with the changes discussed below.

The Finance Board has removed a number of the proposed definitions from the final rule because they are no longer relevant, given changes that have

been adopted to the final capital regulations. The Finance Board has also removed the definition of the term “NRSRO” because the term is defined in § 900.1 of the Finance Board regulations, which provides definitions applicable to all parts of the Finance Board regulations. 12 CFR 900.1 (*as amended* by 65 FR 43969, 43981 (July 17, 2000)).<sup>4</sup> Some changes also have been made in the final rule to clarify the meanings of terms, including “market value at risk,” “capital plan,” and “permanent capital.” The Finance Board also has added to § 930.1 of the final rule, definitions for some additional terms. The term “minimum investment” is defined as the minimum amount of Class A and/or Class B stock that a member is required to own to be a member of a Bank and to obtain advances or engage in other activities with the Bank, consistent with § 931.3 of the final rule. The term “excess stock” is defined as any amount of stock held by a member in excess of the minimum investment. The terms “redeem or redemption” are defined to mean the acquisition of Class A or Class B stock by a Bank at par value following the expiration of the six-month or five-year statutory redemption period, respectively, for the stock. The final rule defines the term “repurchase” to mean the acquisition by a Bank of excess stock prior to the expiration of the applicable statutory redemption period.

#### *E. Part 931—Federal Home Loan Bank Capital Stock*

**In General.** As described in the **SUPPLEMENTARY INFORMATION** section of the proposed rule, 65 FR 43412 (July 13, 2000), the GLB Act requires the capital regulations to permit each Bank to issue “any one or more” of Class A or Class B stock. Class A stock is to be redeemable at par on six months written notice to the Bank; Class B stock is to be redeemable at par on five years written notice to the Bank. The board of directors of each Bank is to determine the “rights, terms, and preferences” for each class of stock, consistent with section 6 of the Bank Act, with the regulations of the Finance Board, and with market requirements. The regulations must prescribe the manner in which Bank stock may be “sold, transferred, redeemed, or repurchased,” and must restrict the issuance and ownership of Bank stock to members of the Bank, prohibit the issuance of other classes of stock, and provide for the liquidation of claims and the redemption of stock upon an

<sup>4</sup> A similar conforming change is adopted herein for part 956 of the Finance Board regulations.

institution's withdrawal from membership.

Apart from authorizing the issuance of two classes of Bank stock, the GLB Act eliminated certain key characteristics of the single class of Bank stock that had been established under prior law. For example, the Bank Act no longer mandates a statutory par value for all Bank stock of \$100 per share and no longer requires all Bank stock to be issued at par value.<sup>5</sup> As a result, the Bank Act now authorizes a Bank to establish the par value for its Class A and Class B stock (which may differ), and permits the issuance of stock at a price other than par value.

*Classes of Capital Stock.* Section 931.1 of the proposed rule set forth the essential characteristics of the two classes of Bank stock. The proposed rule would have required the Class A stock to have a par value of \$100 per share, be issued and redeemed only at par value, be redeemable in cash only on six-months notice, and pay a stated dividend that would have a priority over the Class B dividends. The proposed rule would have required each Bank to determine the par value for its Class B stock, as well as the price at which it would be issued, which could be at par value or at or some other price. The Class B stock also would have been redeemable only at par value and with five years notice, and would have been subordinated to the stated dividend on the Class A stock. The proposed rule also restated the statutory provision that grants the Class B stock an ownership interest in the retained earnings of the Bank. Although not expressly referenced by the GLB Act, the proposed rule would have authorized each Bank to issue one or more subclasses of Class A and Class B stock, provided that each subclass possessed all of the required characteristics of its class.

The final rule makes four principal changes to § 931.1 of the proposed rule, by eliminating the regulatory par value for Class A stock, eliminating the stated dividend for Class A stock, eliminating the priority for Class A dividends, and requiring that each Bank issue its Class B stock at its stated par value.

The commenters that addressed the issue of the par value of the Class A stock generally opposed having the par value set by regulation, contending that each Bank should determine the par value for its stock. The Finance Board

agrees that it is appropriate to allow each Bank to determine the par value and issue price for its stock and has revised the final rule accordingly. Thus, for both Class A and Class B stock, the final rule provides that par value is to be determined by the board of directors of the Bank and stated in the Bank's capital plan. The final rule also extends to the Class B stock the requirement from the proposed rule that the stock be issued only at its par value, which the proposed rule had required only for the Class A stock. The provisions of the proposed rule that would have allowed a Bank to issue Class B stock at a price other than par value prompted criticism from several commenters. Those commenters recommended that the final rule require the Banks to issue Class B stock at its par value, and expressed concerns about allowing a Bank to issue stock at a price above par value when the Bank is required by statute to redeem the stock at its par value. Other commenters noted that allowing the Banks to issue Class B stock at less than its par value would be inconsistent with general corporate practice.

Some commenters requested that the final rule expressly allow a Bank to issue its Class B stock at "book value," rather than at par value. Although the issuance of Class B stock at its book value would appear to be legally permissible under the Bank Act, such an approach would raise other issues, such as how the book value of a Bank would be calculated, how frequently the calculation would be made, and how a Bank would address the issue of selling stock to its members at prices that could vary day to day. Because of those and other issues concerning the issuance at book value, the Finance Board has determined not to include that as an option under the final rule.

A number of commenters also objected to the proposed requirement that Class A stock pay a stated dividend that would have a priority over the payment of dividends on Class B stock. The principal objection to that provision was that such a requirement may trigger a taxable event for some members upon the conversion of their existing Bank stock to Class A stock. One of the reasons for including that provision in the proposed rule was a concern that the members owning Class B stock might favor themselves over the members owning Class A stock with regard to the payment of dividends. The Finance Board received a number of comments suggesting that the concern was unfounded because the members owning the Class B stock also would be likely to own Class A stock, and thus would have no incentive to deprive the

Class A stock of its dividends. The Finance Board sees merit in these arguments and thus has not included in § 931.1 of the final rule the requirement that the Class A stock have a stated dividend or a priority over the Class B dividend. Section 931.4 of the final rule addresses the issue of dividends, and generally allows a Bank to establish a dividend preference as part of its capital plan. Thus, the final rule permits, but does not require, a Bank to establish a stated dividend with a priority. To the extent that any provisions of a Bank's capital plan might unfairly disadvantage one class of stockholders, the Finance Board will be able to address any such inequities through the approval process for the capital plans.

A number of commenters opposed authorizing the issuance of subclasses of the Class A or Class B stock, suggesting that it would create a risk of "cherry-picking" among the subclasses that could be detrimental to the cooperative nature of the Bank System. Other commenters questioned the legal authority for subclasses. As explained in the **SUPPLEMENTARY INFORMATION** section of the proposed rule, the board of directors of a Bank has the authority under section 6(a)(4)(A) and section 6(c)(4)(B) of the Bank Act to establish different rights, terms, and preferences for the stock issued by the Bank. 12 U.S.C. 1426(a)(4)(A), (c)(4)(B), *as amended*. Those provisions clearly authorize a Bank to issue Class A stock with rights, terms, and preferences that differ from Class B stock, and there is nothing in those provisions that would prohibit a Bank from issuing some shares of Class B stock, for example, with rights, terms, and preferences that differ from other shares of the Bank's Class B stock. Thus, if the board of directors of a Bank wished to issue some shares of Class B stock for which the dividend will be determined based on the performance of a specific category of Bank assets and other shares of Class B stock for which the dividend will be determined based on the general profitability of the Bank, it would have the authority to do so. Obviously, if some shares of Class B stock were to have rights, terms, and preferences different from those of other shares of Class B stock, it would be eminently sensible for the Bank to distinguish between the two types of Class B stock, such as by giving them different names. Section 931.1(c) of the final rule makes clear that a Bank can designate such different shares of stock as separate "subclasses" if it wishes to do so. The authority to issue subclasses of either the Class A or Class B stock does not at

<sup>5</sup> 12 U.S.C. 1426(a) (1994). The minimum amount of Bank stock that each member was required to purchase had to be issued at par value. Any subsequent issuance could be at a price in excess of par value, but not less than par value. As a matter of practice, all stock of the Banks has been issued at par value.

all expand the authority of the Bank to issue anything other than Class A or Class B stock. Indeed, the proposed rule explicitly required each subclass to possess all of the characteristics of the class, and the Finance Board has retained that provision in the final rule. Accordingly, the Finance Board believes that the Banks have the authority to issue subclasses of stock and the final rule allows the Banks to do so, subject to the limits described above.

One other issue raised by commenters on this provision concerned the ownership of the retained earnings by the members that have purchased a Bank's Class B stock. The commenters asked that the final rule clarify that ownership of Class B stock does not confer an enforceable right to receive the retained earnings, and that the ownership interest extends to all undistributed retained earnings existing at the time of conversion as well to those existing thereafter. The commenters also sought clarification of how the ownership interest would be affected if a Bank were to issue subclasses of Class B stock, and who would own the retained earnings if a Bank did not issue Class B stock.

The GLB Act provides expressly that a member shall have no right to withdraw or otherwise receive any portion of the Bank's retained earnings, except through a dividend or capital distribution by the Bank, which resolves the first comment. Similarly, the GLB Act provides that the owners of the Class B stock shall own the "retained earnings, surplus, undivided profits, and equity reserves, if any" of the Bank, and does not limit that interest to any particular date in time. Accordingly, once a Bank issues any Class B stock, the holders of that stock will have an ownership interest in the retained earnings of the Bank from that date forward, until they redeem their Bank stock. After a member has redeemed (or the Bank has repurchased) all of its Class B stock, it no longer would have an ownership interest in the retained earnings of the Bank, apart from any dividends declared while the member owned the Class B stock. There is nothing in the language of the GLB Act that suggests that the interest of a Class B stockholder is limited to the retained earnings that exist on the date that the Bank converts from its existing stock to the Class A and/or Class B stock. The Finance Board believes that Congress intended this to be an ongoing interest, such that interest of the Class B stockholders would extend to whatever retained earnings are accumulated over time, as well as those that exist on the date of conversion to the new capital

structure. Similarly, there is no reason to distinguish between subclasses of Class B stock with regard to the ownership of the retained earnings. Because the final rule requires that any subclasses of Class B stock must possess all of the characteristics of Class B stock, the creation of a subclass of Class B stock cannot extinguish ownership interest in the retained earnings of the Bank for that subclass, which is created by statute. The GLB Act also contemplates, however, that the board of directors of a Bank may establish different rights, terms, and preferences for the Bank's stock, which would allow the board of directors to establish different dividend rates for different subclasses of Class B stock, even though each share of Class B stock, including its subclasses, otherwise would have the same residual interest in the retained earnings of the Bank. The final rule does not address the ownership of the retained earnings of a Bank that has issued no Class B stock. The ownership interest in favor of the Class B stockholders was created by Congress as part of the GLB Act. Although earlier versions of the Bank reform legislation had included language that addressed the ownership of the retained earnings by the owners of other classes of stock, the GLB Act did not include such a default provision for any Bank that does not issue Class B stock. Because the ownership of the retained earnings was created by Congress, the Finance Board believes that the matter of ownership for those Banks without Class B stock is best left to the Congress to resolve.

As a related matter, Congress' decision to confer an ownership interest in the retained earnings on the holders of the Class B stock has created some uncertainty about whether a Bank can pay dividends on the Class A stock out of its retained earnings. By law, there are only two sources from which a Bank may pay dividends: previously retained earnings and current net earnings. 12 U.S.C. 1436(a). By giving the Class B stockholders the exclusive ownership of the retained earnings, the GLB Act appears to preclude the payment of dividends on the Class A stock from a Bank's retained earnings. Although by statute a Bank may pay dividends on its Class A stock from "current earnings," that may not be possible under applicable accounting rules, which dictate that a Bank must credit its net earnings to retained earnings when it closes its books for the period. The final rule does not resolve this problem, which is addressed in somewhat greater detail under the discussion of § 931.4. The Finance Board intends to raise the

issue of how best to reconcile these provisions in a subsequent rulemaking.

*Issuance of capital stock.* Section 931.2(a) of the proposed rule would have allowed each Bank to issue either Class A or Class B stock, or both Class A and Class B stock, as well as any subclasses of either. That section also required a Bank to issue stock only to its members, barred the issuance of any other class of capital stock, required the Bank to act as its own transfer agent, and to issue its capital stock only in book-entry form. The Finance Board also requested comments on whether the Banks should be allowed to issue stock certificates and, if so, what safeguards would be appropriate.

Several commenters indicated that requiring book-entry form for Bank stock is reasonable and would prevent the stock from being improperly transferred, though at least one commenter suggested that including the requirement in the rule is unnecessary. One Bank recommended that the final rule allow the use of stock certificates because certain members, such as insurance companies, may be required to hold certificates to comply with state law requirements. That Bank also recommended that a Bank be allowed to use outside transfer agents, indicating that such an option may be particularly helpful for a Bank that uses an outside entity to conduct elections.

The Finance Board is adopting the provisions of § 931.2 largely as set forth in the proposal. Although a number of insurance companies are members of the Bank System, it is the understanding of the Finance Board that all of the Banks currently issue their stock in book-entry form, which appears not to have caused any difficulties for such members under state law. Because no comments identified specific provisions of state law that would require an insurance company to be issued stock certificates in order to become a member of a Bank, the Finance Board is not prepared to create an exception for such entities in the final rule. To the extent that state law may require a particular member to hold stock certificates in order to become a member of a Bank, the Finance Board would be prepared to consider the issue through a waiver request under the Finance Board's existing procedures. In that event, the Finance Board would expect the request for a waiver to demonstrate that state law allows no alternative but for an insurance company to hold physical stock certificates in order to become or remain a member of the Bank System.

When it issued the proposed rule, the Finance Board contemplated that Bank stock would have been traded among

members on a regular basis, which would have presented a more compelling need for a Bank to retain an outside source to act as the transfer agent for its stock. As discussed below, the final rule has eliminated the provisions of the proposed rule that would have required Bank stock to be traded among members, as well as between the Bank and its members, at a negotiated price. Thus, as in the past, the overwhelming majority of stock transactions will be between a Bank and a member. As such, the Finance Board does not anticipate that the need for an outside transfer agent under the new capital structure than will be materially greater than under the current capital structure. The Finance Board anticipates further rulemaking in the first quarter of 2001 on capital issues, and parties who can demonstrate why the Banks would still need to retain an outside source to perform the transfer agent functions in the absence of a trading market for the Bank stock will be able to address the issue at that time.

Proposed § 931.2(b) would have required each Bank to determine the initial method of distribution of its stock in a manner that is fair and equitable to all eligible purchasers. The proposed rule expressly allowed the Banks to conduct the initial issuance through an exchange or conversion but did not mandate either approach. In addition, the proposal would have allowed a Bank to distribute its then-existing unrestricted retained earnings as shares of Class B capital stock.

These provisions are being adopted in the final rule substantially as proposed. A Bank commenter recommended that this section be amended to clarify that a Bank may distribute retained earnings that are unrestricted at the time of conversion in the form of shares in a subclass of Class B stock, in addition to shares of Class B stock as the proposed rule provides. Such action would be authorized under the rule as written so no change to the rule is required.

Proposed § 931.2(c) would have required that a Bank issuing capital stock as a requirement of membership and as a requirement for conducting business with the Bank could do so only in accordance with proposed § 931.7 and § 931.8, respectively. The final rule has replaced those two provisions with a new provision that addresses the minimum investment that each member must maintain in the stock of the Bank, and thus has deleted the substance of § 931.2(c) from the final rule. The provisions regarding the minimum investment are discussed under § 931.3, below.

Proposed § 931.2(d) would have prohibited a Bank from issuing stock to a member or group of affiliated members if the issuance would result in such member or group of affiliated members owning more than 40 percent of any class of the outstanding capital stock of the Bank. Section 931.9 of the proposed rule separately would have limited the amount of stock that any one member, or group of affiliated members, could own to 40 percent of any class of the outstanding capital stock of the Bank. Several commenters suggested that the effect of that provision would be to limit the amount of advances that large members could obtain because they would be barred from purchasing the necessary additional stock that would be required to support any new advances. Other commenters suggested that the provision would effectively require small members to purchase additional stock to support the activities of large members of a Bank. A number of commenters requested that the Finance Board address how the provision would be applied to members that exceeded the 40 percent cap through no action of their own, such as if one or more larger members were to withdraw from the Bank.

The Finance Board agrees the concentration limit could have hampered some large members' access to Bank advances and other activities. The Finance Board further believes that concerns that one member or group of members may exert undue influence over a Bank can be addressed adequately by limiting the voting rights of large members, which the final rule does by retaining the current statutory cap on the number of shares that any one member may vote in an election of directors. Because the existing limits on voting rights will remain in place in the final rule, the proposed stock ownership limits are no longer necessary and have been deleted from the final rule. The application of the voting limits under the new capital structure is discussed separately under the explanation of the amendments to part 915 of the Finance Board's regulations.

*Minimum investment.* Section 931.3 of the final rule addresses the minimum investment in capital stock that is required of each Bank member. This section of the final rule replaces two separate provisions of the proposed rule, §§ 931.7 and 931.8, which addressed "membership investment" and "activity-based" stock purchase requirements, respectively. Each of those provisions included limitations based on the concept of a Bank's "operating capital ratios" (*i.e.*, total and risk-based capital ratios somewhat

higher than the regulatory minimums). Section 931.7 of the proposed rule would have allowed a Bank to require each member to invest in Class A stock as a condition to being a member of the Bank, but would have required that the Bank also allow each member the option of purchasing a lesser proportional amount of Class B stock. If the Bank were at or above either of its operating capital ratios, the proposed rule would have barred the Bank from requiring its members to purchase any additional amounts of Bank stock, though it would have permitted a Bank to assess a membership fee in lieu of a mandatory stock investment. Section 931.8 of the proposed rule would have allowed a Bank to require its members to purchase an amount of Class A or Class B stock as a condition to doing business with the Bank. The proposed rule also would have allowed a Bank to contract with a member for the purchase of stock on a future date (as a means of satisfying an activity-based stock purchase requirement), required that the amount of Class B stock be based on the risk characteristics of the underlying assets, and prohibited a Bank from restricting a member's ability to sell stock that it had purchased under this requirement. As with the membership requirement, if a Bank were at or above either of its operating capital ratios, the proposed rule would have barred the Bank from requiring its members to purchase any additional Class B stock based on the business conducted with the Bank.

Nearly all commenters who addressed the provisions of the proposed rule relating to operating capital ratios recommended that those provisions be eliminated from both the membership and activity-based stock purchase requirements, or that they be revised to establish an operating capital range, rather than a fixed percentage. A principal concern was that the operating capital ratios would cause inconsistent stock ownership and/or stock purchase requirements among members and that they may not be effective in preventing the Banks from becoming overcapitalized. By imposing such limits on stock issuance on a Bank that had reached its operating capital ratios, the proposed rule also would have effectively capped the amount of capital that the Bank would have, which a number of commenters suggested was not consistent with the safe and sound operation of the Banks.

The Finance Board continues to believe that operating capital ratios are a valid business concept that should be retained in the final rule, but has reconsidered the implementation of the concept based on the comments. The

Finance Board believes that operating capital ratios are more appropriately described as a risk management tool for establishing capital levels at which the Banks intend to operate, rather than as a separate regulatory capital requirement for which the Finance Board would impose sanctions if the Banks were to operate at different levels. Accordingly, the final rule deletes from the capital regulation any reference to the operating capital ratios, as well as any reference to limits on a Bank's ability to issue capital stock once it has reached its operating capital ratios. Instead, the final rule includes an amendment to § 917.3 that requires each Bank to include as one element of its risk management policy the total and risk-based capital levels at which the Bank intends to operate. In effect, the board of directors of each Bank must establish the capital ratios or ranges at which it intends the management of the Bank to operate. If the Bank were to operate at capital levels that were materially above or below the operating capital ratios established as part of the risk management policy, the Finance Board would address the variance through the examination and supervision process. The Finance Board expects that the board of directors of each Bank will monitor the Bank's capital level to ensure that management complies with the capital ratios established by the board of directors.

A number of commenters who addressed the membership investment provisions of the proposed rule objected to requiring the investment to be in Class A stock, with the member having an option to invest a lesser amount in Class B stock. Nearly all of the commenters who addressed the use of a membership fee in lieu of a minimum investment in the stock of the Bank opposed the concept, though at least one commenter advocated allowing a Bank to assess a fee in addition to a minimum investment in Bank stock. As discussed in the proposed rule, because the operating ratio provisions would have precluded a Bank from issuing additional stock to certain of its members in certain circumstances, the Finance Board believed it appropriate to allow the Bank to assess an annual membership fee on those members in lieu of the stock purchase that otherwise would have been required. In part, these provisions were intended to avoid an accumulation of excess capital at the Banks. Because the Finance Board has eliminated the concept of operating capital ratios from the final rule, there no longer is any need to permit membership fees to be assessed in lieu

of mandatory stock purchases. As described below, § 931.3 of the final rule requires each Bank to establish a minimum investment in Bank stock as a condition of membership, as well as a condition of doing business with the Bank, but leaves to the individual Bank how the minimum investment is to be structured. Accordingly, the final rule no longer requires that the membership investment be in Class A stock, with an option for the member to invest a lesser amount in Class B stock, and does not authorize a membership fee in lieu of the minimum investment. This revision to the proposed rule would not prevent a Bank from assessing a fee on members in other contexts, but it would bar the assessment of a membership fee in any form.

The activity-based stock purchase requirements of proposed § 931.8 prompted numerous objections that they would have barred a Bank from requiring its members to continue to hold Bank stock that had been purchased to support a particular business activity, such as advances, with a Bank. Many of the commenters suggested that the Banks be allowed to mandate a "buy-and-hold" requirement as part of any activity-based stock purchase requirement. Those commenters contended that allowing a member to sell Bank stock purchased to support a particular activity would make it more difficult for Banks to meet their risk-based capital requirements. Commenters also expressed concern that the proposed rule would threaten the cooperative structure of the Bank System by separating stock ownership from the business that the members conduct with the Banks, and would move the Banks toward a corporate form of business.

A number of commenters advocated retaining the current activity-based stock purchase requirement (*i.e.*, a member must own Bank stock at least equal to 5 percent of its advances), arguing that such a formula would provide adequate capital to cover the credit, market, and operational risks associated with advances. One commenter supporting that approach argued that any capital supporting an advance is "permanent" because the member cannot redeem the stock while the advance is outstanding, and that either Class A or Class B stock could be used as "permanent" capital for advances. The Congress, however, has spoken definitively on these issues and the Finance Board is not at liberty to consider Class A stock as permanent capital. The risk-based capital requirements for a Bank, *i.e.*, the capital required for credit and market risk, may

be satisfied only with "permanent capital," which is defined to include only the amounts paid in for Class B stock plus a Bank's retained earnings (determined in accordance with GAAP). The totality of the GLB Act definitions make it clear that Class A stock cannot lawfully be used to satisfy a Bank's risk-based capital requirements, even if it were to be held for the duration of an advance. With regard to the contention that a Bank should be allowed to retain the "5 percent of advances" requirement from prior law, it would be possible under the final rule for a Bank to do so, provided that the amount of capital generated by that requirement would be sufficient for a Bank to meet its total and risk-based capital requirements, both for its outstanding advances as well as for the other assets on the balance sheets of the Banks. As discussed below, the determination of how to structure the minimum investment is left to the individual Banks under the final rule.

The final rule includes, in § 931.3, much of the substance of the proposed membership and activity-based stock purchase requirements, albeit with a number of revisions and additions that conform the final regulation more closely to the statutory requirements. Consistent with a number of comments, § 931.3(a) of the final rule mandates that each Bank shall require each member to maintain a "minimum investment" in the stock of the Bank. The term "minimum investment" includes whatever amount of Bank stock an institution is required to purchase in order to become a member of a Bank, as well as whatever amount of Bank stock a member is required to purchase in order to obtain an advance or to conduct any other business activity with the Bank. The GLB Act expressly requires each member to maintain a minimum investment in the stock of its Bank, and requires the manner for determining the amount of the minimum investment to be described in the Bank's capital plan. The GLB Act does not speak in terms of the minimum investment being structured as separate membership and activity-based components. The GLB Act does, however, require the amount of capital to be generated by the minimum investment to be sufficient to allow the Bank to comply with its total and risk-based capital requirements, and expressly authorizes a Bank to base the minimum investment on a percentage of a member's assets and/or on a percentage of a member's outstanding advances, all of which suggest that under the new capital structure (as under the existing structure), the minimum investment must encompass

both a membership component and an activity component.

As a fundamental matter, the Banks are cooperatives, which means that the capital to support the business of the Banks must be supplied by the members of the cooperative. If an institution becomes a member of a Bank, it has immediate access to all of the products and services of the Bank even if it does not immediately take advantage of them. Nonetheless, the Bank stands ready to provide advances and other services to the new member and has an infrastructure in place to provide those services. Both the liquid assets that a Bank maintains in order to provide services to its members, as well as parts of the infrastructure of the Bank (i.e., tangible assets) that enable it to provide those services, are assets against which the Bank is required to maintain some amount of permanent and total capital. Thus, even a non-borrowing member benefits from the availability of these services and should be required to purchase some amount of both Class A and Class B stock to support the capital requirements associated with the Bank serving as a standby lender for the member. Indeed, as a number of commenters contended, an institution cannot become a member without having invested some amount in the stock of the Bank. Because a Bank must maintain permanent capital against assets that benefit non-borrowing members, the Finance Board believes that the most appropriate reading of the GLB Act is to require each member to maintain an investment in Bank stock (including Class B stock) regardless of whether it has any business outstanding with the Bank.

Section 931.3(a) of the final rule also requires each Bank to require each member to maintain a minimum investment in Bank stock as a condition to transacting business with the Bank or obtaining advances or other services from the Bank. Under the GLB Act capital provisions, a Bank cannot make an advance or obtain Acquired Member Assets (AMA) unless it has in place the permanent and total capital required to meet the risk-based and leverage capital requirements associated with those assets. Because of that requirement, the Finance Board believes that the concept of a "minimum investment" must include the capital stock that is required to support the risks that a member's business transactions place on the balance sheet of the Bank. Section 931.3(a) of the final rule provides that the specifics of how a "minimum investment" is to be calculated is to be determined by each Bank as part of its capital plan, which reflects the

requirements of the GLB Act. That provision also provides expressly that each Bank must require its members to maintain its minimum investment in Bank stock for as long as it remains a member and for as long as it engages in any business transaction with a Bank against which the Bank is required to maintain capital. Thus, for instance, a member that is required to purchase Bank stock as a condition of obtaining an advance or engaging in AMA transactions with the Bank, must continue to hold that stock for so long as the corresponding asset remains on the Bank's balance sheet.

Section 931.3(b) of the final rule provides that a Bank may establish the minimum investment required of each member as a percentage of the total assets of the member or as a percentage of the advances outstanding to the member, or based on any other provisions approved by the Finance Board as part of the Bank's capital plan. That provision of the final rule reflects exactly the requirements of the GLB Act. Because the business transactions and services that the Banks provide to their members are not limited to advances, the Finance Board also has included in § 931.3(b) of the final rule a provision allowing the Banks to establish a minimum investment as a percentage of any other business activity conducted with the members, which would include AMA transactions. In addition, the final rule provides expressly that the above bases for determining a minimum investment are not mutually exclusive and that a Bank may use any one or more of them in any combination as the basis for determining the minimum investment required of the members. Accordingly, although the final rule allows the Banks several options for structuring the minimum investment that is required of all members, the Banks must require the members to purchase some amounts of stock in order to conduct business with the Banks.

Section 931.3(c) of the final rule provides that a Bank may require a member to satisfy the minimum investment through the purchase of either Class A or Class B stock, or through the purchase of any one or more combinations of Class A and Class B stock that are authorized by the board of directors of the Bank. That section also provides that a Bank may establish a lower minimum investment for members that invest in Class B stock than for those that invest in Class A stock, provided that the reduced investment remains sufficient for the Bank to remain in compliance with its minimum capital requirements. As

discussed previously, even if a member does not borrow or otherwise engage in any business with its Bank, the Bank has to maintain assets and infrastructure to allow it to stand ready to do business with such members, and all of those assets require some amount of permanent capital and total capital to comply with the requirements of the GLB Act. The same is true with regard to members that borrow from or otherwise do business with the Banks, except that the linkage between the Bank assets that are created through such business dealings and the capital requirements is more apparent. In either case, if a Bank could not require its members to purchase some amount of Class A stock and some amount of Class B stock, it could not possibly comply with the capital requirements of the GLB Act. In theory, a Bank could rely on retained earnings to provide the permanent capital to allow it to comply with its risk-based capital requirements but, as a practical reality, no Bank has or is likely to have in the near term sufficient retained earnings to allow that to occur. If the language of the GLB Act were read to provide each member with an option to purchase either Class A or Class B stock, a Bank could not "ensure" that the minimum investment it had established would provide sufficient capital for the Bank to comply with the GLB Act capital requirements. The Finance Board believes that the most appropriate way to construe the GLB Act is to allow the members the option of choosing from whatever combinations of Class A and Class B stock have been authorized by the board of directors of the Bank as a means of satisfying the minimum investment.

Section 931.3(d) provides that each member of a Bank shall maintain an investment in the stock of its Bank in an amount that is sufficient to satisfy the minimum investment requirement established by the Bank's capital plan. This reflects provisions in the GLB Act that require each member to comply with the minimum investment established by the Bank's capital plan. It also addresses concerns expressed by a number of commenters that certain types of institutions, such as commercial banks, which are authorized under state law to invest in Bank stock only to the extent that the investment is required as a condition of membership, might lack the legal authority to invest in Bank stock if the investment were not required as a condition of membership or as a condition of obtaining services from the Bank.

The final rule does not include the provision formerly in § 931.8(c) of the proposed rule, which would have



required that the amount of Class B stock that a member must purchase be based on the risk characteristics associated with the type and duration of asset to be acquired by the Bank as a result of the particular transaction with that member. In order to satisfy the requirement in the final rule that the minimum investment shall be sufficient to ensure that the Bank remains in compliance with all of its minimum capital requirements, the Banks may well have to take into account the risk characteristics associated with particular transactions with members in determining what investment to require for such transactions. Under the final rule, however, that matter is left to the board of directors of each Bank to resolve, through the capital plan.

*Dividends.* As discussed previously, the Finance Board has deleted from the final rule the provisions of the proposed rule that would have required that the Class A stock pay a stated dividend that would have a priority over the dividends on the Class B stock. The final rule also deletes all of proposed § 931.4(b), which would have required the capital plan of each Bank to address certain issues associated with the stated dividend and the priority for the Class A stock, and all of proposed § 931.4(c), which separately addressed the dividends on the Class B stock. As previously discussed, many commenters recommended eliminating the stated dividend and the dividend priority for Class A stockholders, citing potential tax consequences to the members. Several commenters also suggested that each Bank be permitted to decide the dividend structure and preferences, if any, to be assigned to the classes of stock that it issues. The Finance Board agrees with those comments, and has removed those provisions from the final rule for those reasons. Thus, the final rule provides simply that the capital plan may establish different dividend rates or preferences for each class or subclass of Bank stock, which effectively leaves to the board of directors of each Bank the decision as to how to structure dividends to the members. To the extent that the dividend structure adopted by a Bank might unfairly favor one class of stockholder over another, the Finance Board would be prepared to address those issues as part of the approval process for the capital plans. The Finance Board expects that it will not approve a capital plan if it would allow for the holders of either stock class to be treated unfairly. These provisions were included in the proposed rule to preclude the possible manipulation of

the Class A dividend by and for the benefit of Class B shareholders, who may well have a greater influence on the Bank's dividend policies than the Class A shareholders. The Finance Board continues to believe that it is important to ensure that this does not happen, but believes that the capital plan review process is the appropriate means to do so.

One commenter recommended that the final rule bar a Bank from paying a dividend if it is not in compliance with its capital requirement or would fall out of compliance as a result of paying the dividend, explaining that without such a provision a Bank could continue to pay dividends in order to forestall stock redemptions, notwithstanding its lack of sufficient capital. The GLB Act expressly precludes a Bank from distributing its retained earnings unless it would continue to meet all applicable capital requirements following the distribution. Section 2A(a)(3)(A) of the Bank Act also provides that the primary duty of the Finance Board is to ensure that the Banks operate in a financially safe and sound manner. 12 U.S.C. 1422a(a)(3)(A). The minimum capital requirements established by the GLB Act advance the safety and soundness of the Bank System by ensuring that the Banks have sufficient capital to conduct their business. The Finance Board believes that a Bank that fails to maintain the minimum amounts of capital required by the GLB Act would be operating in an unsafe and unsound condition, which would require remedial action by the Finance Board. Although it was never the intent of the Finance Board to suggest that a Bank could pay dividends while not meeting its minimum capital requirements, the Finance Board sees merit in explicitly stating so in regulation and has added such language to the final rule.

Section 931.4(a) of the proposed rule also had provided that any member, including a member withdrawing from the Bank System, that owns Class A or Class B stock, or both, would be entitled to receive dividends declared on its stock for as long as it owned the stock. The final rule retains that provision. Section 931.4(a) of the proposed rule further provided that any dividends on the Class B stock shall be payable only from the net earnings or retained earnings of the Bank, determined in accordance with GAAP and was silent on the sources available for dividends on Class A stock. The final rule includes a similar provision, providing that a Bank may pay dividends only from its previously retained earnings or its current net earnings. That language simply restates the existing statutory

requirements and applies equally to dividends on Class A and to Class B stock. 12 U.S.C. 1436(a). The final rule also provides that a Bank shall declare and pay dividends only in accordance with its capital plan. As previously discussed, certain amendments made by the GLB Act may limit the ability of a Bank to pay dividends on its Class A stock from retained earnings. Section 6(h)(1) of the Bank Act, 12 U.S.C. 1426(h)(1), *as amended*, provides that the "holders of the Class B stock \* \* \* shall own the retained earnings, surplus, undivided profits, and equity reserves \* \* \* of the Bank." The following paragraph of the statute limits that ownership interest, providing that a member has no right to receive any portion of the retained earnings, other than through a dividend or a capital distribution. The next paragraph bars a Bank from distributing any of its retained earnings unless it would continue to meet all of its capital requirements following the distribution. Read together, those provisions appear to require that the retained earnings of a Bank are available only for the payment of dividends to the holders of the Class B stock. To allow the retained earnings to be used as a source for dividends on the Class A stock would appear to require a Bank to use the property of one class of stockholders to pay dividends to another class of stockholders, who have been granted no ownership interest in those retained earnings.

Section 16(a) of the Bank Act, 12 U.S.C. 1436(a), provides that "no dividends shall be paid except out of previously retained earnings or current net earnings." That suggests that even if the retained earnings are available only for payment of dividends to the holders of the Class B stock, a Bank could use its "current net earnings" as the source for paying dividends on its Class A stock. It appears, however, that under generally accepted accounting principles (GAAP), current earnings are closed to retained earnings at the close of each accounting period, the effect of which is to make current earnings unavailable as a source of dividends. Though it appears unlikely that the Congress considered how creating a property interest in the retained earnings in favor of the Class B stockholders might limit the ability of the Banks to pay dividends on their Class A stock, the language that Congress used places the ownership of the retained earnings with the Class B stockholders. The final rule is silent on this issue. As noted previously, the Finance Board anticipates further

rulemaking in the first quarter of 2001 on capital issues, and believes that the resolution of this issue regarding the source of dividends for the Class A stock should occur after there has been an opportunity for public comment on the issue. To the extent that any Bank intends to submit a capital plan that would call for the payment of dividends on Class A stock, the Finance Board expects that the plan would identify the source for paying such dividends, address the authority of the Bank to pay dividends from that source, and describe how the proposal would be treated under relevant accounting principles.

Some commenters expressed concern that any regulatory limits on dividends may prove troublesome over time, given the potential for increased volatility in reported net income and retained earnings that could result from the implementation of Statement of Financial Accounting Standards No. 133 (SFAS 133), the new GAAP accounting standard for derivatives. One commenter recommended that if the transitory income effects associated with SFAS 133 were to prevent the payment of a dividend, it would be appropriate for the Bank's board of directors to have the authority to declare and pay a dividend from earnings without regard to these transitory SFAS 133 effects. Another commenter expressed concern about the market and income volatility generated by the accounting treatment surrounding mortgage-related options, such as those associated with the Mortgage Partnership Finance (MPF) program. As noted previously, by statute a Bank may pay dividends only from its current earnings or its previously retained earnings. To the extent that these comments suggest that the Finance Board should allow a Bank to pay dividends from some other source, the Finance Board is not prepared to do so. Moreover, the GLB Act requires that in calculating risk-based and total capital, the retained earnings of a Bank must be calculated in accordance with GAAP. The GLB Act also restricts a Bank from making a retained earnings distribution, unless following such distribution the Bank would continue to meet all applicable capital requirements. These statutory provisions, read together, persuade the Finance Board that it should not adopt the suggestions raised by these commenters.

*Liquidation, merger, or consolidation.* The proposed rule established a priority for Class A shareholders over Class B shareholders, in the event of a liquidation, merger, or other consolidation of a Bank. As previously

discussed, many commenters recommended eliminating such a preference in order to avoid creating a taxable event with respect to stock previously issued as dividends when existing stock is converted to Class A stock. The Finance Board has eliminated this provision in the final rule, substituting instead a requirement that the respective rights of Class A and Class B stockholders, in the event that the Bank is liquidated, or is merged or otherwise consolidated with another Bank, shall be determined in accordance with the capital plan of the Bank.

*Transfer of capital stock.* Consistent with current practice, the proposed rule would have allowed a member to transfer capital stock only to another member of the Bank or to an institution that is in the process of becoming a member. Unlike current practice, the proposed rule would have required such transfers of stock to be at a price agreed to by the parties, which by implication meant that the price could be below, at, or above the par value of the stock.

Several commenters raised issues with allowing stock transfers to an institution in the process of becoming a member, citing concerns that if it did not become a member, a non-member institution could own Bank stock which would be inconsistent with the GLB Act. To address concerns raised by the commenters, the Finance Board revised the phrase "institution in the process of becoming a member" in the final rule to "institution that has been approved for membership in that Bank and that has satisfied all conditions for becoming a member, other than the purchase of the minimum amount of Bank stock that it is required to hold as a condition of membership."

Many commenters opposed the trading of Bank stock at a negotiated price among its members. Such trading, it was argued, would require members to hold Bank stock as an available-for-sale asset, which would have to be marked to market. The Finance Board agrees that such problems outweigh the potential benefits of other than par value transfers, at this time, and has thus revised the final rule to require that any transfer of stock among members must be at par value.

*Redemption and repurchase of capital stock.* Proposed § 931.10 (§ 931.7 in the final rule) set forth requirements for redemption and purchase of capital stock and provided that a member may seek to have the Bank redeem its Class A and Class B stock with six-months and five-years written notice to the Bank, respectively. At the end of the notice periods, the Bank would be required to pay the par value of the

stock to the member in cash. The proposal also would have barred a member from having pending at any one time more than one notice of redemption for any class of Bank stock. Several commenters expressed concerns with this restriction, indicating that it would inhibit a Bank's ability to pay stock dividends on Class B stock because a member that did not want to hold stock dividends effectively would be precluded from requesting redemptions. One Bank commenter suggested that, rather than restricting redemption requests, the Bank should be allowed to assess a fee for additional redemption requests. To address this issue, the Finance Board has revised the final rule to bar a member from having more than one notice of redemption outstanding at one time for the same shares of Bank stock. This will allow a member that has submitted a redemption notice for certain shares of stock to file an additional notice for other shares of stock if it receives stock dividends or otherwise is holding excess stock that it desires to have redeemed.

The final rule also clarifies that a member may cancel a notice of redemption if it does so in writing to the Bank, and the Bank may impose a fee (to be specified in the capital plan) on any member that cancels a pending notice of redemption. The requirement that a Bank shall not be obligated to redeem its capital stock other than in accordance with this paragraph also is adopted in the final rule.

Section 931.7(b) addresses repurchase of capital stock, which was referred to in the proposal as purchase of capital stock. Repurchase of capital stock differs from redemption in that it is a transaction that is initiated by a Bank, whereas a redemption of Bank stock is a transaction that is initiated by a member. The proposed rule provided that a Bank, in its discretion, may purchase outstanding Class A or Class B capital stock from its members at any time at a negotiated price. Several commenters expressed concerns about the implications of requiring such transactions to occur at a negotiated price, indicating that such a requirement would effectively prevent a Bank from repurchasing excess Bank stock unless the Bank were willing to pay the price demanded by the member. Several commenters also recommended that a Bank be given the unilateral right to purchase excess stock from any member at par value, so long as the purchase would not result in the Bank's failure to comply with any regulatory capital requirement. One commenter suggested that the Banks be given the

right to purchase Class A shares at par value and Class B shares at book value.

The Finance Board agrees that the proposed rule could make it unnecessarily difficult for the Banks to manage effectively their capital accounts. Accordingly, the final rule authorizes the Banks, in their discretion and without regard to the 6-month and 5-year redemption periods, to repurchase excess stock from their members. As noted previously, the term "excess stock" includes any Bank stock owned by a member in excess of the amount that the member is required to own under the minimum investment provisions of the Bank's capital plan. The final rule also addresses an issue raised by the comments by requiring the Banks to provide reasonable notice to any member from which the Bank intends to repurchase excess stock, with the length of such notice being stated in the capital plan. For any such repurchases, the Banks must pay to the members the stated par value of the stock in cash. The final rule also states expressly that a member's submission of a notice of intent to withdraw from membership, or its termination of membership in any other manner, shall not, in and of itself, cause any Bank stock to be deemed excess stock for purposes of this section. That provision reflects a statutory requirement imposed by the GLB Act, 12 U.S.C. 1426(e)(2), *as amended*.

Several Bank commenters recommended that the final rule give the Banks clear discretion to approve or deny a member's request for redemption, so long as the Bank is in compliance with its regulatory capital requirements. It is not apparent from the GLB Act that a Bank would have the authority to deny a redemption request if the capital of the Bank would not become impaired by the redemption or if the Bank would remain in compliance with its regulatory capital requirements following the redemption. Thus, the final rule provides that at the expiration of the six-month or five-year notice period, as applicable, the Bank will be required to pay the par value of the stock to the member in cash, assuming that the capital of the Bank is not impaired, the Bank meets its minimum capital requirements, and the member is not required to hold the stock as a condition of remaining a member or of engaging in any business transactions with the Bank. One commenter recommended that the redemption provisions of the final rule clarify who makes a redemption determination when redemption would cause the Bank to fall below its regulatory capital requirement and whether and under

what circumstances a redemption request may be withdrawn. Under the final rule, a member can withdraw a request for redemption at any time prior to the expiration of the applicable notice period, though the Bank may assess a fee on any member that does so. The Finance Board expects that each Bank will monitor its capital levels at all times and will not honor a redemption request if doing so would cause it to fail to comply with any of its capital requirements. How a Bank would address a situation in which multiple members simultaneously submit redemption requests that would cause the Bank to fall below any minimum capital requirement should be addressed in the Bank's capital plan.

One commenter suggested amending this section to clarify that a Bank that is not in compliance with its regulatory capital requirements not be permitted to redeem stock. The final rule precludes a Bank from redeeming or repurchasing any stock if, following the redemption or repurchase, the Bank would fail to meet any minimum capital requirement, or if the member would fail to maintain its minimum investment in the stock of the Bank, as required by § 931.3.

*Capital Impairment.* The final rule bars a Bank from redeeming or repurchasing any capital stock without the prior written approval of the Finance Board if the Finance Board or the board of directors of the Bank has determined that the Bank has incurred or is likely to incur losses that result in or are likely to result in charges against the capital of the Bank. The proposed rule had included a comparable provision, which would have allowed a Bank to redeem or repurchase stock with Finance Board approval even if the Bank thereafter would fail to meet its minimum capital requirements. The inclusion of the language in the proposed rule that would allow for such transactions with Finance Board approval was inadvertent, and the final rule does not permit such transactions. The final rule also provides that the prohibition on redemption and repurchase will apply even if a Bank is in compliance with its minimum capital requirements, and will remain in effect for however long the Bank continues to incur such charges or until the Finance Board determines that such charges are not expected to continue. As stated in the final rule, the provision more closely tracks the statutory language.

*Transition Provision.* The proposed rule included a general transition provision in § 932.1 for the Banks to meet the risk-based and leverage capital requirements, as well as a separate transition provision in § 933.3,

pertaining to the contents of the capital plans. Section 932.1 of the proposed rule would have required, by a date not later than three years from the effective date of its capital plan, that each Bank have sufficient total capital to meet the minimum leverage capital requirement in proposed § 932.2, and sufficient permanent capital to meet the risk-based capital requirement in proposed § 932.3. The proposed rule also would have mandated that the minimum stock purchase and stock retention requirements of the Bank Act in effect immediately prior to the GLB Act amendments remain in effect until the Bank had issued capital stock in accordance with its approved capital plan, and that each Bank would continue to be governed by certain provisions of the Finance Board's Financial Management Policy (FMP) until the Bank had met the proposed regulatory capital requirements.

One Bank commenter recommended that this provision be amended to clarify that the new minimum stock purchase and retention requirements would not become effective until a Bank had issued all stock under its plan, to allow for issuance of stock in tranches or rounds. A few commenters questioned whether the current leverage limitation, 12 CFR 966.3(a) (65 FR 36290, 36299 (June 7, 2000)), is less flexible than the leverage authority in the GLB Act, and the total capital provision of the proposed and final rule, and requested deletion of § 966.3(a). Section 966.3(a) requires a Bank to hold total assets not in excess of 21 times the total of its paid-in capital stock, retained earnings, and reserves (excluding loss reserves and liquidity reserves for deposits as required by 12 U.S.C. 1421(g)). In addition, that rule provides additional leverage authority by allowing a Bank to have an asset-based leverage of up to 25 to 1 if the non-mortgage assets held by the Bank after deducting the amount of deposits and capital, do not exceed 11 percent of the Bank's total assets. 12 CFR 966.3. Several Banks commented that the existing leverage limit would prevent them from efficiently leveraging the permanent capital base afforded through Class B stock, and that the existing leverage limit is more restrictive than the GLB Act leverage limit otherwise allowed.

The transition provision of the final rule has been clarified in numerous respects to address issues raised by the commenters, as well as other issues. In the final rule, the Finance Board has relocated the general transition provision to § 931.9, and has included a conforming provision in § 933.4 as part of the capital plan requirements. As an

initial matter, the transition provisions of the final rule are keyed to the "effective date" of a Bank's capital plan, which is defined as the date on which the Bank first issues any Class A or Class B stock. Prior to the effective date of a Bank's capital plan, the issuance and retention of Bank stock are to be governed by §§ 925.20 and 925.22, which implement the stock purchase requirements of the Bank Act as they existed prior to the GLB Act. As of the effective date of a Bank's capital plan, the issuance and retention of Bank stock shall be governed exclusively by the capital plan for that Bank.

As a general matter, § 931.9(a) of the final rule requires each Bank to comply with the minimum leverage and risk-based capital requirements of §§ 932.2 and 932.3, respectively, as of the effective date of the Bank's capital plan. If a Bank is in compliance with both the leverage and risk-based capital requirements as of the effective date of its capital plan, it shall thereafter be governed exclusively by the provisions of its capital plan and the capital requirements of §§ 932.2 and 932.3. For any Bank that is in compliance with the GLB Act leverage capital requirements as of the effective date, the final rule provides that existing leverage requirements at § 966.3(a) shall cease to apply to that Bank as of that date.

If a Bank will be out of compliance with the GLB Act capital requirements as of the effective date of its capital plan, then § 931.9(b)(1) of the final rule allows the Bank to establish a transition period over the course of which it will come into compliance with the GLB Act capital requirements. Any such transition period must be established as part of the Bank's capital plan and must describe the steps that the Bank plans to take during the transition period to come into compliance with the new capital requirements. The capital plan also must indicate the length of the transition period, which shall not exceed three years from the effective date of the capital plan. During the period of time that the Bank is out of compliance with the GLB Act leverage requirement, the final rule provides that the Bank will remain subject to the existing regulatory leverage requirement established by § 966.3(a). Once a Bank that has been operating under a transition period comes into compliance with the GLB Act leverage capital requirement, it will cease to be subject to the regulatory leverage requirement of § 966.3(a).

Though it is clear that the Congress intended the Banks to have the option of achieving compliance with the GLB Act capital requirements over a period

of up to three years from the effective date of the capital plan, there is nothing in the GLB Act to suggest that during any such transition period the existing leverage requirements should cease to apply. The Finance Board believes, as a matter of safety and soundness, that it is essential for the Banks always to be subject to a leverage requirement, and that the transition provision should not be read as authorizing the Banks to operate with no leverage capital requirement for up to three years after the effective date of their capital plans. The Finance Board believes that the best way of assuring continuity between the current regulatory leverage requirement and the GLB Act leverage requirements during any transition period is to link the termination of the existing leverage requirements to the commencement of the new leverage requirements. In effect, the final rule leaves to the board of directors of each Bank the ability to determine the date on which the existing leverage requirements in § 966.3(a) will cease to apply to that Bank. Banks that will achieve compliance with the GLB Act capital requirements immediately as of the effective date of their capital plans will no longer be subject to the current regulatory leverage limits. Banks requiring or desiring additional time to come into compliance with the GLB Act leverage requirement will have certainty under the final rule as to what leverage requirements apply to the Bank during the transition period.

Section 931.9(a) of the final rule separately requires each member to comply with the minimum investment established by the capital plan of its Bank as of the effective date of that plan. As was proposed, prior to the effective date of the Bank's capital plan the members will be required to purchase and hold Bank stock in accordance with §§ 925.20 and 925.22 of the Finance Board's regulations, which implement the stock purchase requirements of the Bank Act as in effect prior to the GLB Act.

Although the final rule generally requires members to meet the minimum investment as of the effective date of the Bank's capital plan, it also authorizes a Bank to include in its capital plan a transition provision that would allow members up to three years to purchase the amount of Bank stock that is required by the capital plan. The capital plan shall specify the length of any transition period established for the members and shall describe the actions that the members must take during the transition period in order to come into compliance with the minimum investment provisions of the capital

plan. Consistent with the GLB Act, any such transition period will apply only to those institutions that were members of the Bank as of November 12, 1999, which was the date of enactment of the GLB Act, and whose investment in Bank stock as of the effective date is less than the amount required by the capital plan for that Bank. Any institutions becoming members of a Bank after that date will be required to conform their Bank stock ownership to the amounts required by the capital plan as of the effective date of the capital plan. Similarly, any members that, as of the effective date, own stock in excess of the amount required by the capital plan, will be required to comply with the minimum investment established by the plan from that date forward. The final rule expressly authorizes the Banks to require their members that are subject to any such transition provision to purchase additional shares of Bank stock in increments over the course of the transition period.

The final rule includes two separate provisions that relate to new members and to new business, respectively. Any new members, *i.e.*, those institutions that became members after November 12, 1999 but prior to the effective date of the capital plan, as well as those institutions that become members after the effective date of the capital plan, will be required to comply with the minimum investment requirements of the Bank's capital plan as of the effective date of the plan, or upon becoming a member, as appropriate.

Finally, § 931.9(b)(3) requires a Bank's capital plan to require any member that obtains an advance or other services from the Bank, or that initiates any other business activity with the Bank against which the Bank is required to hold capital after the effective date of the capital plan to comply with the minimum investment specified in the Bank's capital plan for such advance, service, or activity at the time the transaction occurs. The Finance Board views the transition provisions of the GLB Act as authorizing the Banks to establish a period of time during which they, and their members, may increase their existing capital, or their existing investment in Bank stock, to the levels required by the GLB Act amendments. Thus, the transition provision assures that neither the Banks nor their members will be required to capitalize their existing business, *i.e.*, the business existing as of the effective date, in accordance with the GLB Act requirements unless the Banks affirmatively decide to do so. For business transactions that are undertaken after the capital plans take

effect, however, there is no need for a transition period because those transactions never would have been subject to the old capital rules. Moreover, construing the transition provisions as applying to transactions that are initiated after the new capital structure takes effect would pose the risk that the Banks could have up to three years during which to place assets on their books that would not be supported by adequate capital, a risk the Finance Board is not prepared to authorize.

#### *F. Part 932—Federal Home Loan Bank Capital Requirements*

*Overview.* As discussed in the **SUPPLEMENTARY INFORMATION** section of the proposed rule, the Finance Board, in developing the proposed risk-based capital requirements, drew from and expanded upon work done by the Basle Committee on Banking Supervision (BCBS), other federal financial regulators, the Office of Federal Housing Enterprise Oversight (OFHEO), which supervises the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and other sources as well as the work done in developing the Finance Board's Financial Management and Mission Achievement (FMMA) rule proposal. See 65 FR at 43410–11, 43419–34 (July 13, 2000). The Finance Board has made changes in the final rule to refine and clarify its risk-based capital requirement further, although the basic framework remains the same as in the proposal. These changes, which are discussed in more detail below, were based on comments received as well as additional work done by the Finance Board's staff. Changes were also made in the final rule to recognize that, given changes required by SFAS 133, derivative contracts can no longer be considered solely off-balance sheet items. In the final capital rule, derivative contracts are, therefore, referred to and addressed as transactions distinct from assets or off-balance sheet transactions. The Finance Board also addresses the comments received on the risk-based capital requirements in its discussion below of each individual section of these requirements.

#### *Section 932.1—Risk Management and Former Transition Provision*

As previously discussed, proposed § 932.1 contained the transition provision for meeting the risk-based and total capital requirements. The transition provisions for the capital plans and the minimum capital requirements have been consolidated

into a single section, § 931.9, in the final rule. Proposed § 932.1(c), under which the risk management provisions of the FMP would have ceased to apply to a Bank at the end of any transition period, has been eliminated from the consolidated transition requirements. The Finance Board has reconsidered the proposal and has determined that it would be more prudent to grant relief from any remaining FMP requirements at the time each Bank's capital plan is approved. This would allow the Finance Board to consider the specifics of each capital plan, the general economic conditions and any other factors that could affect a Bank's future operations and ability to fulfill its mission, before determining whether any part of the FMP should continue to apply. The comments received on the transition provision for the minimum capital requirements are addressed in the **SUPPLEMENTARY INFORMATION** section discussion of § 931.9.

In addition to the transition provision, proposed § 932.1 contained a requirement that before a Bank's capital plan could take effect, the Bank would have to obtain Finance Board approval of its internal market risk model or internal cash flow model and for the risk assessment procedures and controls that would be used to manage the Bank's credit, market and operations risk. An adequate internal model must be developed and approved before the risk-based capital requirements—a key component underlying the new capital structure—can be calculated.<sup>6</sup> At the same time, adequate internal controls for recognizing and managing the risks faced by the Banks will be an important factor in the successful implementation of a new capital system in which the Banks' required capital levels are closely tied to their risk profiles. No comments were received on the approval requirement in proposed § 932.1(b). Accordingly, the Finance Board continues to view an approved internal market risk or cash flow model and adequate internal risk management controls as necessary prerequisites for implementation of the Banks' capital plans and has adopted this requirement without change in § 932.1 of the final rule.

#### *Section 932.2—Total Capital Requirement*

Proposed § 932.2 set forth the minimum total capital leverage requirement contained in the Bank Act,

<sup>6</sup> As adopted in the final rule, § 932.5 allows each Bank to determine market risk capital charges using an approved internal market risk model or internal cash flow model.

as amended by the GLB Act. 12 U.S.C. 1426(a)(2). Proposed § 932.2(a) would have required a Bank to maintain total capital equal to no less than four percent of its total assets, where total capital was computed without regard to the weighting factor required by the GLB Act and described in proposed § 932(b). This weighting factor would have required a Bank to multiply the permanent capital component of its total capital by 1.5. (Permanent capital is defined to include the paid-in value of Class B stock and retained earnings calculated in accordance with GAAP. 12 U.S.C. 1426(a)(5).) The provision, consistent with the GLB Act, further would have mandated that a Bank's total capital, computed using the weighting factor, could not have been less than five percent of its total assets. In the proposed rule, the Finance Board also would have reserved the right to require a Bank to have and maintain total capital in amounts above the minimum required levels if warranted by safety and soundness concerns. The proposed provision reserving this authority was substantively the same as the provision contained in proposed § 932.3 concerning the minimum risk-based capital requirement.

The Finance Board received several comments on proposed § 932.2, but for the reasons discussed below has not changed the provision in response to those comments and is, therefore, adopting § 932.2 substantially as proposed, with certain technical changes. The requirement describing the weighting factor has been revised to clarify how the weighting factor is applied, and the provision concerning the Finance Board's right to require a Bank to hold total capital above the minimum levels has been revised to conform to the substantively similar provision in § 932.3 of the final rule.

One commenter requested clarification as to whether total capital had to be calculated in accordance with GAAP. The commenter believed that implementation of SFAS 133 as part of GAAP would result in a Bank's assets being artificially "grossed up" because unrealized gains on certain derivative contracts would have to be recorded on a Bank's balance sheet as assets. The commenter urged the Finance Board to allow total capital and the minimum leverage ratios to be calculated without taking account of these unrealized gains on derivative contracts. However, the GLB Act requires that when deriving permanent and total capital, "retained earnings" must be calculated in accordance with GAAP. 12 U.S.C. 1426(a)(5)(A)(ii). By extension, the valuation of all assets and liabilities,

upon which the calculation of retained earnings is based, would likewise have to conform with GAAP. The requested change, therefore, is not consistent with the requirements of the GLB Act. Further, the Finance Board believes that it would undermine the efficacy of the minimum total capital ratios as a regulatory tool if the total asset component (*i.e.*, the denominator) of the minimum total capital ratios were to be calculated on a different basis than the total capital component (*i.e.*, the numerator). Thus, no change in the final rule has been made in response to this comment.<sup>7</sup>

One commenter also requested clarification of what safety and soundness concerns may prompt the Finance Board to require a Bank to hold total capital above the minimum required level. The primary duty of the Finance Board is to ensure that the Banks operate in a "financially safe and sound manner." 12 U.S.C. 1422a(a)(3)(A). The Bank Act has long provided the Finance Board or its predecessor agency the authority to take actions to carry out that duty and other responsibilities under the Bank Act. 12 U.S.C. 1422b. Section 932.2(c) of the final rule is consistent with the duties and authority of the Finance Board under the Bank Act and will be implemented as is necessary and authorized to carry out those duties. However, as explained more fully below in the discussion of the Minimum Risk-Based Capital Requirement, the Finance Board expects that the authority granted under this provision rarely will be used, but nonetheless believes that the provision is an important safeguard measure in case unforeseen events result in anticipated or actual impairment of a Bank's capital.

### Section 932.3—Risk-Based Capital Requirement

Proposed § 932.3 would have required each Bank to maintain at all times an amount of permanent capital equal to at

least the sum of the Bank's credit, market and operations capital risk requirements. The proposed rule also provided that the Finance Board for reasons of safety and soundness could require a Bank to hold a greater amount of permanent capital than the required minimum amount.

The Finance Board received a number of general comments on the risk-based capital requirement. Many commenters believed that the paid-in portion of Class A stock should be considered permanent capital for purposes of fulfilling some aspects of the risk-based capital requirement. Other commenters felt that, overall, the risk-based capital charges were too high and would put the Banks at a competitive disadvantage to Fannie Mae and Freddie Mac. One commenter requested that the Finance Board delineate more clearly the conditions under which it would require a Bank to hold additional permanent capital and to clarify whether Finance Board staff could order such an action. Another commenter requested clarification concerning the risk weighting that would be applied to unrealized gains held as assets for risk-based capital purposes. The Finance Board has considered all comments received on the minimum risk-based capital requirements and, for the reasons discussed below, is adopting § 932.3 substantially as proposed.

One Bank and a number of its members argued that, because Class A stock cannot be redeemed if the Bank is operating below its minimum capital requirements, Class A stock should be considered permanent capital, thus suggesting that the Finance Board allow the paid-in value of Class A stock to be used to meet some portion of the minimum risk-based capital requirement. The Finance Board believes that such a change would be inconsistent with the GLB Act. The term "permanent capital" is specifically defined by the statute to include "the amounts paid for the [C]lass B stock; and the retained earnings of the [B]ank (as determined in accordance with generally accepted accounting principles)." 12 U.S.C. 1426(a)(5)(A). As already addressed in this **SUPPLEMENTARY INFORMATION** section in the discussion of § 931.3, the Congress has spoken definitively on these issues and the Finance Board is not at liberty to consider Class A as permanent capital. Also as previously discussed, the risk-based capital requirements for a Bank may be satisfied only with permanent capital. 12 U.S.C. 1426(a)(3). The totality of the GLB Act definitions make it clear that Class A stock cannot

lawfully be used to satisfy a Bank's risk-based capital requirements.

Some commenters also urged the Finance Board to allow Banks to apply at least some portion of the paid-in value of Class A stock against the operations risk capital charge because, unlike the credit and market risk requirements, an operations risk requirement was not specifically mandated by the GLB Act. However, as addressed elsewhere in this **SUPPLEMENTARY INFORMATION** section, the Finance Board considers an operations risk charge to be an integral part of the risk-based capital requirement. Further, as just discussed, by statute, Class A stock is not suitable risk-bearing capital for credit and market risk. Consistent with this approach, the Finance Board continues to believe that only permanent capital should be held against the operations risk requirement, which, along with the credit and market risk requirements, forms the overall risk-based capital requirement.

More generally, with regard to the magnitude of the risk-based capital charges, estimates by the Finance Board staff indicate that the total risk-based capital charges will not be onerous to the Banks as some commenters have suggested, given the Banks' current balance sheets and risk profiles. Even estimates of the market risk capital charges produced by the Banks' consultant, which involved stress scenarios that would be more rigorous than those required under the proposed rule, did not suggest that the capital requirements being adopted here would be unreasonable. Specifically, the Finance Board anticipates that at least at the time of implementation of the capital plans, the risk-based capital requirement for all Banks will be below the minimum total capital leverage requirements set forth in the GLB Act. More importantly, as addressed more fully in the separate credit, market and operations risk sections, the Finance Board believes that the approaches adopted for calculating individual risk-based charges are reasonable, given available information and the technical capabilities of the Banks. Overall, the Finance Board believes that the risk-based capital charges will adequately reflect the risks faced by the Banks.

In addition, as discussed in the **SUPPLEMENTARY INFORMATION** section of the proposed rule, the Finance Board considered all aspects of OFHEO's proposed risk-based capital rule in developing the proposed rule, as well as in developing the final rule. The GLB Act requires the Finance Board to give due consideration to the OFHEO capital rule in developing the market risk

<sup>7</sup> A few commenters, also citing the effects of SFAS 133, urged the Finance Board to allow a Bank's required payments to the RefCorp and to the Affordable Housing Program (AHP) to be assessed based on "economic earnings" rather than GAAP earnings. The Finance Board has also received a request for a regulatory interpretation that seeks to reduce the potential effects of SFAS 133 on earnings calculations used for certain regulatory purposes. That request, which raises a number of concerns, including some similar to those discussed above with regard to calculating total capital, is now being reviewed by Finance Board staff. The issue of whether the Finance Board should authorize the Banks to calculate their RefCorp and AHP payments by using non-GAAP earnings was not addressed in the proposed rule. The Finance Board, therefore, declines to implement any rule changes to address the RefCorp and AHP payments issue at this time.

component of the risk-based capital requirement for the Banks, but nothing in the GLB Act requires the Finance Board to defer to the OFHEO regulation, either with regard to the market risk or other components of this rule. See 65 FR at 43426–27 (July 13, 2000); *Am. Fed'n of Gov't Employees v. Donovan*, 1982 WL 2167 \*3 (D.D.C.) (the use of the terms “due consideration” in the Service Contract Act of 1965 “are much more nearly precatory than mandatory [and] have a procedural implication,” and do not mean “equivalent to”). Neither does anything in the GLB Act require that the Finance Board’s risk-based capital requirements result in the same or similar risk-based charges for the Banks and for Fannie Mae or Freddie Mac. In fact, Congress established a different risk-based capital stress test and different minimum capital levels for the Banks than it did for Fannie Mae and Freddie Mac.<sup>8</sup> Compare 12 U.S.C. 1426(a)(2), (a)(3), to 12 U.S.C. 4611, 4612. Nevertheless, the Finance Board does not believe that the capital requirements adopted herein are inconsistent with those governing Fannie Mae or Freddie Mac, after taking into account the differences in the relevant statutes and the businesses of the three GSEs. See 65 FR at 43426.

Some commenters requested clarification on certain aspects of the minimum risk-based capital requirement. One Bank urged the Finance Board to specify that, for purposes of the minimum risk-based capital requirement of § 932.3(a), unrealized gains recorded as assets on the Bank’s balance sheet should receive a risk-weighting of zero because “any risks associated with these balances is adequately covered by the [risk-based capital] requirements for credit risk.” The minimum risk-based capital charge set forth at § 932.3 as adopted is the sum of a Bank’s credit, market and operations risk charges calculated in accordance § 932.4, § 932.5 and § 932.6. Contrary to the commenter’s request, § 932.3 does not require a charge independent of these components and does not directly assign risk weights to assets. However, by way of clarification, the credit risk capital charge that will be calculated under § 932.4, as adopted herein, will apply to the underlying derivative contract or asset, and there will be no additional credit risk capital

charge applied to the associated unrealized gain that is carried on the Bank’s balance sheet as an asset. Similarly, when calculating the market risk charge using its approved internal model, a Bank will be expected to “stress” the value of the underlying derivative contract or asset only.

Another commenter requested clarification of when and how “safety and soundness” concerns may prompt the Finance Board to require a Bank pursuant to § 932.3(b) to increase its permanent capital above the minimum levels mandated by § 932.3(a). The primary duty of the Finance Board is to ensure that the Banks operate in a “financially safe and sound manner.” 12 U.S.C. 1422a(a)(3)(A). The Bank Act has long provided the Finance Board or its predecessor agency the authority to take actions to carry out that duty and other responsibilities under the Bank Act. 12 U.S.C. 1422b. Safety and soundness concerns can arise in numerous circumstances and have to be addressed on a case-by-case basis or for the Bank System as a whole. Section 932.3(b) of the final rule is consistent with the duties and authority of the Finance Board under the Bank Act and will be implemented as is necessary and authorized to carry out those duties.

Overall, however, it is highly unlikely that the authority under § 932.3(b) will be used, given the degree of oversight exercised by the Finance Board, the ability of the Banks to make adjustments in their capital plans, the Finance Board’s flexibility to make adjustments to the capital requirements, and the presence of backstop provisions in the capital rule, such as the market value of capital test in the market risk capital requirement. Nonetheless, § 932.2(b) of the final rule is an additional safeguard against unanticipated events that could result in anticipated or actual impairment of a Bank’s capital. Examples of such events could include a Bank’s risk profile evolving in such a way that it is not adequately addressed by the then-current capital requirements, or a Bank’s capital plan failing to meet expectations and generate sufficient capital given the risks faced by the Bank.

#### *Section 932.4—Credit Risk Capital Requirement*

*General.* Proposed § 932.4 set forth a general formula for calculating the credit risk capital charge for on-balance sheet assets and off-balance sheet items, including derivative contracts, held in a Bank’s portfolio. For an asset or item, the credit risk capital charge would have been equal to the book value of the asset or the credit risk equivalent

amount for an off-balance sheet item, multiplied by the appropriate credit risk percentage requirement. The credit risk percentage requirements were provided in four tables. The methodology used in developing the tables was discussed in the **SUPPLEMENTARY INFORMATION** section of the proposed rule. See 65 FR at 43421–24.

The Finance Board received a number of comments about the credit risk capital requirement. Generally, the commenters indicated that the proposed rule showed sophistication in the treatment of credit risk and offered much more detailed credit weightings for various exposure classes, maturities and credit ratings than had ever been offered by other regulators. Commenters did, however, have a number of comments and concerns on specific issues, which are discussed in detail below.

One general concern noted was that the proposed rule failed to capture the correlation between credit and market risk. Under the rule as proposed, the Banks would have been required to determine their credit and market risk requirements separately based upon different historical stress events. This approach is equivalent to assuming that the risks are highly and positively correlated, because the historical stress periods for each of the two risks are treated as if they coincide, regardless of whether they do in fact coincide. The Finance Board believes that this assumption is prudent. The Finance Board notes that there is research that the correlation in stress events (extremes) between market and credit risk is positive. See Mark Carey, “Dimensions of Credit Risk and Their Relationship to Economic Capital Requirements, to be published in *Prudential Supervision: What Works, and What Doesn’t*, Frederic S. Mishkin, ed. (NBER and UC Press, 2001). As the commenters noted, this approach ensures that any estimation bias associated with overstating the correlation of credit and market risk during stress periods will result in capital charges that are conservative rather than deficient. From a safety and soundness perspective, the Finance Board believes this conservative approach is reasonable at this time and is consistent with the OFHEO proposed rule on risk-based capital.<sup>9</sup> Further, although a joint estimation of the credit and market risk requirements would seem more appealing theoretically in

<sup>8</sup> For example, the GLB Act requires that the Finance Board develop a stress test that rigorously tests for changes in interest rates, interest rate volatility and changes in the shape of the yield curve, while the statutory requirements governing Fannie Mae and Freddie Mac set forth specific scenarios for downward and upward shocks in interest rates.

<sup>9</sup> Because the OFHEO model examines both an upward and downward interest-rate shock, but with each subject to the same benchmark credit loss scenario, one of the two interest-rate shocks must be positively correlated with the credit risk losses.

that the correlation between credit and market risk can be better measured, as a practical matter, joint estimation during stress periods is, for now, untested and more challenging analytically, and would not provide a technically sound basis for estimating capital charges at this time. Thus, the Finance Board believes that the conservative approach of the proposed rule best assures that the Banks will remain adequately capitalized and will continue to operate in a safe and sound manner throughout periods of future market stress.

Another commenter stated that the Finance Board did not provide in the proposed rule sufficient detail of the parameters for internal credit models, which models, the commenter believed, will be heavily relied upon by the Banks. However, neither the proposed rule nor the final rule allow a Bank to calculate its credit risk capital requirement using an internal credit risk model. In two narrow circumstances, the rule, both as proposed and adopted, allows a Bank to use an internal model to calculate the potential future credit exposure (PFE) on a derivative contract or the credit equivalent amount on certain off-balance sheet items as an alternative to using the tables and formulas provided in the rule for estimating those values. In both cases, the Finance Board would review the models and the assumptions before allowing a Bank to employ the model. Moreover, neither the derivative contracts nor the off-balance sheet items in question represent a large amount of the Banks' balance sheets.

Based on the comments received, the Finance Board made a number of changes to the credit risk capital requirement in the final rule. These changes, which are discussed in detail below, include refinements to the methodologies used in estimating the credit risk percentage requirements for Table 1.1, Table 1.2, and Table 1.3. The Finance Board also has changed in the final rule the method used to calculate the credit risk charge for derivative contracts and expanded the situations in which the Bank may reduce its capital charge for an asset hedged with a credit derivative. As explained below, while the Finance Board believes that the new method adopted for calculating the credit risk capital charge for derivatives better captures the true risk of the Banks' exposure to these instruments, the Finance Board does not believe that the change will have much practical effect on the level of the credit risk capital requirement because derivative contracts represent a very small part of

the Banks' balance sheets.<sup>10</sup> The Finance Board has adopted § 932.4 of the final rule with the changes discussed below.

*Table 1.1.* The credit risk percentage requirements for Bank advances in the proposed rule were based on the general methodology used to set credit risk percentage requirements for credit exposures of rated assets, off-balance sheet items or derivative contracts other than advances and residential mortgages (Table 1.3). As discussed in more detail in the discussion of Table 1.3 below, the general methodology was based on the highest estimated (proportional) credit losses by rating category and maturity class observable over a two-year period during the interval 1970 to 1999.

Several adjustments were made to the general methodology in setting the credit risk percentage requirements for advances. The general methodology was based on default and downgrade data on corporate bonds. For advances, only default data was used. Downgrade data really has no meaning because advances are fully collateralized and the Banks can require additional collateral at any time. Because the Banks have never incurred credit losses on their advances to a member, the Finance Board assumed, for purposes of establishing a default rate for advances, that advances would exhibit the same default patterns as the highest investment grade (triple-A) corporate bonds and that advances would have a recovery rate of 90 percent (i.e., a loss severity rate of 10 percent). A 90 percent recovery rate was considered consistent with the over-collateralization and other protections afforded advances. A credit risk horizon equal to the remaining maturity of the advance was deemed more appropriate than imposing the maximum two-year horizon used in the general methodology, because advances are unique products of the Banks that cannot readily be sold in the marketplace like most of the other investments of the Banks and, therefore, would have to remain on the books until maturity. The probability of default was then measured as the maximum probability of a triple-A corporate issuer default, but over a period extending to the maturity of the advance.

Adjustments also were made to the credit risk percentage requirements assigned to the shortest and longest remaining maturity classes. As calculated, the requirement for advances with a maturity of four years or less

would be zero. However, recognizing that advances are not totally risk free, a minimum capital requirement of seven basis points was set to ensure that the Banks would hold sufficient capital, particularly in view of the GLB Act's recent amendments to the Bank Act which expanded the types of collateral available to support advances. See 12 U.S.C. 1430(a)(3); 65 FR 44414 (July 18, 2000). Further, as calculated for the proposed rule, the requirement for maturities greater than 10 years would have been 50 basis points. However, because the estimated capital charge for triple-A-rated residential mortgage assets (as presented in proposed Table 1.2) was less than 50 basis points, and because advances clearly have a better credit loss history than residential mortgages, advances with a remaining maturity of greater than 10 years were assigned a credit risk percentage requirement equivalent to the requirement for triple-A-rated residential mortgage assets. In the final rule, the requirement for advances with remaining maturities greater than 10 years was adjusted to reflect the revised methodology used to calculate credit risk requirement percentages for residential mortgage assets for Table 1.2, and is set at 35 basis points. The credit risk percentage requirement of 20 basis points for remaining maturities greater than 4 years up to 7 years was based on actual default rates and remains the same in the final rule. For maturities of greater than 7 years up to 10 years, the credit risk percentage requirement, if based on actual default rates, would have been 40 basis points. In the final rule, however, the credit risk percentage requirement was reduced to 30 basis points to conform with the 35 basis point requirement for maturities greater than 10 years.

In the proposed rule, the Finance Board specifically requested comment on the methodology that should be used for setting the credit risk percentage requirements for advances and whether a more satisfactory analytical framework exists that could be used to determine more appropriate credit risk percentage requirements for advances.

The Finance Board received several comments on the proposed credit risk percentage requirements for advances. One commenter was supportive of treating advances independently of underlying collateral; another stated that the less-than-four-year maturity advance percentage requirement was reasonable. However, commenters generally questioned whether the Finance Board had given adequate consideration to the nature of member borrowers, the strong collateral position

<sup>10</sup> As of December 31, 1999, the Banks' combined maximum credit exposure to derivative contracts was approximately \$2 billion. This was a small amount compared to the Banks' assets of \$633 billion or their capital of \$30 billion.



of the Banks and the additional security provided by the capital stock for advances in developing the credit risk percentage requirements for advances.

Two Banks commented on a possible alternative analytical framework, which was suggested by a consultant to the Banks that could be used to derive the credit risk percentage requirements for advances. The consultant reviewed rating agency data and concluded that financial institution default rates are roughly 30 percent to 40 percent of corporate bond default rates. The consultant further reasoned that because Bank members are regulated financial institutions, and not corporate borrowers, default rates based on corporate borrowers were overstated.

Additionally, the Banks believed that using recovery rates of 90 percent understates the value of collateral pledged to support advances, which when properly accounted for on an estimated market value approach, would yield a value in excess of the underlying advances. One Bank suggested that the Finance Board consider requiring that collateral portfolios be further subjected to stress testing as an alternative input into the credit risk percentage requirement calculations for credit exposures arising from advances. The Bank also argued that the proposed rule did not take account of the fact that by statute, the capital stock investment of a member acts as additional security for advances. The Bank believed that recognition of the collateral and capital values available to the Banks should reduce the credit risk from advances to zero. The Bank further stated that from a safety and soundness perspective, the Finance Board and the Banks themselves should be more concerned with the adequacy of collateral methods and practices than in trying to determine a capital requirement from inappropriate statistics. The Bank asserted that mortgage data, which is available and frequently analyzed, should be the basis for determining credit exposures from secured advances.

The Finance Board has considered all comments and believes that the methodology, described above, used to determine credit risk percentage requirements for advances does adequately consider the unique characteristics of advances. The fact that the credit risk percentage requirements for advances set forth in Table 1.1 of the final rule are lower than those for other residential mortgage assets set forth in Table 1.2 of the final rule demonstrates that the Finance Board explicitly recognizes that advances have less credit risk than other mortgage assets.

This view is based upon, among other things, the fact that advances are well collateralized and are provided additional safeguards under the Bank Act. Further, as is addressed in greater detail in the discussion of Table 1.2, the Finance Board has considered available mortgage data in developing the credit risk percentage requirements for residential mortgage assets other than advances. Because this new approach lowered the credit risk percentage requirements for these residential mortgages assets, the credit risk percentage requirements for advances with remaining maturities in the categories of more-than-seven-years-to-ten-years and over-ten-years in Table 1.1 also have been lowered so that the credit risk percentage requirements for advances remain below the requirements for other residential mortgage assets. Thus, the final rule continues to recognize that advances have less credit risk than other mortgage assets.

Further, the Finance Board does not believe that it will be realistic to eliminate credit risk charges for advances, as some commenters have urged. Given that advances are a large part of the Banks' total assets, the credit risk capital requirement—and the risk-based capital requirements more generally—would not be credible if risk-based capital were not held against the credit risk of advances. Nor have the commenters provided enough information on other suggested approaches for estimating the credit risk percentage requirements for the Finance Board to implement these methodologies at this time. The Finance Board believes that the credit risk percentage requirements adopted in Table 1.1 recognize the unique characteristics of advances while, given current available information, still provide a conservative estimation of the risks presented by these assets. The Finance Board will consider amending its current methodology as better information and theoretical approaches become available.

*Table 1.2.* The credit risk percentage requirements in the proposed rule for residential mortgage assets were based on a quantitative analysis of the default and downgrade experience of rated corporate bonds. However, the Finance Board received comments expressing the view that the credit quality of rated residential mortgage backed instruments (RMBS) is generally better than corporate bonds with similar ratings and tenor. The Finance Board, therefore, reviewed available information on rated RMBS downgrades and defaults. This information indicated that defaults have

been extremely infrequent and that there have been proportionately fewer downgrades on RMBS than on otherwise similar corporate bonds. The magnitude of the difference in credit performance appeared relevant, even given the short history of the RMBS market.

The Finance Board also found that the factors that affect rated RMBS are not typical of those that affect the credit quality of corporate bonds. Factors that appear to generally benefit the credit quality of rated RMBS include: The relative stability of home prices; the diversification in the underlying collateral; and the relatively predictable performance of the collateral pools. The Finance Board found these arguments persuasive and, as explained more fully below, has applied in the final rule a different basis on which to determine the capital charges for residential mortgage assets.

Commenters also expressed the view that the capital charges in the proposed rule for BBB and lower rated residential mortgage assets exceeded the risk of these assets, some noting that bank and thrift depositories are only required to hold four percent risk based capital against unenhanced residential mortgages. The Finance Board generally took this view into account in developing a new basis for determining the capital charges in the final rule, but notes that Banks are only allowed to invest in investment grade assets and therefore the capital charges in the proposed rule for residential mortgage assets rated below investment grade would have applied only if the assets were downgraded. The Finance Board also adopted in the final rule a lower but still stringent credit risk percentage requirement for residential mortgage assets rated below B. This final credit risk percentage requirement still accounts for the fact that these assets may only reside on the books of the Banks as a result of being downgraded from investment grade and are presumed to have some material credit quality issue.

The Finance Board also recognizes that some of the concern with the credit risk percentage requirements for lower-rated mortgage assets may have been prompted by a lack of clarity in the proposed rule. The proposed rule did not make clear that the credit risk percentage requirements would be assigned for AMA based on the credit rating after application of the credit enhancement required under the Finance Board rules or application of any additional enhancements obtained by the Bank. Section 932.4(e)(2)(ii)(E) has been added to the final rule to

clarify this point. The final rule assumes the adequacy of the credit enhancement provided by members under the AMA requirements, and no credit risk capital charge need be applied to any potential exposures arising from these member-provided credit enhancements. The Finance Board may, however, require a Bank to apply a credit risk capital charge to any credit enhancement obtained by a Bank for AMA beyond that required under § 955.3(b) if the Finance Board believes that there are deficiencies associated with those additional enhancements.

While the final rule no longer relies upon quantitative data on the credit performance of rated corporate bonds as an indicator of the credit risk on mortgage assets, the Finance Board was unable to identify any adequate similar quantitative data to substitute for rated RMBS to conduct a similar analysis. The data is not readily available and, because of the brief history of the RMBS market, such data as could be found would not provide a robust information source regarding periods of economic stress. The Finance Board, therefore, has adopted in a final rule a significantly different approach than that employed in the proposed rule—one that is necessarily less mechanical in applying historical credit losses and one that considers the practices of other regulators and market participants. More specifically, the credit risk percentage requirements set forth in Table 1.2 of the final rule are based on an approach that considers: (1) The risk-based capital charges employed by regulated banks and thrifts for residential mortgage loan portfolios and for agency mortgage-backed securities (MBS); (2) the minimum MBS capital charges for Fannie Mae and Freddie Mac; and (3) the capital charges implicitly employed by the nationally recognized statistical rating organizations (NRSRO) when rating RMBS and mortgage insurance companies. The Finance Board also drew from the NRSRO's approach for determining the charges for the different rating categories in developing Table 1.2 of the final rule.

The capital required for performing residential mortgage loans varies widely. Commercial banks and thrifts are required to hold 4 percent risk-based capital against these loans. This requirement was enacted after the severe residential mortgage credit problems of the 1980s. Also, it is applied uniformly to well-diversified, conforming loan portfolios and to the often riskier, non-diversified and non-conforming portfolios. As such, the 4 percent requirement may be viewed as

a conservative benchmark relative to the residential mortgage assets covered by Table 1.2 of the final rule.

In contrast with the residential loan portfolio risk-based requirement, commercial banks and thrifts are only required to hold 1.6 percent risk-based capital for GSE-issued MBS. The fact that many banks and thrift originators do not take advantage of this ability to transfer virtually all of their credit exposure on conforming loans to Fannie Mae and Freddie Mac may indicate that the banks and thrifts view the 2.4 percentage point credit risk differential as larger than the actual difference in the credit exposure between conforming loan pools and GSE MBS.

The Finance Board also reviewed information regarding the credit enhancement required to raise unenhanced loan pools to the highest credit rating as an indication of the capital charge for unenhanced loan pools. For example, whole loan RMBS typically have AAA credit enhancement requirements ranging from four percent to seven percent. However, this may be a conservative indicator relative to the assets covered by this rule because many whole loan RMBS have non-conforming collateral due to loan size or credit issues, or the loans are adjustable rate mortgages (ARMs) or the collateral may have some element of geographic concentration. These factors are associated with higher loss experience. In contrast to whole loan RMBS, the Finance Board has observed that the AAA credit enhancement requirement on many Bank AMA pools falls below 4 percent.

The Finance Board also noted the 0.45 percent statutorily-based minimum capital requirement for Fannie Mae and Freddie Mac MBS guarantees on conforming loans. This requirement on loans with no credit support is less than the Finance Board's credit risk percentage requirement for all but the highest rated mortgage asset. However, comparison between the OFHEO and the Finance Board requirements is difficult because of the different risk-based approaches of the two regulators. Moreover, the OFHEO requirement may not be indicative of a true risk-based charge. The 0.45 percent requirement is part of the statutory minimum total capital requirement for Fannie Mae and Freddie Mac. 12 U.S.C. 4612(a). In this respect, it is more comparable to the minimum total capital leverage requirements of the GLB Act than a risk-based charge. Based on the foregoing, the Finance Board has decided to adopt in the final rule a benchmark exposure, and therefore a credit risk percentage requirement, of 2.4 percent for

performing, well diversified, prime-quality, conforming residential mortgage loan pools.

The Finance Board also has decided to use the general rating scheme and certain aspects of the RMBS rating process to determine the credit risk percentage requirements for residential mortgage assets. The Finance Board has found that the RMBS rating process employs useful standards for understanding the relative risk of residential mortgage pools. The rating process generally relies upon parameters for foreclosures and losses on residential mortgages under various economic stress scenarios. The rating process is typically systematic and appears to be based on a comprehensive review of information bearing on residential mortgage credit losses. Moreover, the Finance Board has found that the rating process for RMBS has relatively wide acceptance in the debt market, among secondary market participants and with mortgage insurers. The Finance Board was informed that, during stable, moderately favorable economic conditions, the unenhanced whole loan pools underlying RMBS could be considered to have credit quality in a range between BB and CCC. The Finance Board believes that, in general, prime-quality, conforming loan pools typically should have more favorable credit quality than RMBS whole-loan pools. Given this, the Finance Board has decided that, for purposes of the final rule, well-diversified conforming loan pools should be considered to have an exposure benchmark similar to a BB rating.

Based on the assumptions that well-diversified, prime-quality, conforming residential mortgage loan pools have a credit risk percentage requirement of 2.4 percent, and that such pools may be assumed to have credit quality similar to a BB-rated mortgage asset, the Finance Board has used the relative credit support required by the RMBS rating process to assign the credit charges for the other rating categories. Using this approach, the credit risk percentage requirements are derived based on the relative amount of credit support that is generally provided for the different rating grades as a percentage of the BB benchmark.

Table 1.2 of the final rule presents the credit risk percentage requirements for FHLBanks' residential mortgage-related exposures. The credit risk percentage requirements presented in the final rule are based on the assumption that residential mortgage assets will typically consist of conforming, prime-quality loans with loan-to-value (LTV)

ratios below 80 percent or loans with higher LTV ratios that have appropriate levels of mortgage insurance. The Finance Board further assumes that the performance of any credit enhancement is assured in all relevant economic stress scenarios, and that the Banks' portfolios of residential mortgage assets will have appropriate diversification, and will not have geographic or other concentration factors that increase credit risk. Finally, the credit risk percentage requirements for mortgage assets adopted in the final rule take into account that the Banks are required to invest in mortgage-backed assets that have credit quality no less than that of the fourth highest credit rating class.

A uniform application of the standard adopted in the final rule, however, would fail to address the fact that the credit risk of pooled residential mortgages may be concentrated in subordinated classes and support tranches. Support classes may also have longer weighted average lives than the senior classes they support. To address this concern, the Finance Board adopted a more stringent capital standard for such asset classes. It was further observed that AAA and AA classes were much less likely to feel the effect of subordination. For these reasons, it was determined that, for subordinated residential mortgage assets below AA, the credit risk percentage requirements should be the same as those for Rated Assets or Rated Items Other Than Advances or Residential Mortgage Assets in the 3 to 7 year maturity class of Table 1.3 of the final rule. Table 1.2 of the final rule has been modified to add specific credit risk percentage requirements for these subordinated classes and support tranches of residential mortgage assets.

The above-described approach best accommodates the information now available to the Finance Board. However, the Finance Board will continue to gather and analyze data on the performance of residential mortgage loan pools and RMBS, and intends to amend these capital charges if more complete and representative information and analysis becomes available.

*Table 1.3.* In the proposed rule, the credit risk percentage requirements in Table 1.3 for credit exposures of rated assets, off-balance sheet items or derivative contracts other than advances and residential mortgages were calculated from Moody's data on corporate bond performance. Specifically, the requirements were based on the highest estimated (proportional) credit losses by rating category and maturity class observable

over a two-year period during the interval 1970 to 1999. The Finance Board received only one comment on the methodology described in the proposed rule used to arrive at the requirements listed in Table 1.3. That commenter identified two concerns. First, only 30 years of performance data were used, whereas 80 years of performance data are available. Second, and more importantly, single-year maximum default rates rather than long-run average default rates were used. The commenter added that the single-year maximum approach would identify maximum default rates based on outlier results, hence the resulting rates need not be representative of the true relative differences in proportionate market value losses by rating class—the goal of a ratings-based approach.

The Finance Board continues to believe that the most recent 30 years of Moody's data includes a sufficient number of observations that are representative of the modern era. The Finance Board does see some merit in the single-year (actually a two-year period is presented in the proposed rule but the point is the same) versus long-run average concern. Not all of the changes recommended in this comment have been adopted in the final rule because basing requirements only on long-run averages would result in too little capital being available to support credit risk during periods of economic stress. However, the methodology for the final rule has been modified to eliminate the single-year concern, thus preserving the true differences in proportionate market value losses by rating class, while retaining a capital requirement sufficient to support credit risk during periods of economic stress. Under the modified approach, the long-run average default and downgrade rate of each rating category/maturity class is multiplied by a factor that represents an average (over rating category and maturity class) of stress-period increases in those rates. This method of determining the credit risk percentage requirements in the final rule is described in detail below, and resulted in modest changes in both directions to the proposed credit risk percentage requirements.

Two factors were considered in selecting credit risk categories for assets on which to impose distinct credit risk capital requirements in percentage terms: an objective measure of the credit risk of the asset, and the term structure, or maturity, of the asset. The credit ratings assigned by NRSROs were used as an objective standard upon which to categorize assets by credit risk. Such ratings are generally accepted in the

market place as well as by other regulators. Of course, not all assets are rated by NRSROs, but most Bank investments either are rated by an NRSRO or can be evaluated internally and assigned a credit rating using models or other methods consistent with the rating methodologies used by NRSROs. In keeping with the standards established by NRSROs,<sup>11</sup> the following rating categories were used in the base analysis:

- AAA Highest investment grade.
- AA Second highest investment grade.
- A Third highest investment grade.
- BBB Fourth highest investment grade.
- BB Highest below investment grade.
- B Second highest below investment grade.
- CCC-C Substantial risk of default.

Credit ratings do not, however, reflect how the credit risk of a rated asset might vary according to its remaining maturity. For example, actual data indicate that the credit risk of a AA-rated asset with a one-year maturity is clearly less than that of an AA-rated asset with a 10-year maturity. In fact, other financial regulators have begun to recognize the term structure of credit risk in their risk-based capital requirements.<sup>12</sup> Consequently, each of the 7 credit rating grades was expanded to reflect 14 different remaining maturity classes resulting in 98 credit risk categories overall. The maturity classes were selected to show how significantly credit risk percentage requirements might change given modest changes in remaining maturity. They also capture the entire term structure of credit spreads, but primarily include maturities for which data is more readily available because there is sufficient trading activity. The remaining maturities used were six and nine months, and 1, 1.5, 2, 3, 4, 5, 7, 10, 15, 20, 25, and 30 years.

For each of the 98 credit risk categories, credit losses from defaults and downgrades were determined as a proportion of face value for each two-year horizon between 1970 and 1999. Furthermore, to simplify the analysis, beginning dates for each horizon were

<sup>11</sup> Each category used by the NRSROs has modifiers, either plus and minus or 1, 2 or 3. However, the derivation of credit risk percentage requirements described here does not take such modifiers into consideration because consideration of modifiers would triple the number of credit risk categories and significantly reduce the historical time period for which data on defaults and credit downgrades is available. To achieve more robust estimates of actual credit losses by category, the modifiers are ignored.

<sup>12</sup> See 65 FR at 43421.

limited to the first day of each month in the sample period. Thus, the first historical period covered January 1, 1970 through December 31, 1971, the second historical period covered February 1, 1970 through January 31, 1972, etc., and the last extended from January 1, 1998 through December 31, 1999, for a total of 336 periods examined for each credit risk category.

A two-year historical period horizon is a more conservative assumption than the one-year horizon, which is perhaps more commonly assumed by commercial banks. As stated by the Federal Reserve System Task Force on Internal Credit Risk Models, “[I]t is often suggested that one year represents a reasonable interval over which a bank—in the normal course of business—could mitigate its credit exposures.”<sup>13</sup> Also, according to a survey conducted by the BCBS, most of the responding commercial banks used a one-year horizon for calculating economic capital for credit risk in the banking book.<sup>14</sup> Nonetheless, the survey did provide some support for a longer historical period horizon. For example, some responding banks used a five-year horizon or modeled losses over the maturity of the exposure. In addition, based on experience in the U.S. and elsewhere, more than one year is often needed to resolve asset-quality problems at troubled banks. Therefore, the Finance Board believes that the two-year horizon would better assure that adequate capital is maintained against the credit risks faced by the Banks than would a shorter time horizon.

All historical data on defaults and downgrades were obtained from Moody's Default Risk Service. The Moody's database contains information on defaults, rating downgrades and market prices for bonds in default, *i.e.*, recovery rates, that span multiple credit cycles from 1970 to the present and covers over 8,000 corporate issuers, 66,000 corporate bonds, 196,000 ratings actions, and 1,200 defaulted bonds. The data set was restricted to U.S.-based entities, because the Banks are not permitted to invest in instruments issued by non-U.S. entities, except U.S. branches and agency offices of foreign banks.

Credit losses associated with defaults were assumed to be 100 percent of the issues' face value. According to a study of defaults by Moody's, the average

recovery rate (based on market prices) for bonds in default has been observed as low as 21 percent and 30 percent in 1932 and 1990, respectively, corresponding to peaks in corporate default activity.<sup>15</sup> Furthermore, the average recovery rate for senior unsecured public debt was \$51.31 per \$100 defaulted face value with a standard deviation of 26.30 percent during the 1977–98 period.

Credit losses associated with downgrades were determined based on approximations of the proportionate difference between the initial market value (corresponding to the initial credit rating) and the market value subsequent to the downgrade. These approximations were derived from the maximum loss in market value associated with downgrades, by credit rating category, observed in data covering 1992–2000. Pre-1992 data were not available. For example, the maximum shift in credit spread for a 10-year bond from AAA to AA was observed to be 29 basis points over the period 1992–2000. Similarly, the shifts from AA to A, and A to BBB, were 57 and 70 basis points, respectively. Shifts of more than one credit rating within a period, such as from AAA to A, were derived as the sum of the corresponding single rating shifts, or in this case the sum of the shift in spreads from AAA to AA and AA to A, or 86 basis points. For downgrades to CCC–C rating categories, a loss in market value of 100 percent was assumed based on the historical evidence that, over a specific three-month horizon, all of the U.S.-based issuers rated CCC–C in the Moody's database actually did default.<sup>16</sup>

For each of the 336 periods examined for each of the 98 credit risk categories, losses generated by downgrades and defaults were added to gains from ratings increases (determined in a like manner to losses from downgrades) to determine a change in value. Each change in value was then divided by the corresponding face value to arrive at a loss rate. The resulting loss rates were aggregated to reduce the number of maturity classes from 14 to 5. Specifically, for each credit rating, maturity classes of less than or equal to 1 year, more than 1 year to 3 years, more than 3 years to 7 years, more than 7 years to 10 years, and over 10 years were created. The loss rates were aggregated in the maturity classes by simple averaging with overlapping

endpoints, such that the 3 year loss rates were included in the averaging to arrive at the 1 to 3 year and 3 to 7 year maturity class loss rates. Loss rate means, distributions, and maximum values were then calculated for each of the 30 remaining credit risk categories (five maturity classes for each of the top 6 credit ratings). The loss rate distributions were not normally distributed. In addition, no isolated observations that could be considered outliers were observed. Consequently, a common stress level of loss rates was determined by averaging (for the 30 credit risk categories) the distance from the mean of the maximum loss rate divided by the standard deviation. The common stress level estimate was 3.22. The credit risk percentage requirements for Table 1.3 were then determined for each of the 30 credit risk categories as equal to the corresponding mean loss rate plus 3.22 times the corresponding standard deviation. These percentage requirements, as they appear in Table 1.3 in the final rule, have been rounded to the nearest 5 hundredths, or, if below investment grade, to the nearest whole percent.

*Table 1.4.* The proposed rule set forth credit risk percentage requirements for certain unrated assets in Table 1.4. These assets, which included cash, premises, plant and equipment, and certain debt and equity investments, had no relevant loss experience from which to calculate a credit risk percentage requirement. In the proposed rule, cash was assigned a credit risk percentage requirement of zero percent, as it was deemed not to present any credit risk to the Bank. All of a Bank's tangible assets, premises, plant and equipment, as well as any unrated debt or equity investments made by the Banks pursuant to § 940.3(e) and (f),<sup>17</sup> were assigned an eight percent credit risk percentage requirement. See 65 FR at 43423–24. As described below, the Finance Board received a few comments on proposed Table 1.4 but has not revised the table in the final rule.

<sup>17</sup> Table 1.4 of the proposed rule made a reference to unrated, targeted investments made under § 940.3(a)(5) of the Finance Board's regulations. This reference was based on the types of targeted investments proposed in § 940.3. See 65 FR 25676 (May 3, 2000.) The Finance Board, when it adopted § 940.3 in final rule form, listed the relevant targeted investments in § 940.3(e), and altered the provision somewhat. See 65 FR 43969, 43972–74, 43981 (July 17, 2000). Table 1.4 of this final rule has been corrected to conform its reference to the relevant targeted investments to the final version of § 940.3 adopted by the Finance Board and to include unrated investments in Small Business Investment Companies (SBICs) as set forth in § 940.3(f) which were inadvertently omitted from the proposed rule.

<sup>13</sup> See “Credit Risk Models at Major U.S. Banking Institutions: Current State of the Art and Implications for Assessment of Capital Adequacy,” Federal Reserve System Task Force on Internal Credit Risk Models, May 1998, p. 10.

<sup>14</sup> See “Credit Risk Modeling: Current Practices and Applications”, BCBS, April 1999.

<sup>15</sup> See “Historical Default Rates of Corporate Bond Issuers, 1920–1998,” Moody's Investors Service, January 1999.

<sup>16</sup> Based on Moody's Default Risk Service database, all issuers rated CCC–C defaulted between March 1, 1984 and May 31, 1984.

One commenter expressed concern that the credit risk percentage requirement for unrated assets made by the Banks would discourage certain new programs that have been initiated by the Banks, such as programs to purchase portions of loans for community economic projects or to fund community development. The commenter believed that the Banks would have been required to hold capital dollar-for-dollar for such investments. However, under both the proposed and the final rule, the Banks are required to hold only 8 percent capital for targeted investments made pursuant to § 940.3(e) of the Finance Board's regulations. 12 CFR 940.3(e). These investments appear to include the investments described by the commenter.<sup>18</sup> The 8 percent credit risk percentage requirement for targeted investments made under § 940.3(e) is consistent with the capital requirements applicable to national banks with regard to public welfare investments. The targeted investments included in Table 1.4 would be certain debt or equity investments that advance specific public welfare goals. See 65 FR 43969, 43972-74 (July 17, 2000). In general, under the final version of the capital rule, the Banks are required to hold 100 percent capital only when rated investments or residential mortgage assets are downgraded to below single-B after the Bank has purchased the investment.

Another commenter expressed concern that the proposed capital requirement of 8 percent for investments made under § 940.3(e) of the Finance Board's regulations could greatly discourage the Banks from making these innovative, mission-oriented investments. The commenter believes that the 8 percent requirement for such investments relative to the capital requirement of only 0.35 percent for long-term advances may cause the Banks to consider making these investments prohibitive. The commenter suggested two approaches for remedying this concern. First, the commenter suggested that the Finance Board permit each Bank to hold a substantially lower level of capital for a limited volume or range of targeted investments. The commenter believed that a modest volume of from \$200 million to \$300 million would not pose

any risk to the safety and soundness of the System, but would greatly encourage the Banks to make and become comfortable with targeted investments.

The commenter's second approach to overcome concerns about whether the Banks would make targeted investments given an 8 percent credit risk percentage requirement was that the Finance Board permit a much lower capital requirement for senior debt investments in community development funds that raise at least a dollar of equity for every two dollars of such investments. According to the commenter, the community development entity could use the proceeds of the Bank investments to finance activities eligible under § 940.3(e)(3), and the structure would be similar to that for SBICs. The commenter posited that the community development fund would have to lose its entire equity stake before the Bank's senior debt investment would be jeopardized, so that a much smaller risk-based capital requirement would be justified.

The Finance Board believes that the fact that targeted investments are included as Core Mission Activities will serve as adequate encouragement for the Banks to make such investments, regardless of the credit risk capital charges. See 12 CFR part 940. Further, the Finance Board believes that it is imperative to the safety and soundness of the Bank System that the Banks hold sufficient capital to cover the risks of permissible investments. As discussed above, the 8 percent credit risk percentage requirement for targeted investments made under § 940.3(e) is consistent with the capital requirements applicable to national banks with regard to public welfare investments. The targeted investments included in Table 1.4 would be certain debt or equity investments that advance specific public welfare goals.

*Derivative contracts.* As already discussed, the final rule has been changed to reflect the fact that implementation of SFAS 133 means that derivative contracts cannot solely be described as off-balance sheet items. More importantly, however, and for reasons unrelated to SFAS 133, the method of calculating the credit risk capital charge and assigning the credit risk percentage requirements for derivative contracts has been changed, as discussed below.

Under the proposed rule, the credit risk capital charge for a derivative contract would have been calculated by adding the current credit exposure to the PFE and then multiplying that sum by the credit risk percentage requirement from Table 1.3

corresponding to the remaining maturity of the derivative contract and the credit rating of the counterparty. This proposed approach was adopted directly from the Finance Board's FMMA proposed rulemaking. 64 FR 52163 (September 27, 1999). The FMMA, however, did not consider the term structure of credit risk when calculating credit risk capital charges. Because § 932.4 of the final rule does consider the term structure of credit risk, the Finance Board has adopted an approach to calculating the credit risk capital charge for derivative contracts that recognizes the term structure of credit risk.

Under § 932.4(d) of the final rule, the credit risk capital charge for a derivative contract will be the sum of two components. The first component will equal the product of the current credit exposure of the derivative contract multiplied by the applicable credit risk percentage requirement for the derivative instrument. However, in assigning the correct credit risk percentage requirement, the current credit exposure will be assumed to have a maturity of less than one year, regardless of the actual remaining maturity of the derivative contract. This approach is consistent with the fact that the current credit exposure of a derivative contract represents the current market value of the derivative contract, and that the value will generally change over the short term. The Finance Board believes that it is reasonable, therefore, to treat the current credit exposure on a derivative contract as a short-term exposure.

The second component of the credit risk capital charge for a derivative contract will equal the product of the PFE for a derivative contract multiplied by the assigned credit risk percentage requirement. For purposes of calculating the capital charge on the PFE, the credit risk percentage requirement under the final rule will be assigned based on the remaining maturity of the derivative contract and the credit rating of the counterparty. This approach is consistent with the fact that the PFE represents the highest future market value that the derivative contract may attain during its remaining life. Although the highest future market value for a derivative contract rarely will occur at the end of the derivative contract's life, the Finance Board is adopting a conservative approach to estimating the credit risk capital charge and is assuming that it will occur at the end of the life of the derivative contract. Thus, the credit risk percentage requirement applied to the PFE of a derivative contract will correspond to

<sup>18</sup> Moreover, if the commenter intended to describe investments that were not included in § 940.3(e) and (f), the Finance Board does not believe, based on its understanding of the comment, that the Banks would have authority to make such investments because the Banks are not generally allowed to invest in assets that are rated below investment grade.

the remaining maturity of the derivative contract.

The proposed rule also did not differentiate between a derivative contract entered into with a counterparty that was a member of the Bank, and one entered into with a counterparty that was not a member of the Bank. In the final rule, however, the Finance Board has determined to treat the credit exposure arising from a derivative contract with a member institution like an advance, because the Banks generally apply the same collateral requirements to these exposures, and the legal rights with regard to the collateral are comparable to those with regard to the collateral for advances. *See e.g.*, 12 U.S.C. 1430(e) (1994). Thus, the credit risk from the derivative contract should be similar to that from an advance. Under § 932.4(d)(2) of the final rule, the credit risk capital charge for derivative contracts entered into between a Bank and one of its member institutions will be calculated as the sum of the credit risk capital charges on the current credit exposure and the PFE, as described above, except that the applicable credit risk percentage requirements will be found in Table 1.1, which sets forth the credit risk percentage requirements for advances. For example, the credit risk percentage requirements applicable to the current credit exposure for a derivative contract entered into with a member institution would be that in Table 1.1 corresponding to an advance with a remaining maturity less than or equal to four years, and the credit risk percentage requirement applicable to the PFE for the same derivative contract would be that in Table 1.1 corresponding to an advance with the same remaining maturity as the derivative contract.<sup>19</sup>

In addition, § 932.4(d) of the final rule provides that collateral held against the credit exposure arising from a derivative contract can only be applied to reduce the credit risk capital charge calculated for the current credit exposure. The collateral must be held and the reduced credit risk capital charge calculated in accordance with the provisions of § 932.4(e)(2)(ii)(B) of the final rule,

<sup>19</sup> For a derivative contract with a nonmember, the applicable credit risk percentage requirement would be found in Table 1.3. For the current credit exposure, the applicable credit risk percentage requirement under the final rule will be assigned based on the credit rating of the counterparty and the assumption that the applicable remaining maturity is less than or equal to one year (unless, as discussed elsewhere in this section, the exposure is collateralized). For the PFE, the applicable credit risk percentage requirement will be based on the remaining maturity of the derivative contract and the credit rating of the counterparty.

which are discussed in more detail below. Collateral cannot be used to reduce the credit risk capital charge calculated for a derivative contract's PFE. This approach is consistent with the fact that the Banks and derivative dealers more generally hold collateral against the current credit exposure and not against the PFE.

The final rule also contains a technical change to clarify how the calculation of the net PFE for derivative contracts subject to a qualifying bilateral netting agreement should be applied.<sup>20</sup> Under the proposed rule, one net PFE value would have been calculated for all the derivative contracts subject to the same qualifying bilateral netting agreement, even though those contracts all may have had different remaining maturities. The proposed rule failed to direct how this single, net sum could be allocated among the different contracts when assigning the credit risk percentage requirement from Table 1.3 (which would have been assigned based in part on remaining maturity of the derivative contracts) and calculating the credit risk capital charges. The Finance Board has addressed this omission in the final rule by clarifying that the PFE for derivative contracts subject to a qualifying bilateral netting agreement should be calculated on a contract-by-contract basis. However, the calculation of the PFE for derivative contracts subject to the bilateral netting agreement, both as proposed and in the final rule, is based on the same theoretical approach recommended by the BCBS and federal banking regulators. *See e.g.*, 12 CFR part 3, Appendix A (2000) (regulation of the Office of the Comptroller of the Currency, Department of the Treasury). As such, the formula for calculating the PFE in the final rule still allows for the beneficial effects of netting to reduce the PFE.

Certain additional technical changes were made to the provisions in the final rule concerning the applications of the credit conversion factors given in Table 3 of part 932 that are used to calculate the PFE for a single derivative contract. Under the final rule, the PFE for a single derivative contract (not subject to a qualifying bilateral netting contract) is found by multiplying the effective notional amount of the contract, rather than just the notional amount as in the proposed rule, by the correct credit conversion factor from Table 3. The effective notional amount takes account of any added leverage that may be built

<sup>20</sup> A qualifying bilateral netting agreement must meet the requirements set forth at § 932.4(h)(3) of the final rule.

into a derivative contract by multipliers or other means and therefore provides a more accurate basis for calculating a Bank's credit exposure under a derivative contract.<sup>21</sup>

Further, a change in the final rule has been made with regard to the credit conversion factor from Table 3 that would be applied in order to calculate the PFE of a credit derivative. Under the proposed rule, the credit conversion factor used for interest rate contracts would have also been applied to calculate the PFE on credit derivative contracts. The Federal Reserve System (Federal Reserve), however, applies factors applicable to equity or other commodity contracts when calculating the PFE for credit derivatives. *See* SR 97-18 (Gen.), Division of Banking Supervision and Regulations, Board of Governors of the Federal Reserve System (June 13, 1997). In effect, the Federal Reserve is treating the credit derivative contracts as riskier instruments than did the Finance Board in the proposed rule. Given the conservative approach taken by the Finance Board in developing these capital requirements, the final rule calculates the PFE for credit derivative contracts using the same approach as that used by the Federal Reserve.

*Collateral.* Section 932.4(d)(2)(ii)(B) of the proposed rule provided that, when an asset or item was not directly rated by a NRSRO, the credit rating of an obligor counterparty, third party obligor or of the collateral backing the asset or item would have to be used to assign the applicable credit risk percentage requirement.<sup>22</sup> For derivative contracts, which are generally not directly rated by an NRSRO, the proposed provision would have allowed a Bank to use the credit rating of the counterparty or of the collateral, whichever rating was more favorable. However, substituting the credit rating of the counterparty, third party obligor, or collateral would have been allowed only to the extent that the collateral or guarantee backed the underlying credit exposure. Further, collateral would have had to have been held in accordance with the specific requirements set forth in proposed § 932.4(d)(2)(ii) to receive the treatment afforded by that provision. While the Finance Board has made some clarifying

<sup>21</sup> For example, if a derivative contract is referenced to a multiple of an interest rate index, the contract would contain greater leverage (and therefore be potentially riskier) than a derivative contract without the multiplier. In such a case, the effective notional value would be greater than the notional value to account for the higher credit exposure under the more highly leveraged contract.

<sup>22</sup> Because § 932.4 of the final rule has been reorganized, the collateral provision is found at § 932.4(e)(2)(ii)(B) of the final rule.

changes to the collateral provision in the final rule, it has adopted this provision substantially as proposed.

The Finance Board received several comments on the proposed collateral provision. A number of the commenters requested clarification of how collateral should be applied to reduce the credit risk capital charge for an instrument. One commenter asked specifically if the provision would allow for the reduction of the credit risk capital charge for advances if it could be demonstrated that the mortgages backing the advances met an AAA or AA rating standard. The Finance Board did not intend that the collateral provision would be applied to advances. The credit risk percentage requirements for advances provided in Table 1.1 of both the proposed and final rule were developed based on the assumption that advances are well-collateralized. No additional reduction in the credit risk capital requirement for advances was contemplated. In effect, the collateral provision is intended to apply only to assets, items or derivative contracts covered by Table 1.3 (*i.e.*, rated assets or items other than advances or residential mortgage assets). The final rule has been changed to make this clear.

Further, as already discussed, the final rule treats credit exposures arising from derivative contracts entered into between a Bank and its member as an advance for the purposes of assigning the credit risk percentage requirement. This treatment would not make it advantageous for a Bank to apply the collateral provision when calculating the credit risk capital charge for derivative contracts with a member, unless the collateral was cash or U.S. government securities. Where a member provides cash or government securities to collateralize a derivative exposure, in accordance with the requirements of the collateral provision, the Finance Board will allow a Bank to apply the credit risk percentage requirement for cash or government securities to that portion of the current credit exposure that is backed by the collateral.

Some commenters believed that collateral held against derivative contracts should either reduce the current credit exposure of the derivative contract dollar-for-dollar, or reduce the credit risk capital charge for a derivative contract dollar-for-dollar. The Finance Board disagrees. Obtaining collateral to back an asset, item or derivative contract does not eliminate credit risk for the Bank, as would be implied if the Finance Board allowed a dollar reduction in the credit exposure or the credit risk capital charge for each dollar of collateral posted. Instead, the Bank is

substituting the credit risk associated with the collateral for that associated with the counterparty to the derivative contract.<sup>23</sup> In practice, however, under both the proposed and final rule, if the collateral backing the credit exposure arising from a derivative contract is cash or U.S. government securities, both of which carry a credit risk percentage requirement of zero, the credit risk capital charge for that portion of the credit exposure backed by the collateral would be zero.

The Finance Board also has made revisions in the final rule to the conditions that must be met before an asset, item or derivative contract will be deemed to be backed by collateral. First, § 932.4(e)(2)(ii)(B)(1) of the final rule was changed to make clear that collateral could be held by an affiliate of a member if permitted under the Bank's collateral agreement. This change is in line with practices concerning collateral otherwise allowed by the Finance Board and was made in response to a request by a commenter. See 12 CFR 950.7 (*as amended by 65 FR 44414, 44429–30 (July 18, 2000)*). The Finance Board also has changed the final rule to make clear that to be acceptable under the final rule, the required discount, or haircut, applied to the value of the collateral must be sufficient to protect against price declines during the holding period and to cover the likely costs of liquidation of the collateral. A Bank must apply a haircut to the value of the collateral before calculating the portion of the credit exposure that is deemed to be backed by the collateral.

To better illustrate how the collateral provision in the final rule will be applied, the Finance Board is providing the following examples.

*Example 1:* Assume that a Bank entered a derivative contract with a counterparty rated at the highest investment grade by all NRSROs. The remaining maturity on the derivative contract is 5 years. Assume further that at the time the credit risk capital charge was being calculated, the derivative contract had a current credit exposure equal to \$10 million and the Bank held U.S. government securities valued at \$4 million after applying an acceptable haircut to those securities, to collateralize that derivative exposure. In this case, the collateral would be deemed to back \$4 million of the current credit exposure. To calculate the credit risk capital charge on the current credit exposure, the \$4 million of the credit equivalent amount backed by collateral would be multiplied by the credit risk percentage requirements assigned to U.S. government securities, which is zero. The remaining \$6 million would be multiplied by

the credit risk percentage requirement as shown in Table 1.3 for the highest investment grade credit rating and a remaining maturity equal to one year or less. To calculate the credit risk capital charge on the PFE, the PFE would be calculated under § 932.4(g) or (h) of the final rule, as applicable, and that amount would be multiplied by the credit risk percentage requirement from Table 1.3 corresponding to the highest investment grade and a remaining maturity equal to 5 years (*i.e.*, the remaining maturity category in Table 1.3 of greater than 3 years up to and including 7 years).

*Example 2:* Assume the same facts as in Example 1 but instead the Bank holds U.S. government securities valued at \$12 million after applying the appropriate haircut. The collateral would be sufficient to cover the total current credit exposure so that the current credit exposure would be multiplied by the credit risk percentage requirement for government securities, which is zero. The resulting capital risk credit charge on the current credit exposure would be zero. The fact that the exposure is overcollateralized does not affect the calculation of the credit risk capital charge for the PFE, which must be calculated as required in Example 1.

*Example 3:* Assume the same facts as under Example 1, but assume that the collateral is not held in accordance with § 932.4(e)(2)(ii)(B)(1)–(5). In this case, the current credit exposure would be deemed not to be collateralized and the credit risk capital charge for the current credit exposure would be calculated based on the credit risk percentage requirement in Table 1.3 corresponding to the credit rating of the counterparty (*i.e.*, the highest investment grade) and a remaining maturity less than or equal to one year. The credit risk capital charge for the PFE would be calculated as in Example 1.

*Short term credit rating.* The proposed rule did not provide specific credit risk percentage requirements for assets, such as commercial paper, that have stated maturities of less than one year and, therefore, may have a short-term credit rating from an NRSRO. Generally, NRSROs use three short-term credit ratings that are considered investment grade, including A–1, A–2 or A–3 (used by S&P), or P–1, P–2 or P–3 (used by Moody's). Research done by Moody's demonstrates that the three investment grade short-term credit ratings correspond to the four investment grade long-term credit ratings. See "Commercial Paper Defaults and Rating Transactions," 1972–1998, Moody's Investors Service (May 1998); "Moody's Credit Opinions: Financial Institutions," Moody's Investors Service (December 1999). In rating short-term commercial paper, Moody's assigns the highest short-term credit rating (P–1) to issuers that have long-term senior unsecured ratings ranging from the highest investment grade (Aaa) to the third highest investment grade (A), and assigns the second highest short-term

<sup>23</sup> This argument would apply to any asset, item or derivative contract backed by a guarantee or collateral.

rating (P-2) to long-term credit ratings ranging from the third highest investment grade to the fourth highest investment grade. *Id.* The lowest investment grade short-term rating (P-3) is reserved solely for the fourth highest long-term credit rating. *Id.* A comparison of U.S. financial institutions' short-term ratings by Moody's shows that the highest short-term credit rating (P-1) is more commonly associated with the third highest long-term credit rating (A) than the highest (Aaa) or second highest (Aa) long-term credit-ratings. *Id.* Based on this research and the fact that credit risk percentage requirements for long-term credit risk ratings have been developed, the Finance Board has added § 932.4(e)(2)(ii)(C) to the final rule to address assets with short-term credit ratings. Under this new provision, the applicable credit risk percentage requirement from Table 1.3 for an asset with a short-term credit rating from a given NRSRO will be based on the remaining maturity of the asset and the long-term credit rating assigned by the same NRSRO to the issuer of the asset.

Although highly unlikely, there are also occasional situations where the issuer of a short-term instrument with a short-term credit rating from an NRSRO does not issue long-term instruments or has not obtained a long-term credit rating for any long-term instruments and, therefore, will not have a long-term credit rating from an NRSRO. In this situation, § 932.4(e)(2)(ii)(C) of the final rule states that the long-term equivalent rating will be determined as follows:

(1) The highest short-term rating shall be equivalent to the third highest long-term rating; (2) The second highest short-term rating shall be equivalent to the fourth highest long-term rating; (3) The third highest short-term rating shall be equivalent to the fourth highest long-term rating; and (4) If the short-term rating is downgraded to below investment grade after acquisition by the Bank, the short-term rating shall be equivalent to the second highest below investment grade long-term rating.

This approach is consistent with the research discussed above. The provision regarding downgrades of short-term credit ratings is also consistent with the way that downgrades of long-term ratings are addressed under Table 1.3.

*Credit equivalent amounts for off-balance sheet items.* As proposed, § 932.4(f), would have required the Banks to convert all off-balance sheet credit exposures into equivalent on-balance sheet credit exposures or credit equivalent amounts, determine the type of the item, and then apply the appropriate credit risk percentage requirement from the tables to estimate

the instrument's credit risk capital charge. The proposed rule would have allowed the Banks to use Finance Board approved internal models to convert some or all off-balance sheet credit exposures into on-balance sheet credit equivalents. For Banks that lack appropriate internal models, the proposed rule provided a table of credit conversion factors for off-balance sheet items. The Finance Board received no comments on the specific credit conversion factors in Table 2 of the proposed rule. The Finance Board, however, has incorporated certain changes to Table 2, as discussed below, and has adopted § 932.4(f) with these changes.

Table 2 in the proposed rule provided a 100 percent credit conversion factor for four separate categories: asset sales with recourse where the credit risk remains with the Bank, sale and repurchase agreements, forward asset purchases, and commitments to make advances or other loans. However, if a Bank treats sale and repurchase agreements as an off-balance sheet item, then the Bank would actually report such agreements as asset sales with recourse where the credit risk remains with the Bank. Because any off-balance sheet sale and repurchase agreements are reported under the category "asset sales with recourse where the credit risk remains with the Bank," a separate category in Table 2 for "sale and repurchase agreements" is redundant and has been removed. Additionally, under SFAS 133, forward asset purchases will qualify as derivative contracts and will appear on the balance sheet. In any case, derivative contracts are addressed independently of off-balance sheet items under § 932.4(d). Therefore, the forward asset purchases category has also been removed from Table 2.

Commitments to make advances or other loans has been expanded into two categories: commitments to make advances, and commitments to make or purchase other loans. This change recognizes the fact that under AMA programs, the Banks may enter into certain commitments to purchase loans that may be recorded as off-balance sheet items.

The Finance Board received one comment regarding standby letters of credit (SLOCs), an off-balance sheet item included in Table 2 with a credit conversion factor of 50 percent. The commenter apparently believed that under the proposed rule, the credit risk percentage requirement for this off-balance sheet item would be determined by applying the credit conversion factor and finding the appropriate credit risk

percentage requirement in Table 1.3 (Requirement for Rated Assets or Rated Items other than Advances or Residential Mortgage Assets). The commenter argued that because SLOCs are in fact "contingent advances," the credit risk percentage requirement should be the same as advances as presented in Table 1.1 (Requirement for Advances). The Finance Board intended that the credit risk percentage requirement for SLOCs would be determined from Table 1.1. In fact, the proposed **SUPPLEMENTARY INFORMATION** section of the proposed rule indicated that SLOCs were given a 50 percent conversion factor, rather than the 100 percent conversion factor assigned to SLOCs by federal banking regulators, because SLOCs issued by the Banks are rarely drawn down and if drawn down, would convert to an advance. See 65 FR at 43425. The Finance Board concurs with the commenter, and the final rule has been changed to clarify that Table 1.1 should be used in determining the credit risk percentage requirement applicable to the credit equivalent amount of any Bank SLOCs.

*Reduced credit risk charge for assets hedged with credit derivatives.* The proposed rule would have allowed assets hedged with credit derivatives to be assigned a zero credit risk capital charge under limited circumstances. These were: (1) if the asset referenced in the credit derivative (referenced asset) and the hedged asset were the same and the remaining maturity of the hedged asset and the credit derivative was the same; (2) the hedged asset and the referenced asset were the same but the remaining maturity of the hedged asset and the credit derivative were different, but only if the remaining maturity of the credit derivative was two years or more; and (3) if the remaining maturity of the hedged asset and the credit derivative contract was the same, and the hedged asset and the referenced asset were different but only if certain additional conditions were met. In all these cases, the proposed rule would have required the applicable credit risk capital charge for the credit derivative contract to be applied. The Finance Board requested general comments regarding the treatment of credit derivatives and specific comments regarding the methodology that should be used to incorporate the benefit of credit derivatives that did not meet the three circumstances described above. See 65 FR at 43426. The Finance Board received no specific comments regarding its treatment of credit derivatives in the proposed capital rule. However, the Finance Board has



realized that its approach may have been somewhat inconsistent with its approach to collateral and third parties guarantees, which allowed for a proportional reduction in the credit risk capital charge on an asset if the collateral or guarantee did not cover 100 percent of the book value of the asset. The Finance Board, therefore, has refined its approach to credit derivatives in the final rule to allow a similar proportional reduction in the credit risk capital charge for assets partially hedged with a credit derivative, under appropriate conditions. This refinement is based on discussions with other financial regulators and a review of proposals by organizations representing capital market participants, such as the International Swaps and Derivatives Association (ISDA). The final rule otherwise retains an emphasis on recognizing credit derivative activities only if they are undertaken in a clear and straightforward manner and used to reduce the credit risk of specific assets. For example, the new approach does not incorporate the use of internal credit models. Further, while the change adds to the consistency in treatment in the capital rule between credit derivatives and other types of credit enhancements, such as collateral and third party guarantees, the change adopted in the final rule, in practical terms, is likely to have little or no effect on the Banks' overall credit risk capital requirement at this time, because the Banks presently have few, if any, credit derivatives on their balance sheets.

The Finance Board also adopted in the final rule an additional general condition governing whether a credit derivative can be used to reduce the capital charge on an asset. Specifically, the final rule requires a credit derivative contract to provide substantial protection against credit losses before the reduction can be taken. Because credit derivative contracts are bilaterally negotiated, the Finance Board believes that in some rare circumstances conditions may be added to the contract that may call into question the ability of the Bank to collect, under all likely scenarios, the amount expected under the credit derivative contract, if there were a default on the hedged asset. Further, there may be questions as to the ability of the counterparty to actually fulfill the terms of the credit derivative contract. The Finance Board, therefore, has added as a safeguard, the condition that the credit derivative contract provide substantial protection against credit losses. As already discussed, the Finance Board does not think that this condition would affect the beneficial

treatment afforded relatively straightforward credit derivative instruments under most circumstances.

Under the final rule, as in the proposed rule, credit derivatives that are referenced to an asset that perfectly matches the asset being hedged may fully offset the credit risk capital charge of the hedged asset, if the credit derivative has a remaining maturity equal to or greater than that of the hedged asset. A credit risk capital charge for the credit derivative must still be applied, however to account for the Bank's credit exposure to the credit derivative counterparty. For example, if a Bank purchases a triple-B-rated corporate bond with a remaining maturity of five years and at the same time enters into a 5-year credit default option contract based on the same bond, the credit risk capital charge for the underlying asset will be zero. The net credit risk capital charge for the pair will equal the credit risk capital charge for the credit exposure on the derivative contract.

This same treatment may be accorded positions in which the credit derivative contract references a different obligation from the same obligor but only if: (1) the credit derivative contract has the same or a longer remaining maturity as the hedged asset; and (2) the referenced asset ranks *pari passu* or junior to the hedged asset, is subject to a cross-default clause with the hedged asset and has the same maturity as the hedged asset. These conditions on the referenced asset are the same in the final rule as in the proposed rule except for one new condition that the referenced asset and the hedged asset have the same remaining maturity. This new condition helps assure that the value of the hedged asset and the credit derivative will move in a similar fashion.

The final rule expands upon the relief offered in the proposed rule by allowing a Bank to take a proportionally reduced capital charge for an asset hedged with a credit derivative even if the remaining maturity of the credit derivative is less than that of the hedged asset. However, the credit derivative must have a remaining maturity of at least one year for this new provision to be applied. The requirement that credit derivatives with a shorter remaining maturity than the hedged asset have at least a one-year minimum remaining maturity is more strict than the six month minimum remaining maturity that has been suggested in work done by ISDA for similar circumstances, but is less strict than the two-year minimum requirement that was applied under the proposed rule. The Finance Board

believes that the one-year minimum requirement is in line with the generally conservative approach adopted in this rule.

Further, the beneficial treatment allowed when calculating a hedged asset's credit risk capital charge if the applicable credit derivative contract has a remaining maturity less than that of the hedged asset may be applied if the hedged asset and the referenced asset are the same. This treatment may also be applied if the hedged asset and the referenced asset are different but only if the referenced asset ranks *pari passu* or junior to the hedged on-balance sheet asset, is subject to a cross-default clause with the hedged on-balance sheet asset and has the same maturity as the hedged asset. Where the above conditions are met, the credit risk capital charge for an asset hedged with a credit derivative that has a remaining maturity less than that of the hedged asset will equal the sum of the capital charges for the unhedged portion of the asset and the hedged portion of the asset.

For example, assume a Bank holds a triple-B-rated corporate bond with a remaining maturity of 5 years and has hedged that position with a credit derivative that is referenced to the same corporate bond but that has a remaining maturity of two years. Under the final rule, the capital charge for the unhedged portion of the asset would equal the credit risk percentage requirement for the asset, assigned based on its credit rating (BBB) and remaining maturity (5 years), multiplied by the book value of the asset minus the product of the credit risk percentage requirement for the asset, assigned based on its credit rating (BBB) but on the remaining maturity of the credit derivative contract (2 years), multiplied by the book value of the asset. The credit risk capital charge for the hedged portion of the asset will equal the credit risk capital charge for the credit derivative contract, calculated in accordance with § 932.4(d) of the final rule.

As in the proposed rule, where the on-balance sheet asset and the asset referenced in the credit derivative have been issued by different obligors, the final rule does not provide capital relief for the underlying asset. See 65 FR at 43426. In the **SUPPLEMENTARY INFORMATION** section of the proposed rule, the Finance Board requested comment on whether it should allow Banks to petition for relief on a case-by-case basis on the credit risk capital charge applied to assets hedged with credit derivatives but that do not meet the specific conditions set forth in the rule, if the petition is accompanied by adequate data and analysis. *Id.*

Although no specific comments were received in response to this request, the Finance Board believes that Banks should be allowed to seek such relief. The Finance Board emphasizes that any petition for relief must be accompanied by evidence that demonstrates with a high degree of certainty that the credit derivative contract will provide protection should there be a default on the hedged asset. The Finance Board also emphasizes that it will be conservative in its approach when reviewing such petitions and will consider all available evidence including any information about how the situation may be handled by other financial regulators before making any decision.

*Reduced charges for derivative contracts.* As was proposed, the final rule also allows foreign exchange rate contracts with an original maturity of 14 calendar days or less to be assigned a zero credit risk capital charge. Gold contracts would not be considered exchange rate contracts. Derivative contracts that are traded on regulated exchanges that require daily collection of variation margin for the contract also would be assigned a zero credit risk capital charge.

#### *Section 932.5—Market Risk Capital Requirement*

*General.* As proposed, § 932.5 set forth the basic requirements for calculating each Bank's market risk capital charge. Under the proposed rule, each Bank would be required to develop either an internal market risk model, or as an alternative, a cash flow model, that would calculate the Bank's market risk capital charge and to have the model reviewed and approved by the Finance Board. The proposed rule required the Bank to use its internal market risk model to estimate the market value of its portfolio at risk. As proposed, the market value of the Bank's portfolio at risk would have been defined as the maximum loss in market value of a Bank's portfolio under various stress scenarios. This loss would have been measured from a base line case such that the probability of loss greater than that estimated was not more than one percent. If a Bank opted to use the alternate cash flow model, the proposed rule would have required the Bank to demonstrate that the cash flow model subjected the Bank's portfolio to a degree of stress comparable to that required for the internal market risk model and to demonstrate how the Bank intended to measure its market risk capital charge using the cash flow approach.

When using an internal market risk model, the proposed rule further stipulated that the Bank's capital charge would equal the sum of two components: the capital charge estimated by the Bank's internal market risk or cash flow model plus the amount by which the current market value of a Bank's total capital was less than 95 percent of the value of the Bank's total capital calculated in accordance with the GLB Act (the 95 percent test). The proposed rule also would have required the Banks to conduct an annual, independent validation of its internal market risk model or internal cash flow model and submit the results of the validation to the Finance Board.

The proposed rule also established broad parameters and standards for the internal risk model and for the stress testing that would be performed using that model. In general, the proposed rule would have required the Bank's internal risk model to cover all material risks arising from a Bank's portfolio of assets, liabilities and off-balance sheet items, including derivative contracts and options. As contemplated by the proposed rule, the Bank would have used the internal market risk model first to estimate the market value of its portfolio as of the last business day of the month for which the market risk capital charge was being calculated and then to stress that baseline market value to calculate the market value of its portfolio at risk. The proposed rule also required that the stress test account for changes in interest rates, interest rate volatility, the shape of the yield curve and changes in market prices equivalent to those that have been observed over 120 business-day periods of market stress. Under the proposed rule, the relevant historic observation period would have begun at the end of the month prior to the month for which the market risk charge was being calculated and extend back to 1978. Further, if the Bank had issued consolidated obligations denominated in foreign currency or linked to equity or commodity prices, the proposed rule would have required the Bank to estimate the market value of its portfolio at risk due to changes in foreign exchange rates, and equity and commodity prices as relevant.

The Finance Board received a large number of comments on proposed § 932.5. Generally, most commenters objected to a market risk capital charge based on changes in market value of a Bank's portfolio as inappropriate given that the Banks hold their assets to maturity. For similar reasons, commenters objected to the Finance Board requiring use of a value-at-risk

(VAR) model for calculating the capital charge. Almost all commenters also expressed opposition to the 95 percent test for a number of reasons, including that the test "double charged" the Banks for market risks and that the "artificial" volatility in GAAP earnings created by implementation of SFAS 133 could make it difficult for Banks to comply with the 95 percent test. Comments were also received on a number of other aspects of the proposed market risk requirement. The Finance Board has considered all the comments received on proposed § 932.5 and will address these comments in more detail below.

Furthermore, the Finance Board has determined to make a number of changes to the proposed rule both in response to comments and based upon its reconsideration of certain aspects of the proposal. The Finance Board discusses these changes more fully below. Among the more important changes, the final rule has revised the 95 percent test so that it now requires a Bank to calculate its market risk capital charge by adding the market value of its portfolio at risk and the amount, if any, by which the market value of the Bank's total capital, estimated using its internal market risk model, falls below 85 percent of the value of the Bank's total capital as defined in the GLB Act (85 percent test). In addition, the final rule explicitly states that the Finance Board may exercise flexibility in determining the appropriate minimum number of scenarios that shall be used in estimating the market value of their portfolio at risk. The Finance Board, however, anticipates increasing the minimum number of required simulations in proportion to the nature and level of market risk taken by the Banks, and as the Banks gain expertise in using their models and available modeling techniques become more sophisticated. Furthermore, as with other provisions, the final rule has revised § 932.5 to reflect the fact that because of SFAS 133, derivatives contracts can no longer be considered strictly off-balance sheet items.

*Internal cash flow model.* Many commenters expressed a concern that the proposed rule was unclear regarding the conditions under which an internal cash flow model could be substituted for an internal risk model. Additionally, commenters indicated a preference for the final rule to include explicit requirements about the parameters that would be required for such a model.

In response to these comments, the Finance Board has clarified in § 932.5(a)(2) of the final rule that a Bank may use an internal cash flow model in

place of an internal market risk model, provided that the Bank obtains prior Finance Board approval of the internal cash flow model and of the imbedded assumptions in the model. In principle, because both the internal market risk model and the alternate internal cash flow model calculate loss estimates based upon the present value of the cash flows of the current assets and liabilities, the market risk capital requirement should be the same whichever model is used. However, even though the Finance Board expects the two methods to be theoretically consistent, it recognizes that, in practice, it is unlikely that the market risk capital requirements calculated by an approved internal cash flow model would be exactly the same as the requirement calculated by an internal market risk model. Further, and contrary to the perception of some commenters, the Finance Board is not requiring a Bank to develop both an internal market risk model and an internal cash flow model to verify that the market risk capital charges calculated by each are equivalent.

Instead, the Finance Board will review the assumptions and time horizon chosen by a Bank in its internal cash flow model to assure that the model captures all material risks faced by the Bank and that the stress applied by the model is comparable to that required by the modeling parameters and by the 85 percent test set forth in § 932.5(a)(1), (b) and (c) of the final rule. However, the final rule does not require a Bank to apply separately the 85 percent test if the Bank uses an alternative cash flow model.

The Finance Board's review of a Bank's proposed internal cash flow model will focus on the assumptions of the cash flow model concerning future business activities, *e.g.*, the acquisition of new assets and their financing. The assumptions concerning future business activities must be well defined, prudent, and consistent with the Bank's practice. The Finance Board has determined, however, that with respect to the internal cash flow model approach, the final rule adopted herein should not include specific assumptions, parameters, or time horizon requirements in recognition of the possibility that such inputs need not be constant across different portfolios and/or business plans. The Finance Board may judge the adequacy of the model's output in various ways including comparing the estimates produced by the internal cash flow model to modeling results from other Banks which may display similar risk profiles to the Bank seeking approval of an

internal cash flow model. The Finance Board will reject an internal cash flow model if after consideration of all relevant factors, it believes that the model fails to calculate an adequate market risk capital charge for a given Bank.

The Finance Board also notes that under the final rule the internal cash flow model will be used to calculate only the market risk capital requirements. A Bank using an internal cash flow model will still calculate its credit risk capital requirements pursuant to § 932.4 of the final rule. Thus, in developing an internal cash flow model, a Bank would want to use the expected cash flows from its assets and not simulate changes in cash flows that would come from changes in credit quality. The expected cash flows, however, could still take into account the credit quality of the asset, *e.g.*, the expected cash flows from a triple A rated bond would be greater than the expected cash flows from a similar single B rated bond.

*Measurement of market value at risk under a Bank's internal market risk model.* The Finance Board received many comments concerning the requirements for the internal market risk model and its proposed approach for estimating the market value of the Banks' portfolios at risk, including comments from all of the Banks, two trade groups, and a housing GSE. Commenters generally expressed opposition and confusion regarding the type of internal market risk model contemplated under the proposed rule. Several commenters asked for clarification of the definition of market value at risk. Most commenters opposed the use of a traditional VAR framework to measure market risk for the Banks. They expressed concern that the VAR framework, which federal banking regulators require commercial banks to use for their trading portfolios under certain conditions, was inappropriate for the held-to-maturity portfolios that are more characteristic of the Banks. More generally and for similar reasons, a number of commenters felt that it was inappropriate to base the market risk capital charge on changes in the market value of the Banks' portfolios. Several commenters also expressed concern that using a traditional VAR model would result in the Banks holding significantly more capital for market risk than OFHEO requires under its proposed capital regulations for Fannie Mae and Freddie Mac, a result that could put the Banks at a competitive disadvantage to the other housing GSEs. A number of commenters also urged the Finance Board not to express a preference for the

VAR-like approach over a cash flow approach.

In proposing § 932.5, the Finance Board did not intend to imply that the Banks were required to use any specified or "typical" VAR approach to calculate the market value of their portfolios at risk. Instead, the Finance Board intends that each Bank uses its internal market risk model to undertake a stress test. As envisioned by the Finance Board, the test is applied such that each Bank will first use its internal market risk model to estimate a base case market value for its portfolio, where the portfolio would consist of all of the Bank's assets and liabilities, off-balance sheet items and derivative contracts. In estimating this base case market value, each Bank's internal risk models could employ actual market prices, and assumptions and methodologies for estimating the value or prices of instruments that would be consistent with approaches that are generally accepted in the financial industry. Then, each Bank will use the internal market risk model to apply market shock scenarios that are based on historical scenarios and data, as specified in § 932.5(b)(4) and (b)(5) of the final rule. The model-derived portion of the market risk capital charge (*i.e.*, the market value of a Bank's portfolio at risk) equals the loss in the market value of a Bank's portfolio measured from a base line case, as determined from market-value loss calculations that are based on more than 20 years of historical experience and that must include an adequate number of stress scenarios derived from these historically stressful periods, such that the probability of loss greater than the determined amount is not more than one percent. This approach generally differs from the traditional VAR approach, which estimates the potential loss of a portfolio given relatively more current market conditions.

Furthermore, the Finance Board believes that estimating the market risk charge based on a stress test of the kind described above is reasonable, even when, as the commenters stated, the Banks' portfolios consist largely of "held-to-maturity" instruments. From a regulatory perspective, the Finance Board is concerned that the Banks hold sufficient capital to withstand historically extreme market conditions that may persist over multi-year periods. The market-value approach adopted in this final rule satisfies this regulatory concern. Specifically, the measure of a decline in market value during a stress period incorporates the decline in long-term earnings that would result, all things being equal, from such market

changes. In this respect, the market-value approach parallels the way the debt markets bid up or down the value of a financial instrument based on its expected earnings relative to the yield expectations of similar instruments in the current market. The arguments voiced by commenters that the Finance Board's approach misstates the capital charge for "held-to-maturity" assets, relies on the expectation that a Bank could regain lost market value if markets "returned to normal" following any stressful conditions. The weakness of this argument is that a Bank must risk further declines in market value in order to position itself to gain from "expected" market corrections. Thus, for the purposes of the Market Risk Capital Requirement, it is irrelevant that the Bank may generally hold its assets to maturity because the regulator is concerned with, and must address, the likelihood that the market will not behave "as expected" and that the losses in market value will eventually be realized through earnings over time. By requiring that an acceptable internal cash flow model subject a Bank's portfolio to a comparable degree of stress as that required for the internal market risk model, the Finance Board also intends to ensure that these regulatory goals are met if a Bank decides to use an internal cash flow model to estimate its market risk capital charge. As was explained in the discussion of the Minimum Risk-Based Capital Requirement, the Finance Board also does not believe that the market-value approach will lead to an onerous market risk capital charge. Given its regulatory goals, the Finance Board, therefore, continues to believe that its general approach to the internal market risk model adopted in the final rule is reasonable.<sup>24</sup>

A few commenters believed that the 120 business day holding period stipulated for the stress test in proposed § 932.5 was excessive. At least one commenter based this view on the fact that most VAR models stipulate a holding period of only one or two days. As already discussed, § 932.5 of the final rule does not mandate a specific VAR approach for estimating the market value of its portfolio at risk. Nevertheless, the 120 business day horizon is also within the range of the holding periods adopted by other

federal bank regulatory agencies for the VAR models used in their market risk test, which, once the mandated multiplier is taken into account, is effectively between 90 and 160 days.<sup>25</sup> Moreover, the Finance Board believes that the 120 business day holding period is reasonable given the goal underlying the market risk capital charge discussed above. For these reasons, the Finance Board remains satisfied that the mandated 120 business day holding period stipulated for the internal market risk model is the correct approach.

A number of commenters requested clarification as to when a Bank should apply the required stress test using a historical simulation approach or when it should use a path-generating approach such as Monte Carlo simulations. In both the proposed and final rule, § 932.5(b)(2) provides that a Bank may use any "generally accepted measurement technique" in its modeling approach. The choice of an approach is subject to the general requirement that the internal market risk model be able to capture all material market risks faced by the Bank. In this regard, the Finance Board has determined that simulations of historical market changes will comply with the regulation. Historical simulations may assume rate changes as a percentage of the prior rate level rather than as changes in the absolute level of the index in question. The Finance Board has also determined that such simulations should encompass market changes for all instruments and indexes. In doing so, such simulation will address general changes in interest rates and basis differences.

The parameters for a Monte Carlo rate path generating process would be derived from and consistent with periods of market stress identified from the same historical time-frame and data, which stretches from 1978 to the month prior to the month for which a market risk capital charge is being calculated, as provided in § 932.5(b)(4) and (5) of the final rule, that would be used in a historical simulation. The process should generate a sufficient number of paths to estimate the 99th percentile in the distribution of losses for the market value of a Bank's portfolio at risk using the same types of calculations as those used in an historical simulation.

Commenters have also asked for guidance on how the Finance Board intends to define material risks. In general, a material risk is any risk that has a potential, substantive effect on a Bank's earnings or capital portfolio, or could potentially have a significant impact on the Bank's market risk capital charge from a regulatory prospective. A determination concerning the materiality of specific risks would include consideration of a Bank's general risk profile and relevant historic data and experience.

Along these same lines, some commenters expressed concern that the Finance Board has not provided sufficient technical specifications for the internal market risk model. As a result, some commenters felt that the Banks cannot be sure if the models used for day-to-day risk management purposes would be sufficient for calculating the market risk capital charge, and at least one commenter believed that without more specificity it would be impossible to judge the adequacy of the market risk capital requirements. The quantitative modeling parameters provided by the Finance Board in the proposed and final rule are consistent with those provided by other Bank regulators for required market risk models. See 61 FR 47358 (Sept. 6, 1996). The Finance Board believes that the quantitative specifications set forth in the final rule provide a degree of flexibility for the Banks in developing their models, yet ensures that the Banks will hold a prudential level of capital with respect to their market risk and that the market risk capital charges will be consistent across the twelve Banks. Further, the adequacy of both the models and the estimates of the market risk produced by those models will be assured through supervisory oversight and the requirement that the Finance Board approve both the Banks' internal models and any subsequent material adjustment to the models. In addition, the Finance Board expects that there will be on-going dialogue between the staffs of the Finance Board and the Banks during the developments of the internal risk-based models so that formal or informal guidance may be provided on issues such as the sufficiency of individual modeling efforts.

The Finance Board has also reconsidered some aspects of proposed § 932.5 and has determined to make some changes in the final rule. Primarily, the Finance Board has changed the criteria in proposed § 932.5(b)(4)(ii) regarding the data time series from which a Bank must draw the relevant historical scenarios in

<sup>24</sup> The Finance Board provides additional background information about the modeling requirement in the **SUPPLEMENTARY INFORMATION** section of the **Federal Register** release proposing the capital rule. This information helps further clarify the Finance Board's reasoning for adopting the internal market risk model approach in this final rule. See 65 FR at 43427-29.

<sup>25</sup> The federal bank regulatory agencies (Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), and Federal Deposit Insurance Corporation (FDIC)) issued a joint final rule in September 1996 to incorporate a measure for market risk, effective as of January 1, 1998. See 61 FR 47358 (Sept. 6, 1996).

executing a stress test. The change provides greater flexibility for the Finance Board to determine an appropriate minimum number of scenarios to be used in the modeling exercise, but intends that the minimum number of scenarios shall be increased as the Bank's risk exposure increases and as the Bank's expertise and the general sophistication of available modeling technology improves. As proposed, the criteria in § 932.5(b)(4)(ii) required an unspecified number of tests to cover the relevant data period from 1978 until the present.<sup>26</sup> The Finance Board recognizes that this requirement may have created a great hardship for the Banks as they try to conform their modeling technology and capabilities to the requirements of the capital rule. The changes to § 932.5(b)(4)(ii) in the final rule are intended to allow the Finance Board to require a Federal Home Loan Bank to use a minimum acceptable but manageable number of scenarios. The periods chosen, however, must be satisfactory to the Finance Board, encompass the periods of the greatest potential market stress, given a Bank's portfolio and the data from the period of 1978 to the month prior to the month for which the market risk capital charge is being calculated, and be comprehensive given the modeling capabilities available to the Bank. The Finance Board will judge whether a Bank's given choice of historic scenarios is comprehensive, based not only on the Bank's internal capabilities at any point in time, but also on the state-of-the-art modeling technology and theory employed by other Banks and within the financial industry, generally. In addition, the Banks will be expected to increase steadily over time the number of scenarios used in calculating the market risk capital charge. The Finance Board will monitor compliance with the requirements of § 932.5(b)(4)(ii) through its general supervisory oversight, and a Bank will not be required to seek specific Finance Board approval each time it increases the number of scenarios used unless the change involves a material adjustment to the model. However, Banks will be expected to defend their choice of stress scenarios and document that their

<sup>26</sup> As proposed and adopted, the relevant historical period set forth in the capital rule by the Finance Board would encompass the period from the beginning of 1978 to the end of the month prior to the month for which the capital charge is being calculated. Each 120 business day period would start at the first of each month. Thus, the first stress period would run from January 1, 1978 forward 120 business days, the second, February 1, 1978 forward 120 business days, etc. The 1978 date was selected to ensure that the most stressful period in recent times is included. 65 FR at 43429.

choice meets the requirements of § 932.5(b)(4)(ii).

A similar change has been made to 932.5(b)(5)(iii) to conform the requirements for the stress scenarios used to model foreign exchange, and equity and commodity price risk to those used for interest rate risks. Section 932.5(b)(5)(iii), however, only applies if a Bank has issued consolidated obligations denominated in a foreign currency or linked to equity or commodity prices, and the resulting relevant foreign exchange or equity or commodity price risk is material.

The Finance Board has also changed the final rule to remove a reference which suggested that a Bank had to seek specific approval for empirical correlations included in its model (*i.e.*, approval beyond that required in the final rule under § 932.5(d)). Instead, the Finance Board intends to review the theoretical and empirical basis for including any correlations among variables in the internal model as part of its initial approval of the model or its subsequent approval of any material adjustments to the model. In general, additions of, or adjustments to, correlations used in the model would be considered a material adjustment by the Finance Board.

**Basis Risk.** In the proposed rule, the Finance Board specifically requested comment on how best to treat basis risk in the final rule. The Finance Board received several comments on basis risk. One commenter suggested that basis risk is not significant enough to require special modeling and capital charges. Another commenter suggested that each Bank should establish its own basis risk management framework, and the Finance Board should review this framework as part of its examination process. However, a review of historical rate changes indicated that some periods of stressful markets were characterized, not only by changes in the general level of rates, but also by significant changes in the relative spread between indices that affect financial positions held by the Banks. The Finance Board, therefore, has determined that basis risk is a material risk for the Banks and should be incorporated into the stress tests. Furthermore, the Finance Board believes that the historical simulation approach that the Banks are most likely to employ, at least initially, can reasonably incorporate the changes in the different market indexes that most affect the Banks' financial strength, and thereby can adequately incorporate basis risk into the required stress tests.

**The 95 percent test.** As discussed briefly above, the Finance Board

received many comments on the proposed 95 percent test. All commenters were generally opposed to the inclusion of the 95 percent test in the market risk capital requirement, often claiming that the proposed test was not required by other financial institutions or was unnecessary from a safety and soundness perspective.

One commenter stated that if the intention of the requirement was to ensure that Bank management takes appropriate action when a Bank's market value of capital falls below some threshold, the proposed requirement may actually exacerbate the problem. If the Bank were forced to increase its market risk capital requirement when its market value deteriorates, then, according to the commenter, the Bank would have the incentive to further increase risk to generate an acceptable return on the additional capital.<sup>27</sup> Commenters suggest that rather than including the 95 percent market to book value test in the rule, the Finance Board should consider requiring that each Bank's Risk Management Policy establish a threshold market to book value of capital ratio that would require the Bank's board of directors to review and determine a plan of action if necessary.

Several commenters stated that while such a requirement may have some conceptual appeal, potential adverse effects outweighed any benefits. They argued that the required test forces a mark-to-market accounting framework on the Banks which are primarily required to report their financial condition on an accrual basis under GAAP and that the conflicting requirements to reconcile accounting conventions to market valuation could lead to adverse consequences. They cite the implementation of SFAS 133 where a Bank may face asymmetrical accounting of its hedged positions that could lead to an increase in book value without any change in a Bank's market value and, therefore, a decrease in the Bank's market to book value below the 95 percent requirement without any change in its underlying economic risk. One commenter, however, agreed that it was "prudent to mandate that capital be held to assure an adequate market to book value capital ratio," but suggested that the test should require a ratio of market to book value of 85 percent.

<sup>27</sup> The commenter failed to recognize that if a Bank actually engaged in the type of behavior described, its risk-based capital requirement would rise in relation to the added risk incurred. Thus, the Finance Board does not believe that the 85 percent test adopted in the final rule will create a perverse incentive as described by the commenter.

The Finance Board finds merit in some of the concerns expressed by the commenters, especially those related to the potential effects of SFAS 133 on the Banks' balance sheets. Therefore, the Finance Board has adopted the one commenter's suggestion and has changed the final rule so that in calculating the market risk capital charge a Bank will have to add to the market risk charge estimated by its internal market risk model the amount, if any, that the market value of its total capital falls below 85 percent of the book value of its total capital.

The final rule has also been changed to make clear that in applying the 85 percent test, what the proposed rule referred to as "the book value of total capital" is the value of total capital required to be reported to the Finance Board under § 932.7 of the final rule and for other regulatory purposes. The Finance Board also wishes to clarify that in applying the 85 percent test, the market value of total capital should be calculated using the Bank's internal market risk model and should be equal to the value of total capital as estimated for the base case market value of a Bank's portfolio (*i.e.*, the value before applying the required stress scenarios).

While the Finance Board has made some changes to the proposed market-to-book value capital test in the final rule, the Finance Board continues to believe that a capital charge is needed to protect against a significant impairment in a Bank's market value of capital, to the extent that it is not reflected in the reported values of total and permanent capital. The provisions of the final rule require a Bank to measure and report its capital adequacy based upon the book value of total or permanent capital, calculated in accordance with GAAP. It is precisely because the Banks have large portfolios of long-term on- and off-balance sheet positions that are held-to-maturity, which under GAAP would generally be valued at historic cost, that a Bank's financial strength, expressed by its market value of capital, can decline significantly without that decline being reflected in the Bank's book value of capital. A market-to-book value capital test assures that the reported values of total and permanent capital are representative of the value of the capital available to absorb losses should a Bank have to liquidate or unwind its positions at any given point in time.

Moreover, contrary to some comments, the portion of capital charge calculated using the internal market risk model (*i.e.*, the market value of the Bank's portfolio at risk) does not, in the absence of the 85 percent test,

adequately protect for a decline in the market value of a Bank's total and permanent capital. As discussed above, the market value of a Bank's portfolio at risk equals the maximum loss between a baseline calculation, which estimates the current market value of a Bank's portfolio as of a certain date, and the worst case loss derived from among all the shock scenarios, where the probability of loss greater than that estimated does not exceed one percent. Because the baseline starting point for the stress test is based on current market value, the stress test does not account for any decline that may have occurred between the book value of capital and the market value of capital as estimated for the baseline starting point. However, the 85 percent test, as adopted in the final rule, is stipulated so that the market value of total capital used in the test equals the market value of total capital determined by the model for the baseline (pre-shock) case.

Based on the above reasoning, the Finance Board believes that the 85 percent test, as adopted, covers the Bank against excessive declines in the current market value of capital while being flexible enough to assure that normal fluctuations in market values do not lead to excessive volatility in the required market risk capital charge.

*Independent validation of a Bank's internal market risk model or cash flow model.* Section 932.5(c) of the proposed rule would have required each Bank to conduct, on an annual basis, an independent validation of its internal market risk model or internal cash flow model. The validation would have to be carried out by personnel not reporting to the business line responsible for conducting business transactions for the Bank or by an outside party qualified to make such determinations. The proposed rule would have required the results of the independent validation to be reviewed by each Bank's board of directors and provided to the Finance Board. As discussed below, the Finance Board has considered the comments received on the validation requirement and continues to believe that the validation requirement is necessary to assure the continued adequacy of each Bank's internal market risk model or internal cash flow model. In addition, the Finance Board does not view the requirement as unduly burdensome given the critical function that the internal models perform. Therefore, the annual validation requirement has been adopted as proposed.

Generally, commenters asked for clarification of the minimum criteria that should be used in the model validation process. One commenter

stated that the requirement to validate the model annually was excessive and suggested that conducting the validation every two years would be more practical. Another commenter suggested that the rule should explicitly allow the validation to be performed by either an outside party or the Bank's internal audit department as long as whoever performs the validation demonstrates appropriate expertise. Another commenter asked whether a letter from a recognized expert in the area of market risk will satisfy the validation requirement or whether each Bank must provide a detailed report.

Given that each Bank most likely will have a market risk model that is customized to its needs and given the expected evolution of sophistication in market risk modeling, the Finance Board does not believe that it is appropriate to provide a list of minimum criteria for the validation process in the rule. However, in view of the comments, following is a general discussion of the validation process as contemplated by the Finance Board at this time.

The Banks should establish a systematic validation procedure. This procedure should take into account the complexity and sensitivity of the Banks' instruments, the level of overall market risk and the Banks' proximity to capital limits. The procedure should include testing, review of input procedures, review of specific modeling assumptions, and review of modeling methodology. Some longer-term planning should also be involved in the validation process so that over a two or three year cycle all major assumptions and components of the model are subject to review and rigorous testing. Further, the Finance Board expects that Banks will treat the validation exercise as an on-going process throughout the year and not confine the exercise to a narrow, few-week period.

The Finance Board also does not intend that Banks back-test the full model, as is often required for traditional VAR models. However, the Banks should have criteria and procedures for reviewing significant variations between the estimations generated by the model and actual changes in the value of the Bank's portfolio or its income. In general, significant unexplained variances should result in an expansion of the scope of the validation and review process. The validation process should be documented, including documenting any reviewer-recommended action, findings, analysis, or any responses to identified problems taken by the Bank and any other relevant supporting

information. However, the Finance Board would expect each Bank only to submit a letter confirming that the required validation exercise has been completed for a given year and highlighting any problems that may have been identified and any actions that were taken by the board of directors in response. The more extensive documentation, however, should be available for inspection by Finance Board staff. As with other aspects of the § 932.5 requirements, the Finance Board expects that the staff of the Banks and the Finance Board will maintain an ongoing discussion of the validation process so that the Banks can be provided with informal or formal guidance on issues that arise.

The final rule also retains the requirement that the independent valuation must be conducted by personnel not reporting to the business line responsible for conducting business transactions for the Bank or by an outside party qualified to make such determinations. The Finance Board believes that this language implies that the validation may be conducted by personnel from the Bank's internal audit department, if qualified, and that it is not necessary to explicitly state so in the rule. Given the newness of the modeling requirement and the rapid evolution of model sophistication, the Finance Board does not consider the validation requirement as clarified here to be overly burdensome.

#### *Section 932.6—Operations Risk.*

Operations risk is the risk of an unexpected loss resulting from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems. As proposed, § 932.6 provided that each Bank's operations risk capital requirement would equal 30 percent of the sum of the Bank's credit and market risk capital requirements, but would have allowed a Bank to substitute an alternative methodology for calculating the operations risk charge if such methodology was approved by the Finance Board. The proposed rule also allowed a Bank, with Finance Board approval, to reduce the operations risk capital requirement by obtaining insurance to cover it for operations risk. In no event, however, would a Bank have been permitted to reduce its capital charge for operations risk to less than 10 percent of the sum of its credit and market risk requirements.

Almost all of the comments received by the Finance Board addressed the proposed operations risk capital charge. Commenters generally disagreed with at least some aspect of the proposed

requirement, although one trade association supported the proposal as reasonable. One of the most often voiced comment was that the Finance Board lacked a sound theoretical basis for linking operations risk to market and credit risk. One commenter noted, however, that this approach had some support in regulatory circles. A number of commenters felt that a charge equal to 30 percent of the market and credit risk charges was too onerous, either as a percentage or in absolute terms. A few commenters welcomed the flexibility afforded by proposed § 932.6(b) to allow the Banks to develop alternative methods of measuring the operations risk capital charge. A substantial number of commenters also requested that the operations risk charge be eliminated from the capital regulation altogether. After considering all of the comments received, the Finance Board is not persuaded that the operations risk charge should be eliminated and has decided to adopt the regulation as proposed.

In the proposed rule, the Finance Board stated that although not required by the GLB Act, the operations risk capital charge was necessary to assure that the Banks remained adequately capitalized and able to operate in a safe and sound manner. The Finance Board noted that the credit and market risk capital charges in the proposed rule were not meant to cover unexpected losses that may arise from operations failures, and that a separate capital charge was needed to protect the Banks from such losses. See 65 FR at 43420–21. The Finance Board continues to believe that an operations risk capital charge is a necessary part of any complete and adequate risk-based capital regulation, and therefore, that it is authorized to adopt the operations risk capital charge in fulfillment of its statutory duties to assure that the Banks “operate in a financially safe and sound manner” and “remain adequately capitalized.” 12 U.S.C. 1422a(a)(3)(A) and (B), 1422b.

Moreover, in proposing the operations risk charge, the Finance Board recognized that there are theoretical difficulties in measuring operations risk. As a number of commenters pointed out, the Finance Board stated in the preamble to the proposed regulation that there was “currently no generally accepted methodology for measuring the magnitude of operations risk.” 65 FR at 43429. However, in acknowledging a lack of consensus concerning a methodology for quantifying operations risk, the Finance Board was not in any way conceding that difficulties in measuring operations risk either

lessened the potential for losses from such risks, or reduced the importance of mandating an adequate operations risk capital charge. Further, while many commenters questioned the theoretical basis for the operations risk charge, none provided alternative empirical methods or analysis for quantifying operations risk or assessing an adequate operations risk charge.

Given the difficulties in measuring operations risk, the Finance Board proposed to use the same approach to operations risk as that provided for Fannie Mae and Freddie Mac by statute, 12 U.S.C. 4611(c)(2), reasoning that Congress considered and deemed reasonable for regulatory purposes a linkage between an operations risk charge and credit and market risk charges. The Finance Board continues to believe that the statutory requirement established for the other housing GSEs provides a reasonable basis for assessing an operations risk charge. Further, in allowing a Bank to reduce its operations risk charge by providing an alternative method for calculating the operation risk charge, the regulation affords the Banks an opportunity to demonstrate that their operations are less risky than the other housing GSEs or that their business lines present little operations risk, and thereby, qualify for a lower operations risk charge.

One of the housing GSEs criticized the provision of the proposed rule that would allow the Banks to reduce their operations risk charges, stating that it would significantly reduce a Bank's capital. Instead, the GSE suggested that the Finance Board compare the Banks' operations risks to those of leading financial institutions and allow for a reduction in the operations risk charge only if a Bank could demonstrate that it exceeds best practices with regard to controlling such risks. In response to this comment, the Finance Board wishes to clarify that before it will approve an alternative methodology for measuring operations risk under § 932.6(b) of the final rule, it will expect a Bank to demonstrate, using a comprehensive, empirically-based approach, that the alternative methodology adequately quantifies the Bank's operations risk. Any analysis would have to take into account the complexity of a particular Bank's business and hedging activities as well as its internal controls, in-house expertise and other factors that relate to operations risks. Similarly, in order to receive a reduction in the operations risk charge for insurance, the Bank would have to demonstrate that the insurance covers the specific risks faced by the Bank and provide a comprehensive analysis to justify the

reduction in the operations risk requirement sought by the Bank. While the Finance Board will be flexible in the types of approaches that it is willing to consider under § 932.6(b), it expects rigorous analysis to support any Bank claims before it will approve a reduced capital charge for operations risk, and will in every case require the Banks to hold operations risk capital equal to at least ten percent of credit and market risk. Therefore, the Finance Board believes that the flexibility provided in 932.6(b) will be consistent with achieving sound levels of capital for the Banks.

A few commenters also criticized the approach proposed in § 932.6(b) as not being flexible enough and suggested that the regulation should allow a Bank to decrease its operations risk charge to zero, where justified. They believed that the ten percent minimum charge would create a disincentive for the Banks to insure against operations risk or take added steps to control operations risk. However, in general, a business can not realistically expect to identify or eliminate all potential losses from computer "glitches," human error, fraud, natural disasters or other similar unforeseen, and in many cases, uncontrollable events. Nor does it appear possible to insure against events that may arise as part of new technology, new business processes or that otherwise may not be identified at any point in time. Thus, the Finance Board believes that it would be unrealistic, and in the long-run unsafe, to remove the minimum operations risk charge contained in the rule. Further, the Finance Board believes that the ten-percent floor is in keeping with its conservative approach to assessing capital charges.

A substantial number of commenters felt that the operations risk charge was too high and should be reduced or eliminated. A number of commenters urged the Finance Board to delete the operations risk charge and instead, to rely on its supervisory oversight to protect the Bank System against this risk. While supervision is an important component of any regulatory system, the changes mandated by the GLB Act require a Bank to hold capital against the losses from the risks that it faces. This assures that the enterprise, *i.e.*, the Bank System, and not taxpayers generally, will bear the risk associated with the Banks' activities and operations. Thus, consistent with this goal of the GLB Act, the Finance Board believes that permanent capital should be held by a Bank against potential losses arising from operations risk, and that the Finance Board should not rely

solely on a supervisory approach to guard against such losses.

In support of their requests for a reduced operations risk capital charge, some Banks also cited a study done by one of their consultants that estimated an operations risk capital charge at about ten percent of credit and market risk (Study). The Study relied on loss estimates from a small number of publicly acknowledged operations risk failures and made some broad assumptions about the Banks' operations. The Finance Board has reviewed the Study, which is a useful initial attempt to measure the Banks' operations risk. However, while recognizing the time constraints under which the Study was completed and the inherent difficulties of measuring operations risk, the Finance Board finds that the Study is not comprehensive, or more specifically, that the data used is incomplete and many of the assumptions made were not adequately supported by empirical evidence. Thus, the Finance Board does not believe that the results of the Study provide a sufficient basis for changing the proposed rule.

Along similar lines, some commenters argued that the proposed capital charge was too onerous given the Banks' historical lack of losses from operational problems. However, without having to address the accuracy of such views, it is clear that the Banks recently have received additional investment authority and are entering into new business areas. *See, e.g.*, 65 FR 43969 (July 17, 2000) (adopting rules governing acquired member asset program), 65 FR 44414 (July 18, 2000) (adopting rules expanding eligible collateral to support advances and procedures for approval of new business activities). While these new activities may not present new or unique credit or market risks, they are likely to result in changes in existing business and hedging operations and in the development of new or more complex operational processes. The Finance Board believes that the likelihood of such changes further supports the conservative approach embodied in the operations risk capital charge as adopted. Moreover, as with all aspects of the capital regulation, the Finance Board is willing to consider changes to the operations risk capital requirements if it is presented with sufficient evidence to justify such amendments.

#### *Section 932.7—Reporting Requirements*

Section 932.7 of the proposed rule would have required each Bank to report to the Finance Board by the 15th day of each month its risk-based capital

requirement by component amounts, and its actual total capital amount and permanent capital amount. These reported values would have been calculated as of the last day of the preceding month. In the proposed rule, the Finance Board also reserved the right to require the Banks to report this information more frequently. Comments received on the reporting requirement indicated that commenters found reporting capital requirements by the 15th day of each month to be unrealistic. Most commenters suggested that a reporting date later in the month would be more practical. Several commenters recommended eliminating the requirement, but said that if the Finance Board retained the requirement, it should be moved to the final calendar day of the month. One commenter recommended moving the reporting requirement to the 20th of the month.

The Finance Board believes that it is important to monitor the capital requirements of the Banks to ensure that they remain in compliance with the requirements and to identify any potential situations that may require remedial action, but recognizes that sufficient time must be provided if the reported information is to be accurate. As a result, the Finance Board has retained the reporting requirement in the final rule, but has changed the reporting date from the 15th day of the month to the 15th business day of the month providing more time for the Banks to prepare their capital calculations. Currently, the Banks report duration of equity and market value of equity calculations for the previous month to the Finance Board on the 15th business day of each month. The change in the reporting date in the final rule to the 15th business day would add approximately five days providing more time for the Banks to prepare their calculations and would be in conformance with current reporting requirements for the Banks for market risk measures. Except for the change in the reporting date, the Finance Board is adopting § 932.7 as proposed.

#### *Section 932.8—Minimum liquidity requirements*

As proposed, § 932.8 would require each Bank to hold contingency liquidity<sup>28</sup> in an amount sufficient to

<sup>28</sup> Contingency liquidity, as defined in the Finance Board regulations, means the sources of cash a Bank may use to meet its operational requirements when its access to the capital markets is impeded, and includes: (1) marketable assets with a maturity of one year or less; (2) self-liquidating assets with a maturity of seven days or less; (3) assets that are generally accepted as collateral in the repurchase agreement market; and



enable it to cover its liquidity risk, assuming a period of not less than five business days of inability to borrow in the capital markets. This requirement is in addition to meeting the deposit liquidity requirements contained in § 965.3 of the Finance Board's regulations. 12 CFR 965.3. Proposed § 932.8 also specifically stated that an asset that has been pledged under a repurchase agreement cannot be used to satisfy the contingency liquidity requirement. As discussed below, the Finance Board received several comments on proposed § 932.8, but did not alter the proposed provision in response. The Finance Board is, therefore, adopting § 932.8 as proposed.

Generally, commenters indicated that because there are already regulations that require each Bank to develop a liquidity policy, additional liquidity requirements are not necessary. One commenter indicated that if the Finance Board determines to have additional liquidity requirements, such a regulation should be postponed until after the capital regulation is finalized. Another commenter stated that if the liquidity regulation is adopted, then the Finance Board should provide guidance on how to measure compliance with the regulation. In this regard, the Finance Board believes that the analytical framework on liquidity measurement and management specified in the 1992 Basle paper serves as a useful guide in the measurement of contingency liquidity. See "A Framework for Measuring and Managing Liquidity," Basle Committee on Banking Supervision (September 1992).

Another commenter believed that the proposed § 932.8 requirement would not be sufficient to avoid the risk that a Bank's operations would be disrupted during a significant financial crisis and recommended that to adhere to the Basle Accord Capital Standards, the Bank should hold sufficient capital against liquidity risk to withstand a period of one-to-three months' inability to access debt markets. The contingency liquidity requirement set forth in § 932.8 is not intended to fully resolve a situation where the Bank System's access to the capital markets is effectively limited for a period of time extended more than a few days. See 65 FR at 43430-31. Furthermore, neither the Basle Committee nor the banking regulators in the U.S. have indicated any desire to propose risk-based capital standards for liquidity risk. Therefore,

the Finance Board has decided not to require a specific liquidity risk capital for the Banks, as suggested by the commenter.

The Banks currently operate under two general liquidity requirements, both of which are easily met by the Banks. Under § 965.3 of the Finance Board rules, which implements 12 U.S.C. 1431(g), the Banks must maintain investments in obligations of the United States, deposits in banks or trusts, or advances to members that mature in 5 years or less in an amount equal to the total deposits received from its members. In addition, the Banks must meet a liquidity requirement set forth in the FMP that requires each Bank to maintain a daily average liquidity level each month in an amount not less than 20 percent of the sum of the Bank's daily average demand and overnight deposits and other overnight borrowings during the month, plus 10 percent of the sum of the Bank's daily average term deposits, COs, and other borrowings that mature within one year. See FMP section III.C. In addition to these specific requirements, each Bank also must set standards in its risk management policy for day-to-day operational liquidity<sup>29</sup> and contingency liquidity needs that enumerate the specific types of investments to be held for such liquidity needs and establish the methodology to be used for determining the Bank's operational and contingency liquidity needs. 12 CFR 917.3(b)(3)(iii).

Neither of the existing liquidity requirements is structured to meet the Bank's liquidity needs should their access to the capital markets be limited in the short term for any reason. The requirement adopted in § 932.8 is meant to address principally events that may temporarily disrupt a Bank's access to credit markets. It may be viewed as conservative when examined in the context of events which could impair the normal operations of the Office of Finance (OF). The likelihood that there would be no access to the capital markets for as long as five business days is extremely remote, given OF's contingency plans to be back in operation within the same business day following a disaster. The OF contingency plans include back-up power sources and two back-up facilities, plus procedures to back-up their databases at both their main location as well as the primary

alternative site. A back-up data tape from OF's main location is sent and stored off-site on a daily basis.

Rating agencies also consider adequate liquidity an important component in a financial institution's rating. Liquid investments held by the Banks are stated by Moody's as one of the reasons behind the triple-A rating for the Banks.<sup>30</sup> Thus, the Finance Board believes that the contingency liquidity requirement set forth in § 932.8 is important to maintaining a sound credit rating for the Banks and assuring continued safe and sound operation of the Bank System and access to the capital markets.

In the **SUPPLEMENTARY INFORMATION** section of the proposed rule, the Finance Board asked for comment on whether the rule should address the issue of operational liquidity, and if so, how it should do so. One commenter specifically addressed the question posed in the **SUPPLEMENTARY INFORMATION** section of the proposed rule. The commenter stated that each Bank should establish its own operational liquidity policy and that the Finance Board should not specify a specific requirement. After further consideration, the Finance Board believes that the requirements in § 917.3 and § 965.3 of the Finance Board's regulations sufficiently cover operational liquidity and will not address it further in its regulations at this time. 12 CFR 917.3, 965.3.

#### *Section 932.9—Limits on Unsecured Extensions of Credit*

Section 932.9 of the proposed rule established maximum capital exposure limits for unsecured extensions of credit by a Bank to a single counterparty or to affiliated counterparties and reporting requirements for total unsecured credit exposures and total secured and unsecured credit exposures to single counterparties and affiliated counterparties that exceed certain thresholds.

The proposed rule provided that unsecured credit exposure by a Bank to a single counterparty that would arise from authorized Bank investments or hedging transactions must not exceed the maximum capital exposure percent limit applicable to such counterparty, as set forth in Table 4 of the proposed rule, multiplied by the lesser of: (i) the Bank's total capital; or (ii) the counterparty's Tier 1 capital, or total capital if information on Tier 1 capital is not available. The maximum capital

(4) irrevocable lines of credit from financial institutions rated not lower than the second highest credit rating category by a credit rating organization regarded as a NRSRO by the Securities and Exchange Commission. 12 CFR 917.1.

<sup>29</sup>Operational liquidity, as defined in the Finance Board's regulations, means sources of cash from both a Bank's ongoing access to the capital markets and its holdings of liquid assets to meet operational requirements in a Bank's normal course of business. 12 CFR 917.1.

<sup>30</sup>"Moody's Investor Service, Global Credit Research, Moody's Credit Opinions—Financial Institutions", (June 1999).

exposure percent limits applicable to specific counterparties in Table 4 ranged from a high of 15 percent, for counterparties with the highest investment grade rating, to a low of one percent for counterparties with a below investment grade rating.

The proposed rule also provided that where a counterparty has received different credit ratings for its transactions with short-term and long-term maturities: (i) the higher credit rating shall apply for purposes of determining the allowable maximum capital exposure limit under Table 4 applicable to the total amount of unsecured credit extended by the Bank to such counterparty; and (ii) the lower credit rating shall apply for purposes of determining the allowable maximum capital exposure limit under Table 4 applicable to the amount of unsecured credit extended by the Bank to such counterparty for the transactions with maturities governed by that rating. The proposed rule also provided that if a counterparty is placed on a credit watch for a potential downgrade by an NRSRO, the Bank would use the credit rating from that NRSRO at the next lower grade. The proposed rule also required that the total amount of unsecured extensions of credit by a Bank to all affiliated counterparties may not exceed: (i) the maximum capital exposure limit applicable under Table 4 based on the highest credit rating of the affiliated counterparties; (ii) multiplied by the lesser of: (A) the Bank's total capital; or (B) the combined Tier 1 capital, or total capital if information on Tier 1 capital is not available, of all of the affiliated counterparties.

The proposed rule required that the Banks report monthly to the Finance Board the amount of the Bank's total secured and unsecured credit exposures to any single counterparty or group of affiliated counterparties that exceeds 5 percent of the Bank's total assets.

The principal change made by the Finance Board in the final rule refined the calculation of the maximum allowable credit exposure to a counterparty. The proposed rule required that the determination be made on the basis of the counterparty's Tier 1 capital, or if Tier 1 capital is not available, total capital (as defined by the counterparty's principal regulator). The final rule adds another option in situations where Tier 1 capital and regulatory capital are not available and allows a Bank to use in these cases some comparable measure identified by the Bank. This was added in recognition that there may be unregulated counterparties that don't have regulatory capital (because they do not

have a principal regulator) and allows a Bank to use some other comparable measurement such as equity, owners equity, or net worth.

Most of the commenters that addressed this section of the proposed rule opposed the implementation of unsecured credit limits. One commenter indicated that the limits are tolerable, but not necessary. Others commented that this section is not pertinent to the restructuring of Bank capital and therefore should be eliminated from the final rule, and one indicated a belief that limits on unsecured extensions of credit should be established by each Bank's board of directors, subject to review by the Finance Board during the examination process.

The Finance Board has long maintained limits on unsecured extensions of credit, which currently are contained in the FMP, and other financial institution regulatory agencies also limit the amount of credit that can be extended to one borrower. As explained in the proposed rule, concentrations of unsecured credit by a Bank with a limited number of counterparties or group of affiliated counterparties raise safety and soundness concerns because unsecured credit extensions are more likely to result in limited recoveries in the event of default that secured extensions of credit. Significant credit exposures to a few counterparties increase the probability that a Bank may experience a catastrophic loss in the event of default by one of the counterparties. In contrast, holding small credit exposures in a large number of counterparties reduces the probability of a catastrophic loss to a Bank.

Concentrations of credit by multiple Banks in a few counterparties also may raise safety and soundness concerns at the Bank System level. It is conceivable that some counterparties spread their exposure among several Banks, which may result in large aggregate credit exposures for the Bank System. Such exposures raise concerns regarding the liquidity of such debt in the event of adverse information regarding a counterparty.

Because the risk-based capital requirement does not take into account the increase in credit risk associated with concentrations of credit exposures, the Finance Board believes it is necessary, for safety and soundness reasons, to impose separate limits on unsecured credit exposures of a Bank to single counterparties and to affiliated counterparties. The Finance Board also believes that the limits established in this rule are appropriate in order to limit Bank System exposure to a

counterparty or group of affiliated counterparties. The Finance Board is not imposing System-wide limits due to the operational difficulties in tracking and allocating exposure and thus feels that the limits applied to individual Banks must be low enough to limit System exposure. The Finance Board may solicit additional comments regarding the appropriateness of the limits in a future rulemaking and may consider revising them at that time.

#### *G. Part 933—Bank Capital Structure Plans*

*Submission of Plans.* Section 933.1(a) of the proposed rule would have required the board of directors of each Bank to submit to the Finance Board within 270 days after the date of publication of the final rule a capital plan that complies with part 931 and that, when in effect, would provide the Bank with sufficient total and permanent capital to meet the minimum regulatory capital requirements established by part 932. The proposed rule also would have allowed the Finance Board to approve a reasonable extension of the 270-day period upon a demonstration of good cause. As set forth in the GLB Act, the proposal would have required a Bank to receive Finance Board approval prior to implementing its capital plan or any subsequent amendment to the plan.

Proposed § 933.1(b) also stated that if a Bank, for any reason, were to fail to submit a capital plan to the Finance Board within the 270-day period, including any Finance Board approved extension, the Finance Board would be authorized to establish a capital plan for that Bank, and the Finance Board also would have the discretion to take any enforcement action against the Bank, its directors, or its executive officers authorized by section 2B(a) of the Bank Act, 12 U.S.C. 1422b(a), or to merge the Bank in accordance with section 26 of the Bank Act, 12 U.S.C. 1446, into another Bank that has submitted a capital plan.

The Finance Board is adopting § 933.1(a) and (b) without any material changes, though it has added a new § 933.1(c), which deals with Finance Board consideration of the capital plans. Section 933.1(c) provides that upon receipt of a capital plan from a Bank, the Finance Board may return the plan to the Bank if it does not comply with section 6 of the Bank Act or with any regulatory requirement, or if it is incomplete or materially deficient in any other respect. If the Finance Board accepts a plan for review, it still may require the Bank to submit additional information, as needed to review the

plan, or to amend the plan, as necessary to comply with the statute or regulations. The final rule also provides that the Finance Board may approve the capital plan conditionally, i.e., the approval is contingent upon the Bank complying with certain conditions stated in the approval resolution from the Finance Board. It is well established that an agency's authority to deny a regulatory submission includes the authority to approve an application subject to certain conditions, which the Finance Board will do as circumstances dictate. The final rule further provides that the Finance Board may require that the capital plans for all twelve Banks take effect on the same date. This issue was raised by several commenters, who contended that the joint-and-several liability of the Banks on their consolidated obligations may require that the individual Banks not operate under materially different capital structures, as such an arrangement could result in some Banks bearing a portion of the risks created by the other Banks. The Finance Board believes that the concern expressed by the commenters merits some consideration and has addressed the issue by reserving to itself the right to set a uniform effective date for the capital plans of all of the Banks. The Finance Board will decide whether to do so after reviewing the plans submitted by the Banks, and is not prepared to mandate in the final rule that all of the plans must take effect on the same date. Most of the comments on § 933.1 dealt with timeframes for review of capital plans, and the "commonality" of plans. Two Bank commenters suggested that the final rule impose a time limit for Finance Board review of the plans, while another Bank recommended a procedure and timeframe for addressing capital plan amendments. Other commenters suggested an expedited review process, or possibly pre-approval, for certain types of amendments to the capital plan during the initial implementation period and recommended that the rule require each Bank to include in its plan provisions to address simply and quickly any unintended consequences that may arise as the Banks implement their capital plans.

Many commenters suggested, to assure safety and soundness, coordination of the System as a whole and an appropriate degree of commonality among plans, that the Finance Board approve all of the Banks' capital plans at the same time or not approve any one plan until it has received plans from all of the Banks. Commonality was a common theme

among commenters, who sought coordination of the final capital plans across the Bank System to avoid a potentially destabilizing competition and arbitrage of membership and to preserve the cooperative nature of the Bank System. The Finance Board intends to assess the issue of commonality as part of the approval process, and will consider, for example, differences between the plans on matters such as the minimum investment, including both membership and activity-based stock purchase requirements, dividend policy, and voting preferences. It is only by making such comparisons that the Finance Board will be able to assess accurately the possibility that the differences among the plans might encourage members of one Bank to relocate to another Bank in order to benefit from what they perceive to be a more advantageous Bank capital structure.

The Finance Board has not imposed any time limits for its review of the individual capital plans. Though the Congress spoke precisely to when the Finance Board must promulgate the final rule and when the Banks must submit their capital plans for review, it was silent on the issue of Finance Board review of the individual plans. Given that silence, and the possible variables that could affect the Finance Board's review of each plan, the Finance Board is not prepared to establish time periods in the final rule within which it must act on the capital plans. The length of time that it will take the Finance Board to review each capital plan will depend on a number of factors, including the quality of the initial submission, the timing of the submissions, and the approval of certain models to be used by the Banks on which capital plan approvals are contingent. For all of those reasons, and with so many unknown factors, the Finance Board does not believe that it is in the best interest of the agency or the Banks to establish a time limit for Finance Board review of the plans. Nonetheless, the Finance Board is committed to reviewing each plan in as expeditious a manner as is possible and encourages the Banks to communicate with the Finance Board as issues arise during the development of their capital plans. The Finance Board believes such communication during the development of the plans can aid immeasurably in eliminating potential problems that might otherwise delay the Finance Board's consideration of the capital plans. That approach will ensure that the Finance Board has the opportunity to fully and completely review each

Bank's capital plan and to deal with unforeseen issues that may arise during the review period without imperiling the quality of its review.

*Contents of Plans.* Section 933.2 of the proposed rule would have implemented the GLB Act provisions regarding the contents of capital plans by requiring each Bank's capital plan to address, at a minimum, the classes of capital stock, capital stock issuance, membership investment or fee structure, transfer of capital stock, termination of membership, independent review of the capital plan, and implementation of the plan. The Finance Board received relatively few comments on this provision. Among those parties commenting, one Bank contended that the GLB Act requirement that members promptly comply with any amendments to the minimum investment would constitute an "unlimited capital call" on the assets of the members should the financial condition of the Bank deteriorate. Other commenters recommended that the final rule require each Bank to submit the capital plans to its members for their approval prior to submitting the plan to the Finance Board, and that the plans themselves be subject to public comment. Most of the revisions made in the final rule have been added in order to conform § 933.2 to the revisions that have been made to part 931 of the final rule. The most significant change to § 933.2 is the inclusion of § 933.2(a), which relates to the minimum investment that each Bank must establish for its members. Generally speaking, those changes reflect the amendments made to § 931.3 of the final rule, which added the minimum investment provisions to part 931 and which have been described previously. The final rule provides that each Bank's capital plan must require each member to purchase and maintain a minimum investment in the capital stock of the Bank in accordance with § 931.3, and must prescribe the manner in which the minimum investment is to be calculated. The capital plan must require each member to maintain its minimum investment in the Bank's stock for as long as it remains a member and, with regard to Bank stock purchased to support an advance or other business activity, for as long as the advance or business activity remains outstanding.

The final rule also requires the capital plan to specify the amount and class (or classes) of Bank stock that an institution is required to own in order to become and remain a member of the Bank, as well as the amount and class (or classes) that a member must own in order to obtain advances from, or to engage in

other business transactions with, the Bank. If a Bank issues both Class A and Class B stock and the board of directors of that Bank authorizes the members to satisfy their minimum investment through the purchase of some combination of Class A and Class B stock, the capital plan must specify what combinations of stock are authorized. If the Bank were to authorize only one combination of Class A and Class B stock for the members to purchase, the members would be limited to whatever combination had been approved by the Bank's board of directors. Consistent with part 931, as well as with the GLB Act, § 933.2(a)(3) of the final rule provides the Banks with several alternatives for structuring their minimum investment. Thus, a capital plan may establish a minimum investment that is calculated as a percentage of the total assets of the member, as a percentage of the advances outstanding to the member, as a percentage of the other business activities conducted with the member, on any other basis approved by the Finance Board, or on any combination of the above. This affords each Bank the latitude to tailor its minimum investment to the needs of its members, and recognizes that each Bank may have a different operating philosophy and may wish, for example, to establish relatively lower activity-based stock purchase requirements and relatively higher membership stock purchase requirements, or vice versa. However a Bank decides to structure its minimum investment, the final rule requires that the minimum investment be set at such a level as to provide sufficient capital for the Bank to comply with its minimum capital requirements, as specified in part 932. The final rule also requires the plan to require the board of directors of the Bank to monitor and, as necessary, to adjust, the minimum investment to ensure that the stock that the members are required to purchase remains sufficient to allow the Bank to comply with its minimum capital requirements. The final rule further provides that the plan shall require each member to comply with any such adjusted minimum investment, but may permit a member a reasonable period of time within which to come into compliance with the adjusted minimum investment. The final rule expressly provides that a Bank may permit a member to comply with an adjusted minimum investment by reducing its outstanding business with the Bank to a level that would be fully supported by its existing investment in the stock of the Bank.

A number of commenters criticized the provision in the proposed rule that would have required members to "comply promptly" with any adjustment to the minimum investment required under the capital plan for a Bank. The principal objection was that the provision is tantamount to an "unlimited call" by the Bank on the assets of the members to support the capital of the Bank, which could discourage institutions from remaining members after the capital plans take effect. As an initial matter, the requirements that each capital plan "impose a continuing obligation on the board of directors of the bank to review and adjust the minimum investment required of each member of that bank, as necessary to ensure that the bank remains in compliance with applicable minimum capital levels" and to "require each member to comply promptly with any adjustments to the required minimum investment" are statutory requirements and the Finance Board cannot delete them from the final rule. 12 U.S.C. 1426(c)(1)(D).

Historically, the amount of Bank stock that each member must own was set by statute as the greater of 1 percent of the member's mortgage assets or 5 percent of the advances outstanding to the member. In the GLB Act, the Congress repealed the statutory stock purchase requirements and replaced them with provisions directing each Bank to establish a "minimum investment" for its members. Aside from giving the Banks different options for how the minimum investment could be structured, Congress largely left the details of the minimum investment to the Banks. That delegation to the Banks was subject, however, to a statutory requirement that whatever method a Bank chose for its minimum investment must provide sufficient permanent and total capital for the Bank to meet the risk-based and leverage capital requirements established by the GLB Act. As a trade-off for allowing the Banks to establish the details of the minimum investment, the Congress imposed two new requirements. One requirement imposed on the board of directors of each Bank a "continuing obligation" to review and, as necessary, to adjust the minimum investment required of each member to ensure that the Bank remains in compliance with the GLB Act capital requirements. The other requirement imposed on the members an obligation to "comply promptly" with any revisions to the minimum investment established by that Bank.

As the Finance Board understands the criticisms of this aspect of the law, the

requirement to "comply promptly" with the revised minimum investment is viewed by some as creating an open-ended obligation on the part of the members to guarantee the capital adequacy of the Banks. To those parties, this obligation would effectively require the members to pay to the Banks, for the purchase of additional Bank stock, whatever amounts might be demanded by the Banks. The Finance Board does not share the view of those commenters that this provision constitutes an "unlimited call" on the assets of the members of each Bank. Although the GLB Act does require the members of a Bank to comply promptly with any increased minimum investment requirement, it does not provide any means for a Bank to compel payment from any members that decline to purchase the additional amounts of Bank stock. Indeed, it is not clear that either the Banks or the Finance Board has any legal authority to compel a member to pay to its Bank any amounts that the member does not want to pay. In the absence of any ability of either the Bank or the Finance Board to compel payment, the Finance Board does not believe that this provision can reasonably be construed to impose an unlimited call on the assets of any member.

That is not to say that a member's refusal to comply promptly with the stock purchase requirement of the Bank's capital plan would be without consequences for the member. For instance, a member that refused to comply with an amended minimum investment requirement would be in violation of section 6(c)(1)(D) of the Bank Act, as well as with the provisions of the capital regulations. If a member violates those provisions, it will provide the Bank with grounds to terminate its membership involuntarily, in accordance with section 6(d)(2) of the Bank Act, as amended by the GLB Act. 12 U.S.C. 1426(c)(1)(D), (d)(2). Moreover, depending on the terms of the advances agreements or other agreements between the Bank and its member, a refusal to comply with the minimum investment may constitute an event of default under such agreements that would allow the Bank to take certain other actions, such as calling due all outstanding advances to that member, liquidating its collateral, or suspending dividend payments to that member, or may give the Bank grounds for a civil action against the member. How the Banks and members resolve these issues will depend in large part on the particular circumstances of each case. As a fundamental matter, however,

the Banks are cooperatives and as such must look solely to their members as the source of the capital needed to support the business conducted by the Banks with their members. As members of a cooperative, the members of a Bank have an obligation to provide the Bank with the capital that the Banks are required to hold in order to support the risks attendant to the business that they conduct with their members. Under the GLB Act, membership is voluntary for all institutions, as are the transactions that a member initiates with its Bank. If an institution wishes to remain a member of a Bank, or if it wishes to obtain (or retain) advances from its Bank, it simply cannot refuse to provide the Bank with the capital that the GLB Act requires the Bank to have for such transactions. That does not mean that the Bank has an unlimited call on the assets of the member. It does mean that the Banks will be required to manage actively the important relationships they maintain with their members, and that members may be required, from time to time, to reevaluate the economics of remaining a member of the Bank. If the costs of continued membership exceed the benefits that the member expects to receive from being a member, then the member can withdraw voluntarily from membership or can allow the Bank to terminate its membership for noncompliance with the Bank Act. In either event, the decision of the member will be a voluntary decision based on the economics of the situation, which is precisely the type of decision that the members make every day in the conduct of their business.

The Finance Board recognizes that "comply promptly" does not necessarily mean that a member must comply with an adjusted minimum investment immediately, and has included in the final rule a provision that allows a Bank to establish a reasonable period of time for the members to comply with the new minimum investment. As a practical matter, this is most apt to be an issue only with regard to advances or other transactions that are already on the books of the Bank at the time that the minimum investment is adjusted. With respect to advances and other transactions initiated subsequent to the revised minimum investment provisions, the Finance Board expects that the members will purchase the required amount of Bank stock prior to closing the new transaction. With respect to outstanding transactions, the Bank will determine what constitutes a reasonable period of time, and may take into consideration the fact that advances

or other transactions may mature or otherwise terminate in the short term. The Finance Board notes, however, that it would not be a safe or sound practice for the Bank to carry undercapitalized assets on its books for more than a relatively brief period, nor would it be equitable to other members that promptly purchase the additional stock to allow disparate stock purchase requirements to remain outstanding for a significant period.

It also should be noted that a Bank cannot unilaterally increase the minimum investment that it requires of its members. By law, the minimum investment must be specified in the capital plan, which must be approved by the Finance Board. Thus, in order for a Bank to increase its minimum investment, the board of directors of the Bank would have to authorize the amendment to the capital plan and its submission to the Finance Board. Moreover, it is by no means certain that the Bank will ask to apply the increased minimum investment to all of its outstanding business with its members. Depending on the circumstances, it is possible that a Bank could ask that the minimum investment be approved only for new business and that it could ask for a transition period for the members to adjust their stock holdings for their existing business with the Banks. Regardless of the content of the submission, the Finance Board would review the amendment in the same manner as it reviews the initial capital plan and, presumably, would approve the plan. It will only be after the Finance Board has approved the amendment that the Bank could impose the revised minimum investment on its members.

As required by the GLB Act, § 933.2(b) of the final rule also requires that the capital plan specify the class or classes of stock (including subclasses, if any) that the Bank will issue, and establish the par value, rights, terms, and preferences associated with each class (or subclass) of stock. The final rule allows a Bank to establish preferences that are related to, but not limited to, the dividend, voting, or liquidation rights for each class or subclass of Bank stock. Any voting preferences established by the Bank pursuant to § 915.5 shall expressly identify the voting rights that are conferred on each class of stock with regard to the election of Bank directors. As specified in the GLB Act, the final rule also requires that the capital plan provide that the owners of the Class B stock own the retained earnings, and paid-in surplus of the Bank, but shall have no right to withdraw or otherwise receive distribution of any portion of

such retained earnings or paid-in surplus of the Bank except through the declaration of a dividend or a capital distribution approved by the board of directors of the Bank, or through the liquidation of the Bank.

Section 933.2(c) of the final rule requires the capital plan to establish the manner in which the Bank will pay dividends, if any, on each class or subclass of stock, and shall provide that the Bank may not declare or pay any dividends if it is not in compliance with any capital requirement or if, after paying the dividend, it would not be in compliance with any capital requirement.

Section 933.2(d) of the final rule requires the capital plan to address issues relating to initial issuance of the Class A and/or Class B capital stock, to specify the date on which the Bank will implement the new capital structure, to establish the manner in which the Bank will issue stock to its existing members, as well as to eligible institutions that subsequently become members, and to address how the Bank will retire the stock that is outstanding as of the effective date, including stock held by a member that does not affirmatively elect to convert or exchange its existing stock to either Class A or Class B stock, or some combination thereof.

Section 933.2(e) of the final rule requires the capital plan to set forth the criteria for stock transactions, including the issuance, redemption, repurchase, transfer, and retirement of all Bank stock. The capital plan also must provide that the Bank may not issue stock other than in accordance with § 931.2; that the stock of the Bank may be issued only to and held only by the members of that Bank; and that the stock of the Bank may be transferred only in accordance with § 931.6, and may be traded only between the Bank and its members. The capital plan may provide for a minimum investment for members that purchase Class B stock that is lower than the minimum investment for members that purchase Class A stock, provided that the level of investment is sufficient for the Bank to comply with its regulatory capital requirements. The capital plan must specify the fee, if any, to be imposed on a member that cancels a request to redeem Bank stock, and must specify the period of notice that the Bank will provide to a member before the Bank, on its own initiative, determines to repurchase any excess Bank stock from a member.

As required by the GLB Act, § 933.2(f) of the final rule requires the capital plan to address the manner in which the Bank will provide for the disposition of

its capital stock that is held by institutions that terminate their membership, and the manner in which the Bank will liquidate claims against its members, including claims resulting from the prepayment of advances prior to their stated maturity.

Under § 933.2(g) of the final rule, each Bank's capital plan must demonstrate that the Bank has made a good faith determination that the Bank will be able to implement the plan as submitted and that the Bank will be in compliance with its regulatory total capital requirement and its regulatory risk-based requirement after the plan is implemented. As required by the GLB Act, the final rule requires each Bank to conduct a review of its plan by an independent certified public accountant prior to submission to the Finance Board, to ensure, to the extent possible, that implementation of the plan would not result in the write-down of the redeemable stock owned by its members, and must conduct a separate review by at least one NRSRO to determine, to the extent possible, whether the implementation of the plan would have a material effect on the credit rating of the Bank. The final rule requires each Bank to submit a copy of each report to the Finance Board at the time it submits its proposed capital plan.

Though some commenters recommended that the final rule require the Banks to submit their capital plans to their members for approval prior to submitting the plans to the Finance Board, the Finance Board has not included such a requirement in the final rule. Nothing in the GLB Act requires member approval of capital plans, nor indicates how such a vote would be conducted. The Finance Board notes that the interests of the members are represented by the elected directors of each Bank, each of whom is an officer or a director of a member and who collectively constitute a majority of the board of each Bank. Moreover, the GLB Act expressly charges the board of directors of each Bank with the responsibility for developing a capital plan that, among other things, "is best suited for the condition and operation of the bank and the interest of the members of the bank." The Finance Board further notes, however, that there is nothing in the GLB Act that would prohibit a Bank from soliciting the views of its members in creating the capital plan or from seeking the approval of the members prior to submitting the capital plan to the Finance Board. Regardless of how a Bank addresses the issue of member involvement, the Finance Board expects

that each Bank will submit its capital plan to the Finance Board on or before the statutory deadline.

#### *H. Parts 956, 960 and 966*

The final rule amends § 966.8 by adding new paragraph (d) which sets forth requirements for the issuance of consolidated obligations denominated in foreign currencies or linked to equity or commodity prices. This provision was proposed in the capital regulation as part of § 932.5(b)(5). Because § 932.5 generally addresses requirements governing the Banks' internal market risk capital models, the Finance Board has determined that it would be more appropriate for these requirements relating to the issuance of consolidated obligations to appear in part 966 of the Finance Board's regulations, which concerns the issuance of consolidated obligations. As such, the requirements governing the issuance of consolidated obligations denominated in foreign currencies or linked to equity or commodity prices that were proposed in § 932.5(b) are being adopted in the final rule without substantive change as a new paragraph (d) to § 966.8.

Conforming changes to § 956.3(b), which reference the requirements of new § 966.8(d), have also been adopted. These conforming changes to § 956.3(b) were not part of the proposed regulation but do not alter the substance of recently adopted § 956.3. 65 FR 43969, 43986 (July 17, 2000). Instead, they merely provide a cross reference to the requirements in part 966. The Finance Board also proposed to add new part 960 of its regulations in the proposed capital regulation. The new part would have authorized the Banks to engage in specific off-balance sheet transactions, including derivative contracts, and set forth requirements that the Banks must document non-speculative use of any derivative instruments that do not qualify as hedging instruments under GAAP. These changes would have adopted authority that already existed in the FMP.

As already discussed, recent changes in accounting standards for derivatives means that derivatives can no longer be considered purely off-balance sheet items. Further, some of the other transactions that would have been authorized under proposed part 960 could also be on-balance sheet under certain circumstances. The Finance Board did not wish to imply that if accounting treatment required one of the transactions listed in proposed part 960 to be on the Bank's balance sheet that the transaction would not be authorized. Thus, in the final rule the Finance Board has combined proposed

part 960 with part 956, which sets forth the authority for the Banks to make specific investments. The items that would have been authorized as off-balance sheet transactions in proposed part 960 are now authorized under new § 956.5. The Finance Board also made a conforming change to the list of transactions authorized under § 956.5 of the final rule to recognize that under the AMA programs, Banks may enter into commitments to purchase loans that may be recorded as off-balance sheet items.

In addition, one comment was received on proposed part 960. It requested the Finance Board to add standby bond purchase agreements to the list of authorized off-balance sheet transactions. Given the brevity of the comment, Finance Board staff has sought additional information and clarification from the commenters on this request and is still studying the issues involved. Thus, the Finance Board has determined not to address this issue at this time but may do so at some future date.

The Finance Board did not receive any specific comments on the amendments to part 956 that were proposed as part of the capital regulation. These proposed amendments were adopted with the changes discussed above.

### **III. Paperwork Reduction Act**

As part of the notice of proposed rulemaking, the Finance Board published a request for comments concerning the collection of information contained in §§ 931.7 through 931.9 and 933.2(c)(2) of the proposed rule. The Finance Board submitted the proposed collection of information, and accompanying analysis, to the Office of Management and Budget (OMB) for review in accordance with section 3507(d) of the Paperwork Reduction Act, 44 U.S.C. 3507(d). The Finance Board received no comments on the proposed information collection.

OMB has approved the proposed information collection without conditions and assigned control number 3069-0059 with an expiration date of November 30, 2003. Likely respondents and/or record keepers will be Banks and Bank members. The Banks will use the information collection to implement their new capital structures, determine requirements for member ownership of Bank stock, and determine whether Bank members satisfy the statutory and regulatory capital stock requirements. See 12 U.S.C. 1426. Responses are mandatory and are required to obtain or retain a benefit. See 12 U.S.C. 1426. As a result of reorganization and revision of

certain proposed provisions in the final rule, the information collections are now located in §§ 931.3 and 933.2(e)(4) of the final rule. Proposed § 931.9, which required a Bank and member to agree on a plan to divest Bank stock to meet certain concentration limits, is not included in the final rule and, therefore, there is no information collection required in this connection.

The final capital rule does not substantively or materially modify the approved information collection. Potential respondents are not required to respond to the collection of information unless the regulation collecting the information displays a currently valid control number assigned by OMB. See 44 U.S.C. 3512(a).

The following is the estimated annual reporting and recordkeeping hour burden as approved by OMB:

- a. Number of respondents: 7,512
- b. Total annual responses: 52,500
- Percentage of these responses collected electronically: 0%
- c. Total annual hours requested: 900,648

The following is the estimated annual reporting and recordkeeping cost burden as approved by OMB:

- a. Total annualized capital/startup costs: 0
- b. Total annual costs (O&M): 0
- c. Total annualized cost requested: \$46,717,758.48

Comments regarding the collection of information may be submitted in writing to the Finance Board at 1777 F Street, N.W., Washington, D.C. 20006, and to the Office of Information and Regulatory Affairs of OMB, Attention: Desk Officer for Federal Housing Finance Board, Washington, D.C. 20503.

#### IV. Regulatory Flexibility Act

The final rule would apply only to the Finance Board and to the Banks, which do not come within the meaning of small entities as defined in the Regulatory Flexibility Act (RFA). See 5 U.S.C. 601(6). Thus, in accordance with section 605(b) of the RFA, 5 U.S.C. 605(b), the Finance Board hereby certifies that the final rule will not have a significant impact on a substantial number of small entities.

#### List of Subjects

##### 12 CFR Part 915

Banks, banking, Conflict of interests, Elections, Ethical conduct, Federal home loan banks, Financial disclosure, Reporting and recordkeeping requirements.

##### 12 CFR Part 917

Community development, Credit, Federal home loan banks, Housing,

Reporting and recordkeeping requirements.

##### 12 CFR Part 925

Credit, Federal home loan banks, Reporting and recordkeeping requirements.

##### 12 CFR Parts 930, 931, 932 and 933

Capital, Credit, Federal home loan banks, Investments, Reporting and recordkeeping requirements.

##### 12 CFR Part 956

Community development, Credit, Federal home loan banks, Housing, Investments, Reporting and recordkeeping requirements.

##### 12 CFR Part 966

Federal home loan banks, Securities. Accordingly, the Federal Housing Finance Board amends title 12, chapter IX of the Code of Federal Regulations, as follows:

#### PART 915—BANK DIRECTOR ELIGIBILITY, APPOINTMENT AND ELECTIONS

1. The authority citation for part 915 continues to read as follows:

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1427, and 1432.

2. Amend § 915.3 by revising the introductory text of paragraph (b) and paragraph (b)(3) to read as follows:

##### § 915.3 Director elections.

\* \* \* \* \*

(b) *Designation of elective directorships.* The Finance Board annually shall designate each elective directorship as representing the members that are located in a particular state. The Finance Board shall conduct the annual designation of directorships for each Bank based on the number of shares of Bank stock required to be held by the members in each state as of December 31 of the preceding calendar year. If a Bank has issued more than one class of stock, the Finance Board shall designate the directorships for that Bank based on the combined number of shares required to be held by the members in each state. For purposes of conducting the designation, if a Bank's capital plan was not in effect on the immediately preceding December 31st, the number of shares of Bank stock that the members were required to hold as of that date shall be determined in accordance with § 925.20 and § 925.22. If a Bank's capital plan was in effect on the immediately preceding December 31st, the number of shares of Bank stock that the members were required to hold as of that date shall be determined in

accordance with the minimum investment established by the capital plan for that Bank, provided, however, that for any members whose Bank stock is less than the minimum investment during a transition period, the amount of stock to be used in the designation of directorships shall be the number of shares of Bank stock actually owned by those members as of December 31st. In all cases, the Finance Board shall designate the directorships by using the information provided by the Banks in the capital stock report required by § 915.4. The Finance Board shall allocate the elective directorships among the states as follows:

\* \* \* \* \*

(3) If the number of elective directorships allocated to any State pursuant to paragraphs (b)(1) and (b)(2) of this section is less than the number allocated to that State on December 31, 1960, as specified in § 915.15, the Finance Board shall allocate such additional elective directorships to that State until the total allocated equals the number allocated to that State on December 31, 1960;

\* \* \* \* \*

3. Revise § 915.4 to read as follows:

##### § 915.4 Capital stock report.

(a) On or before April 10 of each year, each Bank shall submit to the Finance Board a capital stock report that indicates, as of the record date, the number of members located in each voting state in the Bank's district, the number of shares of Bank stock that each member (identified by its docket number) was required to hold, and the number of shares of Bank stock that all members located in each voting state were required to hold. If a Bank has issued more than one class of stock, it shall report the total shares of stock of all classes required to be held by the members. The Bank shall certify to the Finance Board that, to the best of its knowledge, the information provided in the capital stock report is accurate and complete, and that it has notified each member of its minimum capital stock holdings pursuant to § 925.22(b)(1) of this chapter.

(b) If a Bank's capital plan was not in effect as of the record date, the number of shares of Bank stock that the members are required to hold as of the record date shall be determined in accordance with § 925.20 and § 925.22. If a Bank's capital plan was in effect as of the record date, the number of shares of Bank stock that the members were required to hold as of that date shall be determined in accordance with the minimum investment established by the

capital plan for that Bank, provided, however, that for any members whose Bank stock is less than the minimum investment during a transition period, the amount of Bank stock to be reported shall be the number of shares of Bank stock actually owned by those members as of the record date.

4. Revise § 915.5 to read as follows:

**§ 915.5 Determination of member votes.**

(a) *In general.* Each Bank shall determine, in accordance with this section, the number of votes that each member of the Bank may cast for each directorship that is to be filled by the vote of the members that are located in a particular state.

(b) *Number of votes.* For each directorship that is to be filled in an election, each member that is located in the state to be represented by the directorship shall be entitled to cast one vote for each share of Bank stock that the member was required to hold as of the record date. Notwithstanding the preceding sentence, the number of votes that any member may cast for any one directorship shall not exceed the average number of shares of Bank stock that were required to be held by all members located in that state as of the record date. If a Bank has issued more than one class of stock, it shall calculate the average number of shares separately for each class of stock and shall apply those limits separately in determining the maximum number of votes that any member owning that class of stock may cast in the election. If a Bank's capital plan was not in effect as of the record date, the number of shares of Bank stock that a member was required to hold as of the record date shall be determined in accordance with § 925.20 and § 925.22. If a Bank's capital plan was in effect as of the record date, the number of shares of Bank stock that a member was required to hold as of the record date shall be determined in accordance with the minimum investment established by the Bank's capital plan, provided, however, that for any members whose Bank stock is less than the minimum investment during a transition period, the amount of Bank stock to be used shall be the number of shares of Bank stock actually owned by those members as of the record date.

(c) *Voting preferences.* If the board of directors of a Bank includes any voting preferences as part of its approved capital plan, those preferences shall supercede the provisions of paragraph (b) of this section that otherwise would allow a member to cast one vote for each share of Bank stock it was required to hold as of the record date. If a Bank establishes a voting preference for a

class of stock, the members with voting rights shall remain subject to the provisions of Section 7(b) of the Act that prohibit any member from casting any vote in excess of the average number of shares of stock required to be held by all members in its state.

5. Amend § 915.6 by revising paragraph (a)(3) to read as follows:

**§ 915.6 Elective director nominations.**

(a) \* \* \*

(3) An attachment indicating the name, location, and docket number of every member in the member's voting state, and the number of votes each such member may cast for each directorship to be filled in the election, as determined in accordance with § 915.5.

\* \* \* \* \*

6. Amend § 915.7 by adding a new sentence at the end of paragraph (b)(2) to read as follows:

**§ 915.7 Eligibility requirements for elective directors.**

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \* For purposes of this paragraph, the term appropriate federal regulator has the same meaning as the term "appropriate Federal banking agency" in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)), and, for federally insured credit unions, shall mean the National Credit Union Administration, and the term appropriate State regulator means any State officer, agency, supervisor, or other entity that has regulatory authority over, or is empowered to institute enforcement action against, a member.

\* \* \* \* \*

**PART 917—POWERS AND RESPONSIBILITIES OF BANK BOARDS OF DIRECTORS AND SENIOR MANAGEMENT**

7. The authority citation for part 917 is revised to read as follows:

**Authority:** 12 U.S.C. 1422a(3), 1422b(a)(1), 1426, 1427, 1432(a), 1436(a), 1440.

8. Amend § 917.3(b)(1) to read as follows:

**§ 917.3 Risk management.**

\* \* \* \* \*

(b) \* \* \*

(1) After the Finance Board has approved a Bank's capital plan, but before the plan takes effect, the Bank shall amend its risk management policy to describe the specific steps the Bank will take to comply with its capital plan and to include specific target ratios of total capital and permanent capital to

total assets at which the Bank intends to operate. The target operating capital-to-assets ratios to be specified in the risk management policy shall be in excess of the minimum leverage and risk-based capital ratios and may be expressed as a range of ratios or as a single ratio;

\* \* \* \* \*

9. Amend § 917.9 by designating the existing text as paragraph (a) and adding a new paragraph (b) to read as follows:

**§ 917.9 Dividends.**

\* \* \* \* \*

(b) The requirement in paragraph (a) of this section that dividends shall be computed without preference shall cease to apply to any Bank that has established any dividend preferences for one or more classes or subclasses of its capital stock as part of its approved capital plan, as of the date on which the capital plan takes effect.

**PART 925—MEMBERS OF THE BANKS**

10. The authority citation for part 925 continues to read as follows:

**Authority:** 12 U.S.C. 1422, 1422a, 1422b, 1423, 1424, 1426, 1430, 1442.

11. Revise § 925.24 to read as follows:

**§ 925.24 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 § 925.29.

(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 § 925.29.

(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 § 925.29, 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 required by section 6 of the Act. If a Bank's capital plan has not taken effect, the amount of

stock that the consolidated institution is required to own shall be as provided in § 925.20 and § 925.22. If the capital plan for the Bank has taken effect, the amount of stock that the consolidated institution is required to own shall be equal to the minimum investment established by the capital plan for that Bank.

(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 § 925.29.

(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 § 931.4(a) of this Chapter.

(d) *Stock transfers.* With regard to any transfer of Bank stock from a disappearing member to the surviving or consolidated member, as appropriate, for which the approval of the Finance Board is required pursuant to section 6(f) of the Act, 12 U.S.C. 1426(f), as in effect prior to November 12, 1999, such transfer shall be deemed to be approved by the Finance Board by compliance in all applicable respects with the requirements of this section.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069-0004 with an expiration date of April 30, 2001.)

#### § 925.25 [Removed]

- 12. Remove § 925.25.
- 13. Revise § 925.26 to read as follows:

#### § 925.26 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, but 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 the Finance Board 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, unless the institution has cancelled its notice of withdrawal prior to that date.

(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.

(d) *Certification.* No institution may withdraw from membership unless, on the date that the membership is to terminate, there is in effect a certification from the Finance Board that the withdrawal of a member will not cause the Bank System to fail to satisfy its requirements under 12 U.S.C. 1441b(f)(2)(C) to contribute toward the interest payments owed on obligations issued by the Resolution Funding Corporation.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069-0004 with an expiration date of April 30, 2001.)

- 14. Revise § 925.27 to read as follows:

#### § 925.27 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 Act, any regulation adopted by the Finance Board, 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 by the Bank.

#### § 925.28 [Removed]

15. Remove § 925.28.

16. Revise § 925.29 to read as follows:

#### § 925.29 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.

17. Revise § 925.30 to read as follows:

#### § 925.30 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 5 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. Any institution that withdrew from Bank membership prior to December 31, 1997, and for which the 5-year period has not expired, may apply for membership in a Bank at any time, subject to the approval of the Finance Board and the requirements of this part 925.

18. In subchapter E, add new parts 930, 931, 932, and 933 to read as follows:

### PART 930—DEFINITIONS APPLYING TO RISK MANAGEMENT AND CAPITAL REGULATIONS

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

#### § 930.1 Definitions.

As used in this subchapter:

*Affiliated counterparty* means a counterparty that is an affiliate of another counterparty, as the term "affiliate" is defined in 12 U.S.C. 371c(b).

*Capital plan* means the capital structure plan required for each Bank by Section 6(b) of the Act, 12 U.S.C. 1426(b), as approved by the Finance Board, unless the context of the regulation refers to the capital plan prior to its approval by the Finance Board.

*Class A stock* means capital stock issued by a Bank, including subclasses, that has the characteristics specified by § 931.1(a) of this subchapter.

*Class B stock* means capital stock issued by a Bank, including subclasses, that has the characteristics specified by § 931.1(b) of this subchapter.

*Contingency liquidity* has the meaning set forth in § 917.1 of this chapter.

*Derivative contract* means a derivative contract that transfers credit risk.

*Credit risk* has the meaning set forth in § 917.1 of this chapter.

*Derivative contract* means generally a financial contract the value of which is derived from the values of one or more underlying assets, reference rates, or indices of asset values, or credit-related events. Derivative contracts include interest rate, foreign exchange rate, equity, precious metals, commodity, and credit contracts, and any other instruments that pose similar risks.

*Excess stock* means that amount of capital stock of a Bank held by a member in excess of the minimum investment in Bank stock required by § 931.3 of this chapter.

*Exchange rate contracts* include cross-currency interest-rate swaps, forward foreign exchange rate contracts, currency options purchased, and any similar instruments that give rise to similar risks.

*GAAP* means accounting principles generally accepted in the United States.

*General allowance for losses* means an allowance established by a Bank in accordance with GAAP for losses, but which does not include any amounts held against specific assets of the Bank.

*Government Sponsored Enterprise, or GSE,* means a United States

Government-sponsored agency or instrumentality originally established or chartered to serve public purposes specified by the United States Congress, but whose obligations are not obligations of the United States and are not guaranteed by the United States.

*Interest rate contracts* include, single currency interest-rate swaps, basis swaps, forward rate agreements, interest-rate options, and any similar instrument that gives rise to similar risks, including when-issued securities.

*Investment grade* means:

(1) A credit quality rating in one of the four highest credit rating categories by an NRSRO and not below the fourth highest rating category by any NRSRO; or

(2) If there is no credit quality rating by an NRSRO, a determination by a Bank that the issuer, asset or instrument is the credit equivalent of investment grade using credit rating standards available from an NRSRO or other similar standards.

*Market risk* has the meaning set forth in § 917.1 of this chapter.

*Marketable* means, with respect to an asset, that the asset can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

*Market value at risk* is the loss in the market value of a Bank's portfolio measured from a base line case, where the loss is estimated in accordance with § 932.5 of this chapter.

*Minimum investment* means the minimum amount of Class A and/or Class B stock that a member is required to own in order to be a member of a Bank and in order to obtain advances and to engage in other business activities with the Bank in accordance with § 931.3 of this chapter.

*Operations risk* has the meaning set forth in § 917.1 of this chapter.

*Permanent capital* means the retained earnings of a Bank, determined in accordance with GAAP, plus the amount paid-in for the Bank's Class B stock.

*Redeem or Redemption* means the acquisition by a Bank of its outstanding

Class A or Class B stock at par value following the expiration of the six-month or five-year statutory redemption period, respectively, for the stock.

*Regulatory risk-based capital requirement* means the amount of permanent capital that a Bank is required to maintain in accordance with § 932.3 of this chapter.

*Regulatory total capital requirement* means the amount of total capital that a Bank is required to maintain in accordance with § 932.2 of this chapter.

*Repurchase* means the acquisition by a Bank of excess stock prior to the expiration of the six-month or five-year statutory redemption period for the stock.

*Repurchase agreement* means an agreement between a seller and a buyer whereby the seller agrees to repurchase a security or similar securities at an agreed upon price, with or without a stated time for repurchase.

*Total assets* means the total assets of a Bank, as determined in accordance with GAAP.

*Total capital* of a Bank means the sum of permanent capital, the amounts paid-in for Class A stock, the amount of any general allowance for losses, and the amount of other instruments identified in a Bank's capital plan that the Finance Board has determined to be available to absorb losses incurred by such Bank.

*Walkaway clause* means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

## PART 931—FEDERAL HOME LOAN BANK CAPITAL STOCK

Sec.

931.1 Classes of capital stock.

931.2 Issuance of capital stock.

931.3 Minimum investment in capital stock.

931.4 Dividends.

931.5 Liquidation, merger, or consolidation.

931.6 Transfer of capital stock.

931.7 Redemption and repurchase of capital stock.

931.8 Capital impairment.

931.9 Transition provision.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

### § 931.1 Classes of capital stock.

The authorized capital stock of a Bank shall consist of the following instruments:

(a) Class A stock, which shall:

(1) Have a par value as determined by the board of directors of the Bank and stated in the Bank's capital plan;

(2) Be issued, redeemed, and repurchased only at its stated par value; and

(3) Be redeemable in cash only on six-months written notice to the Bank.

(b) Class B stock, which shall:

(1) Have a par value as determined by the board of directors of the Bank and stated in the Bank's capital plan;

(2) Be issued, redeemed, and repurchased only at its stated par value;

(3) Be redeemable in cash only on five-years written notice to the Bank; and

(4) Confer an ownership interest in the retained earnings, surplus, undivided profits, and equity reserves of the Bank; and

(c) Any one or more subclasses of Class A or Class B stock, each of which may have different rights, terms, conditions, or preferences as may be authorized in the Bank's capital plan, provided, however, that each subclass of stock shall have all of the characteristics of its respective class, as specified in paragraph (a) or (b) of this section.

### § 931.2 Issuance of capital stock.

(a) *In general.* A Bank may issue either one or both classes of its capital stock (including subclasses), as authorized by § 931.1, and shall not issue any other class of capital stock. A Bank shall issue its stock only to its members and only in book-entry form, and the Bank shall act as its own transfer agent. All capital stock shall be issued in accordance with the Bank's capital plan.

(b) *Initial issuance.* In connection with the initial issuance of its Class A and/or Class B stock (or any subclass of either), a Bank may issue such stock in exchange for its existing stock, through a conversion of its existing stock, or through any other fair and equitable transaction or method of distribution. As part of its initial stock issuance transaction, a Bank may distribute any portion of its then-existing unrestricted retained earnings as shares of Class B stock.

### § 931.3 Minimum investment in capital stock.

(a) A Bank shall require each member to maintain a minimum investment in the capital stock of the Bank, both as a condition to becoming and remaining a member of the Bank and as a condition to transacting business with the Bank or obtaining advances and other services from the Bank. The amount of the required minimum investment shall be determined in accordance with the

Bank's capital plan and shall be sufficient to ensure that the Bank remains in compliance with its minimum capital requirements. A Bank shall require each member to maintain its minimum investment for as long as the institution remains a member of the Bank and for as long as the member engages in any activity with the Bank against which the Bank is required to maintain capital.

(b) A Bank may establish the minimum investment required of each member as a percentage of the total assets of the member, as a percentage of the advances outstanding to the member, as a percentage of any other business activity conducted with the member, on any other basis that is approved by the Finance Board, or any combination thereof.

(c) A Bank may require each member to satisfy the minimum investment requirement through the purchase of either Class A or Class B stock, or through the purchase of one or more combinations of Class A and Class B stock that have been authorized by the board of directors of the Bank in its capital plan. A Bank, in its discretion, may establish a lower minimum investment for members that invest in Class B stock than is required for members that invest in Class A stock, provided that such reduced investment provides sufficient capital for the Bank to remain in compliance with its minimum capital requirements.

(d) Each member of a Bank shall at all times maintain an investment in the capital stock of the Bank in an amount that is sufficient to satisfy the minimum investment required for that member in accordance with the Bank's capital plan.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069-0059 with an expiration date of November 30, 2003.)

### § 931.4 Dividends.

(a) *In general.* A Bank may pay dividends on its capital stock only out of previously retained earnings or current net earnings, and shall declare and pay dividends only as provided by its capital plan. The capital plan may establish different dividend rates or preferences for each class or subclass of stock, which may include a dividend that tracks the economic performance of certain Bank assets, such as Acquired Member Assets. A member, including a member that has provided the Bank with a notice of intent to withdraw from membership or one whose membership is otherwise terminated, shall be entitled to receive any dividends that a

Bank declares on its capital stock while the member owns the stock.

(b) *Limitation on payment of dividends.* In no event shall a Bank declare or pay any dividend on its capital stock if after doing so the Bank would fail to meet any of its minimum capital requirements, nor shall a Bank that is not in compliance with any of its minimum capital requirements declare or pay any dividend on its capital stock.

**§ 931.5 Liquidation, merger, or consolidation.**

The respective rights of the Class A and Class B stockholders, in the event that the Bank is liquidated, or is merged or otherwise consolidated with another Bank, shall be determined in accordance with the capital plan of the Bank.

**§ 931.6 Transfer of capital stock.**

A member of a Bank may transfer any excess capital stock of the Bank to another member of that Bank or to an institution that has been approved for membership in that Bank and that has satisfied all conditions for becoming a member, other than the purchase of the minimum amount of Bank stock that it is required to hold as a condition of membership. Any such stock transfers shall be at par value and shall be effective upon being recorded on the appropriate books and records of the Bank.

**§ 931.7 Redemption and repurchase of capital stock.**

(a) *Redemption.* A member may have its capital stock in a Bank redeemed by providing written notice to the Bank in accordance with this section. For Class A stock, a member shall provide six-months written notice, and for Class B stock a member shall provide five-years written notice. The notice shall indicate the number of shares of Bank stock that are to be redeemed, and a member shall not have more than one notice of redemption outstanding at one time for the same shares of Bank stock. A member may cancel a notice of redemption by so informing the Bank in writing, and the Bank may impose a fee (to be specified in its capital plan) on any member that cancels a pending notice of redemption. At the expiration of the applicable notice period, the Bank shall pay the stated par value of that stock to the member in cash. A Bank shall not be obligated to redeem its capital stock other than in accordance with this paragraph.

(b) *Repurchase.* A Bank, in its discretion and without regard to the applicable redemption periods, may repurchase from a member any outstanding Class A or Class B capital

stock that is in excess of the amount of that class of Bank stock that the member is required to hold as a minimum investment, in accordance with the capital plan of that Bank. A Bank undertaking such a stock repurchase at its own initiative shall provide the member with reasonable notice prior to repurchasing any excess stock, with the period of such notice to be specified in the Bank's capital plan, and shall pay the stated par value of that stock to the member in cash. For purposes of this section, any Bank stock owned by a member shall be considered to be excess stock if the member is not required to hold such stock either as a condition of remaining a member of the Bank or as a condition of obtaining advances or transacting other business with the Bank. A member's submission of a notice of intent to withdraw from membership, or its termination of membership in any other manner, shall not, in and of itself, cause any Bank stock to be deemed excess stock for purposes of this section.

(c) *Limitation.* In no event may a Bank redeem or repurchase any stock if, following the redemption or repurchase, the Bank would fail to meet any minimum capital requirement, or if the member would fail to maintain its minimum investment in the stock of the Bank, as required by § 931.3.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069-0004 with an expiration date of April 30, 2001.)

**§ 931.8 Capital impairment.**

A Bank may not redeem or repurchase any capital stock without the prior written approval of the Finance Board if the Finance Board or the board of directors of the Bank has determined that the Bank has incurred or is likely to incur losses that result in or are likely to result in charges against the capital of the Bank. This prohibition shall apply even if a Bank is in compliance with its minimum capital requirements, and shall remain in effect for however long the Bank continues to incur such charges or until the Finance Board determines that such charges are not expected to continue.

**§ 931.9 Transition provision.**

(a) *In general.* Each Bank shall comply with the minimum leverage and risk-based capital requirements specified in § 932.2 and § 932.3 of this chapter, respectively, and each member shall comply with the minimum investment established in the capital plan, as of the effective date of that Bank's capital plan. The effective date of a Bank's capital

plan shall be the date on which the Bank first issues any Class A or Class B stock. Prior to the effective date, the issuance and retention of Bank stock shall be as provided in § 925.20 and § 925.22 of this chapter.

(b) *Transition period.* (1) *Bank transition.* A Bank that will not be in compliance with the minimum leverage and risk-based capital requirements specified in § 932.2 and § 932.3 of this chapter as of the effective date of its capital plan shall maintain compliance with the leverage limit requirements in § 966.3(a) of this chapter and shall include in its capital plan a description of the steps that the Bank will take to achieve compliance with the minimum capital requirements specified in § 932.2 and § 932.3 of this chapter. The period of time for compliance with the minimum capital requirements shall be stated in the plan and shall not exceed three years from the effective date of the capital plan. When the Bank has achieved compliance with the leverage requirement of § 932.2 of this chapter, the leverage limit requirements of § 966.3(a) of this chapter shall cease to apply to that Bank.

(2) *Member transition.* (i) *Existing members.* A Bank's capital plan shall require any institution that was a member on November 12, 1999, and whose investment in Bank stock as of the effective date of the capital plan will be less than the minimum investment required by the plan, to comply with the minimum investment by a date specified in the Bank's capital plan. The length of the transition period shall be specified in the capital plan and shall not exceed three years. The capital plan shall describe the actions that the existing members are required to take to achieve compliance with the minimum investment, and may require such members to purchase additional Bank stock periodically over the course of the transition period.

(ii) *New members.* A Bank's capital plan shall require any institution that became a member after November 12, 1999, but prior to the effective date of the capital plan, to comply with the minimum investment specified in the Bank's capital plan as of the effective date of the plan. A Bank's capital plan shall require any institution that becomes a member after the effective date of the capital plan, to comply with the minimum investment upon becoming a member.

(3) *New business.* A Bank's capital plan shall require any member that obtains an advance or other services from the Bank, or that initiates any other business activity with the Bank against which the Bank is required to hold

capital, after the effective date of the capital plan to comply with the minimum investment specified in the Bank's capital plan for such advance, services, or activity at the time the transaction occurs.

**PART 932—FEDERAL HOME LOAN BANK CAPITAL REQUIREMENTS**

- Sec.
- 932.1 Risk management.
- 932.2 Total capital requirement.
- 932.3 Risk-based capital requirement.
- 932.4 Credit risk capital requirement.
- 932.5 Market risk capital requirement.
- 932.6 Operations risk capital requirement.
- 932.7 Reporting requirements.
- 932.8 Minimum liquidity requirements.
- 932.9 Limits on unsecured extensions of credit to one counterparty or affiliated counterparties; reporting requirements for total extensions of credit to one counterparty or affiliated counterparties.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

**§ 932.1 Risk management.**

Before its new capital plan may take effect, each Bank shall obtain the approval of the Finance Board for the internal market risk model or the internal cash flow model used to calculate the market risk component of its risk-based capital requirement, and for the risk assessment procedures and controls (whether established as part of its risk management policy or otherwise) to be used to manage its credit, market, and operations risks.

**§ 932.2 Total capital requirement.**

(a) Each Bank shall maintain at all times:  
 (1) Total capital in an amount at least equal to 4.0 percent of the Bank's total assets; and

(2) A leverage ratio of total capital to total assets of at least 5.0 percent of the Bank's total assets. For purposes of determining the leverage ratio, total capital shall be computed by multiplying the Bank's permanent capital by 1.5 and adding to this product all other components of total capital.

(b) For reasons of safety and soundness, the Finance Board may require an individual Bank to have and maintain a greater amount of total capital than mandated by paragraph (a)(1) of this section.

**§ 932.3 Risk-based capital requirement.**

(a) Each Bank shall maintain at all times permanent capital in an amount at least equal to the sum of its credit risk capital requirement, its market risk capital requirement, and its operations risk capital requirement, calculated in accordance with §§ 932.4, 932.5 and 932.6, respectively.

(b) For reasons of safety and soundness, the Finance Board may require an individual Bank to have and maintain a greater amount of permanent capital than required by paragraph (a) of this section.

**§ 932.4 Credit risk capital requirement.**

(a) *General requirement.* Each Bank's credit risk capital requirement shall be equal to the sum of the Bank's credit risk capital charges for all assets, off-balance sheet items and derivative contracts.

(b) *Credit risk capital charge for assets.* Except as provided in paragraph (i) of this section, each Bank's credit risk capital charge for an asset shall be equal to the book value of the asset multiplied by the credit risk percentage requirement assigned to that asset pursuant to paragraph (e)(2) of this section.

(c) *Credit risk capital charge for off-balance sheet items.* Each Bank's credit risk capital charge for an off-balance sheet item shall be equal to the credit equivalent amount of such item, as determined pursuant to paragraph (f) of this section multiplied by the credit risk percentage requirement assigned to that item pursuant to paragraph (e)(2) of this section, except that the credit risk percentage requirement applied to the credit equivalent amount for a stand-by letter of credit shall be that for an advance with the same remaining maturity as that stand-by letter of credit.

(d) *Derivative contracts.* (1) *Derivative contracts with non-member counterparties.* Except as provided in paragraph (j) of this section, each Bank's credit risk capital charge for a specific derivative contract entered into between a Bank and a non-member institution shall equal the sum of:

(i) The current credit exposure for the derivative contract, calculated in accordance with paragraph (g) or (h) of this section, as applicable, multiplied by the credit risk percentage requirement assigned to that derivative contract pursuant to paragraph (e)(2) of this section, provided that:

(A) The remaining maturity of the derivative contract shall be deemed to be less than one year for the purpose of applying Table 1.1 or 1.3 of this part; and

(B) Any collateral held against an exposure from the derivative contract shall be applied to reduce the portion of the credit risk capital charge corresponding to the current credit exposure in accordance with the requirements of paragraph (e)(2)(ii)(B) of this section; plus

(ii) The potential future credit exposure for the derivative contract

calculated in accordance with paragraph (g) or (h) of this section, as applicable, multiplied by the credit risk percentage requirement assigned to that derivative contract pursuant to paragraph (e)(2) of this section, where the actual remaining maturity of the derivative contract is used to apply Table 1.1 or Table 1.3 of this part.

(2) *Derivative contracts with a member.* Except as provided in paragraph (j) of this section, the credit risk capital charge for any derivative contract entered into between a Bank and one of its member institutions shall be calculated in accordance with paragraph (d)(1) of this section.

However, the credit risk percentage requirements used in the calculations shall be found in Table 1.1 of this part, which sets forth the credit risk percentage requirements for advances.

(e) *Determination of credit risk percentage requirements.*—(1) *Finance Board determination of credit risk percentage requirements.* The Finance Board shall determine, and update periodically, the credit risk percentage requirements set forth in Tables 1.1 through 1.4 of this part applicable to a Bank's assets, off-balance sheet items, and derivative contracts.

(2) *Bank determination of credit risk percentage requirements.* (i) Each Bank shall determine the credit risk percentage requirement applicable to each asset, each off-balance sheet item and each derivative contract by identifying the category set forth in Table 1.1, Table 1.2, Table 1.3 or Table 1.4 of this part to which the asset, item or derivative belongs, given, if applicable, its demonstrated credit rating and remaining maturity (as determined in accordance with paragraphs (e)(2)(ii) and (e)(2)(iii) of this section). The applicable credit risk percentage requirement for an asset, off-balance sheet item or derivative contract shall be used to calculate the credit risk capital charge for such asset, item, or derivative contract in accordance with paragraphs (b), (c) or (d) of this section respectively. The relevant categories and credit risk percentage requirements are provided in the following Tables 1.1 through 1.4 of this part:

**TABLE 1.1.—REQUIREMENT FOR ADVANCES**

Type of advances	Percentage applicable to advances
Advances with: Remaining maturity <= 4 years .....	0.07
Remaining maturity > 4 years to 7 years .....	0.20

TABLE 1.1.—REQUIREMENT FOR ADVANCES—Continued

Type of advances	Percentage applicable to advances
Remaining maturity > 7 years to 10 years .....	0.30
Remaining maturity > 10 years .....	0.35

TABLE 1.2.—REQUIREMENT FOR RATED RESIDENTIAL MORTGAGE ASSETS

Type of residential mortgage asset	Percentage applicable to residential mortgage assets
Highest Investment Grade .....	0.37
Second Highest Investment Grade .....	0.60

TABLE 1.2.—REQUIREMENT FOR RATED RESIDENTIAL MORTGAGE ASSETS—Continued

Type of residential mortgage asset	Percentage applicable to residential mortgage assets
Third Highest Investment Grade .....	0.86
Fourth Highest Investment Grade .....	1.20
If Downgraded to Below Investment Grade After Acquisition By Bank:	
Highest Below Investment Grade .....	2.40
Second Highest Below Investment Grade .....	4.80
All Other Below Investment Grade .....	34.00
Subordinated Classes of Mortgage Assets:	
Highest Investment Grade .....	0.37

TABLE 1.2.—REQUIREMENT FOR RATED RESIDENTIAL MORTGAGE ASSETS—Continued

Type of residential mortgage asset	Percentage applicable to residential mortgage assets
Second Highest Investment Grade .....	0.60
Third Highest Investment Grade .....	1.60
Fourth Highest Investment Grade .....	4.45
If Downgraded to Below Investment Grade After Acquisition By Bank:	
Highest Below Investment Grade .....	13.00
Second Highest Below Investment Grade .....	34.00
All Other Below Investment Grade .....	100.00

TABLE 1.3.—REQUIREMENT FOR RATED ASSETS OR RATED ITEMS OTHER THAN ADVANCES OR RESIDENTIAL MORTGAGE ASSETS

[Based on remaining maturity]

	Applicable percentage				
	≤ 1 year	>1 yr to 3 yrs	>3 yrs to 7yrs	>7 yrs to 10 yrs	>10 yrs
U.S. Government Securities .....	0.00	0.00	0.00	0.00	0.00
Highest Investment Grade .....	0.15	0.40	0.90	1.40	2.20
Second Highest Investment Grade .....	0.20	0.45	1.00	1.45	2.30
Third Highest Investment Grade .....	0.70	1.10	1.60	2.05	2.95
Fourth Highest Investment Grade .....	2.50	3.70	4.45	5.50	7.05
If Downgraded Below Investment Grade After Acquisition by Bank:					
Highest Below Investment Grade .....	10.00	13.00	13.00	13.00	13.00
Second Highest Below Investment Grade .....	26.00	34.00	34.00	34.00	34.00
All Other .....	100.00	100.00	100.00	100.00	100.00

TABLE 1.4.—REQUIREMENT FOR UNRATED ASSETS

Type of unrated asset	Applicable percentage
Cash .....	0.00
Premises, Plant, and Equipment .....	8.00
Investments Under § 940.3(e) & (f) .....	8.00

(ii) When determining the applicable credit risk percentage requirement from Tables 1.2 or 1.3 of this part, each Bank shall apply the following criteria:

(A) For assets or items that are rated directly by an NRSRO, the credit rating shall be the NRSRO's credit rating for the asset or item as determined in accordance with paragraph (e)(2)(iii) of this section.

(B) When using Table 1.3 of this part, for an asset, off-balance sheet item, or derivative contract that is not rated directly by an NRSRO, but for which an NRSRO rating has been assigned to any

corresponding obligor counterparty, third party guarantor, or collateral backing the asset, item, or derivative, the credit rating that shall apply to the asset, item, or derivative, or portion of the asset, item, or derivative so guaranteed or collateralized, shall be the credit rating corresponding to such obligor counterparty, third party guarantor, or underlying collateral, as determined in accordance with paragraph (e)(2)(iii) of this section. If there are multiple obligor counterparties, third party guarantors, or collateral instruments backing an asset, item, or derivative not rated directly by an NRSRO, or any specific portion thereof, then the credit rating that shall apply to that asset, item, or derivative or specific portion thereof, shall be the highest credit rating among such obligor counterparties, third party guarantors, or collateral instruments, as determined in accordance with paragraph (e)(2)(iii) of this section. Assets, items or derivatives shall be

deemed to be backed by collateral for purposes of this paragraph if the collateral is:

(1) Actually held by the Bank or an independent, third-party custodian, or, if permitted under the Bank's collateral agreement with such party, by the Bank's member or an affiliate of that member where the term "affiliate" has the same meaning as in § 950.1 of this chapter;

(2) Legally available to absorb losses;

(3) Of a readily determinable value at which it can be liquidated by the Bank;

(4) Held in accordance with the provisions of the Bank's member products policy established pursuant to § 917.4 of this chapter; and

(5) Subject to an appropriate discount to protect against price decline during the holding period, as well as the costs likely to be incurred in the liquidation of the collateral.

(C) When using Table 1.3 of this part, for an asset with a short-term credit rating from a given NRSRO, the credit

risk percentage requirement shall be based on the remaining maturity of the asset and the long-term credit rating provided for the issuer of the asset by the same NRSRO. Should the issuer of the short-term asset not have a long-term credit rating, the long-term equivalent rating shall be determined as follows:

- (1) The highest short-term credit rating shall be equivalent to the third highest long-term rating;
- (2) The second highest short-term rating shall be equivalent to the fourth highest long-term rating;
- (3) The third highest short-term rating shall be equivalent to the fourth highest long-term rating; and
- (4) If the short-term rating is downgraded to below investment grade after acquisition by the Bank, the short-term rating shall be equivalent to the second highest below investment grade long-term rating.

(D) For residential mortgage assets and other assets or items, or relevant portion of an asset or item, that do not meet the requirements of paragraphs (e)(2)(ii)(A), (e)(2)(ii)(B) or (e)(2)(ii)(C) of this section, and are not identified in Tables 1.1 or Table 1.4 of this part, each Bank shall determine its own credit rating for such assets or items, or relevant portion thereof, using credit rating standards available from an NRSRO or other similar standards. This credit rating, as determined by the Bank, shall be used to identify the applicable credit risk percentage requirement under Table 1.2 of this part for residential mortgage assets, or under Table 1.3 of this part for all other assets or items.

(E) The credit risk percentage requirement for mortgage assets that are acquired member assets described in § 955.1(a) of this chapter shall be assigned from Table 1.2 of this part based on the rating of those assets after taking into account any credit enhancement required by § 955.3 of this chapter. Should a Bank further enhance a pool of loans through the purchase of insurance or by some other means, the credit risk percentage requirement shall

be based on the rating of such pool after the supplemental credit enhancement, except that the Finance Board retains the right to adjust the credit capital charge to account for any deficiencies with the supplemental enhancement on a case-by-case basis.

(iii) In determining the credit ratings under paragraph (e)(2)(ii)(A), (e)(2)(ii)(B) and (e)(2)(ii)(C) of this section, each Bank shall apply the following criteria:

(A) The most recent credit rating from a given NRSRO shall be considered. If only one NRSRO has rated an asset or item, that NRSRO's rating shall be used. If an asset or item has received credit ratings from more than one NRSRO, the lowest credit rating from among those NRSROs shall be used.

(B) Where a credit rating has a modifier (e.g., A-1+ for short-term ratings and A+ or A- for long-term ratings) the credit rating is deemed to be the credit rating without the modifier (e.g., A-1+ = A-1 and A+ or A- = A);

(f) *Calculation of credit equivalent amount for off-balance sheet items.* (1) *General requirement.* The credit equivalent amount for an off-balance sheet item shall be determined by a Finance Board approved model or shall be equal to the face amount of the instrument multiplied by the credit conversion factor assigned to such risk category of instruments, subject to the exceptions in paragraph (f)(2) of this section, provided in the following Table 2 of this part:

TABLE 2.—CREDIT CONVERSION FACTORS FOR OFF-BALANCE SHEET ITEMS

Instrument	Credit conversion factor (in percent)
Asset sales with recourse where the credit risk remains with the Bank .....	100
Commitments to make advances	
Commitments to make or purchase other loans	
Standby letters of credit .....	50

TABLE 2.—CREDIT CONVERSION FACTORS FOR OFF-BALANCE SHEET ITEMS—Continued

Instrument	Credit conversion factor (in percent)
Other commitments with original maturity of over one year	
Other commitments with original maturity of one year or less .....	20

(2) *Exceptions.* The credit conversion factor shall be zero for Other Commitments With Original Maturity of Over One Year and Other Commitments With Original Maturity of One Year or Less, for which credit conversion factors of 50 percent or 20 percent would otherwise apply, that are unconditionally cancelable, or that effectively provide for automatic cancellation, due to the deterioration in a borrower's creditworthiness, at any time by the Bank without prior notice.

(g) *Calculation of current and potential future credit exposures for single derivative contracts.* (1) *Current credit exposure.* The current credit exposure for a derivative contract that is not subject to a qualifying bilateral netting contract described in paragraph (h)(3) of this section shall be:

(i) If the mark-to-market value of the contract is positive, the mark-to-market value of the contract; or (ii) If the mark-to-market value of the contract is zero or negative, zero.

(2) *Potential future credit exposure.* (i) The potential future credit exposure for a single derivative contract, including a derivative contract with a negative mark-to-market value, shall be calculated using an internal model approved by the Finance Board or, in the alternative, by multiplying the effective notional amount of the derivative contract by one of the assigned credit conversion factors, modified as may be required by paragraph (g)(2)(ii) of this section, for the appropriate category as provided in the following Table 3 of this part:

TABLE 3.—CREDIT CONVERSION FACTORS FOR POTENTIAL FUTURE CREDIT EXPOSURE DERIVATIVE CONTRACTS [In percent]

Residual maturity	Interest rate	Foreign exchange and gold	Equity	Precious metals except gold	Other commodities
One year or less .....	0	1	6	7	10
Over 1 year to five years .....	.5	5	8	7	12
Over five years .....	1.5	7.5	10	8	15

(ii) In applying the credit conversion factors in Table 3 of this part the following modifications shall be made:

(A) For derivative contracts with multiple exchanges of principal, the conversion factors are multiplied by the number of remaining payments in the derivative contract; and

(B) For derivative contracts that automatically reset to zero value following a payment, the residual maturity equals the time until the next payment; however, interest rate contracts with remaining maturities of greater than one year shall be subject to a minimum conversion factor of 0.5 percent.

(iii) If a Bank uses an internal model to determine the potential future credit exposure for a particular type of derivative contract, the Bank shall use the same model for all other similar types of contracts. However, the Bank may use an internal model for one type of derivative contract and Table 3 of this part for another type of derivative contract.

(iv) Forwards, swaps, purchased options and similar derivative contracts not included in the Interest Rate, Foreign Exchange and Gold, Equity, or Precious Metals Except Gold categories shall be treated as other commodities contracts when determining potential future credit exposures using Table 3 of this part.

(v) If a Bank uses Table 3 of this part to determine the potential future credit exposures for credit derivative contracts, the credit conversion factors provided in Table 3 for equity contracts shall also apply to the credit derivative contracts entered into with investment grade counterparties. If the counterparty is downgraded to below investment grade, the credit conversion factor provided in Table 3 of this part for other commodity contracts shall apply.

(h) *Calculation of current and potential future credit exposures for multiple derivative contracts subject to a qualifying bilateral netting contract—*

(1) *Current credit exposure.* The current credit exposure for multiple derivative contracts executed with a single counterparty and subject to a qualifying bilateral netting contract described in paragraph (h)(3) of this section, shall be calculated on a net basis and shall equal:

(i) The net sum of all positive and negative mark-to-market values of the individual derivative contracts subject to a qualifying bilateral netting contract, if the net sum of the mark-to-market values is positive; or

(ii) Zero, if the net sum of the mark-to-market values is zero or negative.

(2) *Potential future credit exposure.*

The potential future credit exposure for each individual derivative contract from among a group of derivative contracts that are executed with a single counterparty and subject to a qualifying bilateral netting contract described in paragraph (h)(3) of this section shall be calculated as follows:

$$A_{\text{net}} = 0.4 \times A_{\text{gross}} + (0.6 \times \text{NGR} \times A_{\text{gross}}),$$

where:

(i)  $A_{\text{net}}$  is the potential future credit exposure for an individual derivative contract subject to the qualifying bilateral netting contract;

(ii)  $A_{\text{gross}}$  is the gross potential future credit exposure, *i.e.*, the potential future credit exposure for the individual derivative contract, calculated in accordance with paragraph (g)(2) of this section but without regard to the fact that the contract is subject to the qualifying bilateral netting contract;

(iii) NGR is the net to gross ratio, *i.e.*, the ratio of the net current credit exposure of all the derivative contracts subject to the qualifying bilateral netting contract, calculated in accordance with paragraph (h)(1) of this section, to the gross current credit exposure; and

(iv) The gross current credit exposure is the sum of the positive current credit exposures of all the individual derivative contracts subject to the qualifying bilateral netting contract, calculated in accordance with paragraph (g)(1) of this section but without regard to the fact that the contract is subject to the qualifying bilateral netting contract.

(3) *Qualifying bilateral netting contract.* A bilateral netting contract shall be considered a qualifying bilateral netting contract if the following conditions are met:

(i) The netting contract is in writing;

(ii) The netting contract is not subject to a walkaway clause;

(iii) The netting contract provides that the Bank would have a single legal claim or obligation either to receive or to pay only the net amount of the sum of the positive and negative mark-to-market values on the individual derivative contracts covered by the netting contract in the event that a counterparty, or a counterparty to whom the netting contract has been assigned, fails to perform due to default, insolvency, bankruptcy, or other similar circumstance;

(iv) The Bank obtains a written and reasoned legal opinion that represents, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy, or similar circumstances, the relevant court and administrative authorities would find the Bank's exposure to be the net amount under:

(A) The law of the jurisdiction by which the counterparty is chartered or the equivalent location in the case of non-corporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(B) The law of the jurisdiction that governs the individual derivative contracts covered by the netting contract; and

(C) The law of the jurisdiction that governs the netting contract;

(v) The Bank establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the netting contract continues to satisfy the requirements of this section; and

(vi) The Bank maintains in its files documentation adequate to support the netting of a derivative contract.

(i) *Credit risk capital charge for assets hedged with credit derivatives—*(1) Credit derivatives with a remaining maturity of one year or more. The credit risk capital charge for an asset that is hedged with a credit derivative that has a remaining maturity of one year or more may be reduced only in accordance with paragraph (i)(3) or (i)(4) of this section and only if the credit derivative provides substantial protection against credit losses.

(2) *Credit derivatives with a remaining maturity of less than one year.* The credit risk capital charge for an asset that is hedged with a credit derivative that has a remaining maturity of less than one year may be reduced only in accordance with paragraph (i)(3) of this section and only if the remaining maturity on the credit derivative is identical to or exceeds the remaining maturity of the hedged asset and the credit derivative provides substantial protection against credit losses.

(3) *Capital charge reduced to zero.* The credit risk capital charge for an asset shall be zero if a credit derivative is used to hedge the credit risk on that asset in accordance with paragraph (i)(1) or (i)(2) of this section, provided that:

(i) The remaining maturity for the credit derivative used for the hedge is identical to or exceeds the remaining maturity for the hedged asset, and either:

(A) The asset referenced in the credit derivative is identical to the hedged asset; or

(B) The asset referenced in the credit derivative is different from the hedged asset, but only if the asset referenced in the credit derivative and the hedged asset have been issued by the same obligor, the asset referenced in the credit derivative ranks *pari passu* to or more junior than the hedged asset and



has the same maturity as the hedged asset, and cross-default clauses apply; and

(ii) The credit risk capital charge for the credit derivative contract calculated pursuant to paragraph (d) of this section is still applied.

(4) *Capital charge reduction in certain other cases.* The credit risk capital charge for an asset hedged with a credit derivative in accordance with paragraph (i)(1) of this section shall equal the sum of the credit risk capital charges for the hedged and unhedged portion of the asset provided that:

(i) The remaining maturity for the credit derivative is less than the remaining maturity for the hedged asset and either:

(A) The asset referenced in the credit derivative is identical to the hedged asset; or

(B) The asset referenced in the credit derivative is different from the hedged asset, but only if the asset referenced in the credit derivative and the hedged asset have been issued by the same obligor, the asset referenced in the credit derivative ranks *pari passu* to or more junior than the hedged asset and has the same maturity as the hedged asset, and cross-default clauses apply; and

(ii) The credit risk capital charge for the unhedged portion of the asset equals:

(A) The credit risk capital charge for the hedged asset, calculated as the book value of the hedged asset multiplied by the hedged asset's credit risk percentage requirement assigned pursuant to paragraph (e)(2) of this section where the appropriate credit rating is that for the hedged asset and the appropriate maturity is the remaining maturity of the hedged asset; minus

(B) The credit risk capital charge for the hedged asset, calculated as the book value of the hedged asset multiplied by the hedged asset's credit risk percentage requirement assigned pursuant to paragraph (e)(2) of this section where the appropriate credit rating is that for the hedged asset but the appropriate maturity is deemed to be the remaining maturity of the credit derivative; and

(iii) The credit risk capital charge for the hedged portion of the asset is equal to the credit risk capital charge for the credit derivative, calculated in accordance with paragraph (d) of this section.

(j) *Zero Credit risk capital charge for certain derivative contracts.* The credit risk capital charge for the following derivative contracts shall be zero:

(1) A foreign exchange rate contract with an original maturity of 14 calendar

days or less (gold contracts do not qualify for this exception); and

(2) A derivative contract that is traded on an organized exchange requiring the daily payment of any variations in the market value of the contract.

(k) *Date of calculations.* Unless otherwise directed by the Finance Board, each Bank shall perform all calculations required by this section using the assets, off-balance sheet items, and derivative contracts held by the Bank, and, if applicable, the values or credit ratings of such assets, items, or derivatives as of the close of business of the last business day of the month for which the credit risk capital charge is being calculated.

#### **§ 932.5 Market risk capital requirement.**

(a) *General requirement.* (1) Each Bank's market risk capital requirement shall equal the sum of:

(i) The market value of the Bank's portfolio at risk from movements in interest rates, foreign exchange rates, commodity prices, and equity prices that could occur during periods of market stress, where the market value of the Bank's portfolio at risk is determined using an internal market risk model that fulfills the requirements of paragraph (b) of this section and that has been approved by the Finance Board; and

(ii) The amount, if any, by which the Bank's current market value of total capital is less than 85 percent of the Bank's book value of total capital, where:

(A) The current market value of the total capital is calculated by the Bank using the internal market risk model approved by the Finance Board under paragraph (d) of this section; and

(B) The book value of total capital is the same as the amount of total capital reported by the Bank to the Finance Board under § 932.7 of this part.

(2) A Bank may substitute an internal cash flow model to derive a market risk capital requirement in place of that calculated using an internal market risk model under paragraph (a)(1) of this section, provided that:

(i) The Bank obtains Finance Board approval of the internal cash flow model and of the assumptions to be applied to the model; and

(ii) The Bank demonstrates to the Finance Board that the internal cash flow model subjects the Bank's assets and liabilities, off-balance sheet items and derivative contracts, including related options, to a comparable degree of stress for such factors as will be required for an internal market risk model.

(b) *Measurement of market value at risk under a Bank's internal market risk model.* (1) Except as provided under paragraph (a)(2) of this section, each Bank shall use an internal market risk model that estimates the market value of the Bank's assets and liabilities, off-balance sheet items, and derivative contracts, including any related options, and measures the market value of the Bank's portfolio at risk of its assets and liabilities, off-balance sheet items, and derivative contracts, including related options, from all sources of the Bank's market risks, except that the Bank's model need only incorporate those risks that are material.

(2) The Bank's internal market risk model may use any generally accepted measurement technique, such as variance-covariance models, historical simulations, or Monte Carlo simulations, for estimating the market value of the Bank's portfolio at risk, provided that any measurement technique used must cover the Bank's material risks.

(3) The measures of the market value of the Bank's portfolio at risk shall include the risks arising from the non-linear price characteristics of options and the sensitivity of the market value of options to changes in the volatility of the options' underlying rates or prices.

(4) The Bank's internal market risk model shall use interest rate and market price scenarios for estimating the market value of the Bank's portfolio at risk, but at a minimum:

(i) The Bank's internal market risk model shall provide an estimate of the market value of the Bank's portfolio at risk such that the probability of a loss greater than that estimated shall be no more than one percent;

(ii) The Bank's internal market risk model shall incorporate scenarios that reflect changes in interest rates, interest rate volatility, and shape of the yield curve, and changes in market prices, equivalent to those that have been observed over 120-business day periods of market stress. For interest rates, the relevant historical observations should be drawn from the period that starts at the end of the previous month and goes back to the beginning of 1978;

(iii) The total number of, and specific historical observations identified by the Bank as, stress scenarios shall be:

(A) Satisfactory to the Finance Board;

(B) Representative of the periods of the greatest potential market stress given the Bank's portfolio, and

(C) Comprehensive given the modeling capabilities available to the Bank; and

(iv) The measure of the market value of the Bank's portfolio at risk may

incorporate empirical correlations among interest rates.

(5) For any consolidated obligations denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, each Bank shall, in addition to fulfilling the criteria of paragraph (b)(4) of this section, calculate an estimate of the market value of its portfolio at risk due to the material foreign exchange, equity price or commodity price risk, such that, at a minimum:

(i) The probability of a loss greater than that estimated shall not exceed one percent;

(ii) The scenarios reflect changes in foreign exchange, equity, or commodity market prices that have been observed over 120-business day periods of market stress, as determined using historical data that is from an appropriate period; and

(iii) The total number of, and specific historical observations identified by the Bank as, stress scenarios shall be:

(A) Satisfactory to the Finance Board;

(B) Representative of the periods of greatest potential stress given the Bank's portfolio; and

(C) Comprehensive given the modeling capabilities available to the Bank; and

(iv) The measure of the market value of the Bank's portfolio at risk may incorporate empirical correlations within or among foreign exchange rates, equity prices, or commodity prices.

(c) *Independent validation of Bank internal market risk model or internal cash flow model.* (1) Each Bank shall conduct an independent validation of its internal market risk model or internal cash flow model within the Bank that is carried out by personnel not reporting to the business line responsible for conducting business transactions for the Bank. Alternatively, the Bank may obtain independent validation by an outside party qualified to make such determinations. Validations shall be done on an annual basis, or more frequently as required by the Finance Board.

(2) The results of such independent validations shall be reviewed by the Bank's board of directors and provided promptly to the Finance Board.

(d) *Finance Board approval of Bank internal market risk model or internal cash flow model.* Each Bank shall obtain Finance Board approval of an internal market risk model or an internal cash flow model, including subsequent material adjustments to the model made by the Bank, prior to the use of any model. Each Bank shall make such adjustments to its model as may be directed by the Finance Board.

(e) *Date of calculations.* Unless otherwise directed by the Finance Board, each Bank shall perform any calculations or estimates required under this section using the assets and liabilities, off-balance sheet items, and derivative contracts held by the Bank, and if applicable, the values of any such holdings, as of the close of business of the last business day of the month for which the market risk capital requirement is being calculated.

**§ 932.6 Operations risk capital requirement.**

(a) *General requirement.* Except as authorized under paragraph (b) of this section, each Bank's operations risk capital requirement shall at all times equal 30 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement.

(b) *Alternative requirements.* With the approval of the Finance Board, each Bank may have an operations risk capital requirement equal to less than 30 percent but no less than 10 percent of the sum of the Bank's credit risk capital requirement and market risk capital requirement if:

(1) The Bank provides an alternative methodology for assessing and quantifying an operations risk capital requirement; or

(2) The Bank obtains insurance to cover operations risk from an insurer rated at least the second highest investment grade credit rating by an NRSRO.

**§ 932.7 Reporting requirements.**

Each Bank shall report to the Finance Board by the 15th business day of each month its risk-based capital requirement by component amounts, and its actual total capital amount and permanent capital amount, calculated as of the close of business of the last business day of the preceding month, or more frequently, as may be required by the Finance Board.

**§ 932.8 Minimum liquidity requirements.**

In addition to meeting the deposit liquidity requirements contained in § 965.3 of this chapter, each Bank shall hold contingency liquidity in an amount sufficient to enable the Bank to meet its liquidity needs, which shall, at a minimum, cover five business days of inability to access the consolidated obligation debt markets. An asset that has been pledged under a repurchase agreement cannot be used to satisfy minimum liquidity requirements.

**§ 932.9 Limits on unsecured extensions of credit to one counterparty or affiliated counterparties; reporting requirements for total extensions of credit to one counterparty or affiliated counterparties.**

(a) *Unsecured extensions of credit to single counterparty.* (1) *General requirement.* Unsecured extensions of credit by a Bank to a single counterparty that arise from the Bank's on-and off-balance sheet transactions shall not exceed the product of the maximum capital exposure limit applicable to such counterparty, as set forth in paragraph (a)(2) and Table 4 of this part, multiplied by the lesser of:

(i) The Bank's total capital; or  
 (ii) The counterparty's Tier 1 capital, or if Tier 1 capital is not available, total capital (as defined by the counterparty's principal regulator) or some similar comparable measure identified by the Bank.

(2) *Bank determination applicable maximum exposure limits.* The applicable maximum capital exposure limits for specific counterparties are assigned to each counterparty based upon the credit rating of the counterparty, as determined in accordance with paragraph (a)(3) of this section, and are provided in the following Table 4 of this part:

TABLE 4.—MAXIMUM LIMITS ON UNSECURED EXTENSIONS OF CREDIT TO A SINGLE COUNTERPARTY BY COUNTERPARTY CREDIT RATING CATEGORY

Credit rating of counterparty category	Maximum capital exposure limit (in percent)
Highest Investment Grade .....	15
Second Highest Investment Grade .....	12
Third Highest Investment Grade .....	6
Fourth Highest Investment Grade .....	1.5
Below Investment Grade or Other .....	1

(3) *Bank determination of applicable credit ratings.* In determining the applicable credit rating category under Table 4 of this part, the following criteria shall be applied:

(i) The most recent credit rating from a given NRSRO shall be considered. If only one NRSRO has rated the counterparty, that NRSRO's rating shall be used. If a counterparty has received credit ratings from more than one NRSRO, the lowest credit rating from among those NRSROs shall be used;

(ii) Where a credit rating has a modifier, the credit rating is deemed to

be the credit rating without the modifier;

(iii) If a counterparty has received different credit ratings for its transactions with short-term and long-term maturities:

(A) The higher credit rating shall apply for purposes of determining the allowable maximum capital exposure limit applicable to the total amount of unsecured credit extended by the Bank to such counterparty; and

(B) The lower credit rating shall apply for purposes of determining the allowable maximum capital exposure limit applicable to the amount of unsecured credit extended by the Bank to such counterparty for the transactions with maturities governed by that rating.

(iv) If a counterparty is placed on a credit watch for a potential downgrade by an NRSRO, the credit rating from that NRSRO at the next lower grade shall be used; and

(v) If a counterparty is not rated by a NRSRO, the Bank shall determine the applicable credit rating by using credit rating standards available from an NRSRO or other similar standards.

(b) *Unsecured extensions of credit to affiliated counterparties.* The total amount of unsecured extensions of credit by a Bank to all affiliated counterparties shall not exceed the product of the maximum capital exposure limit provided under Table 4 of this part based upon the highest credit rating of the affiliated counterparties, as determined in accordance with paragraph (a)(3) of this section, multiplied by the lesser of:

(1) The Bank's total capital; or

(2) The combined Tier 1 capital, or if Tier 1 capital is not available, the combined total capital (as defined by each affiliated counterparty's principal regulator) or some similar comparable measure identified by the Bank, of all of the affiliated counterparties.

(c) *Reporting requirements*—(1) *Total unsecured extensions of credit.* Each Bank shall report monthly to the Finance Board the amount of the Bank's total unsecured extensions of credit arising from on- and off-balance sheet transactions to any single counterparty or group of affiliated counterparties that exceeds 5 percent of:

(i) The Bank's total capital; or

(ii) The counterparty's, or affiliated counterparties' combined, Tier 1 capital, or if Tier 1 capital is not available, total capital (as defined by each counterparty's principal regulator) or some similar comparable measure identified by the Bank.

(2) *Total secured and unsecured extensions of credit.* Each Bank shall report monthly to the Finance Board the

amount of the Bank's total secured and unsecured extensions of credit arising from on- or off-balance sheet transactions to any single counterparty or group of affiliated counterparties that exceeds 5 percent of the Bank's total assets.

## PART 933—BANK CAPITAL STRUCTURE PLANS

Sec.

933.1 Submission of plan.

933.2 Contents of plan.

933.3 Independent review of capital plan.

933.4 Transition provisions.

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1426, 1440, 1443, 1446.

### § 933.1 Submission of Plan.

(a) *In general.* By no later than October 29, 2001, the board of directors of each Bank shall submit to the Finance Board a plan to establish and implement a new capital structure for that Bank, which plan shall comply with part 931 of this chapter and under which, when implemented, the Bank shall have sufficient total and permanent capital to comply with the regulatory capital requirements established by part 932 of this chapter. The Finance Board, upon a demonstration of good cause submitted by the board of directors of a Bank, may approve a reasonable extension of the 270-day period for submission of the capital plan. A Bank shall not implement its capital plan, or any amendment to the plan, without Finance Board approval.

(b) *Failure to submit a capital plan.* If a Bank fails to submit a capital plan to the Finance Board by October 29, 2001, including any approved extension, the Finance Board may establish a capital plan for that Bank, take any enforcement action against the Bank, its directors, or its executive officers authorized by section 2B(a) of the Act (12 U.S.C. 1422b(a)), or merge the Bank pursuant to section 26 of the Act (12 U.S.C. 1446) into any other Bank that has submitted a capital plan.

(c) *Consideration of the plan.* After receipt of a Bank's capital plan, the Finance Board may return the plan to the Bank if it does not comply with section 6 of the Act (12 U.S.C. 1426) or any regulatory requirement or is otherwise incomplete or materially deficient. If the Finance Board accepts a capital plan for review, it may require the Bank to submit additional information regarding its plan or to amend the plan, prior to determining whether to approve the plan. The Finance Board may approve a capital plan as submitted or as amended, or may condition its approval on the Bank's compliance with certain stated

conditions, and may require that the capital plans of all Banks take effect on the same date.

### § 933.2 Contents of plan.

The capital plan for each Bank shall include, at a minimum, provisions addressing the following matters:

(a) *Minimum investment.* (1) The capital plan shall require each member to purchase and maintain a minimum investment in the capital stock of the Bank, in accordance with § 931.3, of this chapter and shall prescribe the manner in which the minimum investment is to be calculated. The plan shall require each member to maintain its minimum investment in the Bank's stock for as long as it remains a member and, with regard to Bank stock purchased to support an advance or other business activity, for as long as the advance or business activity remains outstanding.

(2) The capital plan shall specify the amount and class (or classes) of Bank stock that an institution is required to own in order to become and remain a member of the Bank, and shall specify the amount and class (or classes) of Bank stock that a member is required to own in order to obtain advances from, or to engage in other business transactions with, the Bank. If a Bank requires its members to satisfy its minimum investment through the purchase of one or more combinations of Class A and Class B stock, the authorized combinations of stock shall be specified in the capital plan, which shall afford the members the option of satisfying the minimum investment through the purchase of any such combination of stock.

(3) The capital plan may establish a minimum investment that is calculated as a percentage of the total assets of the member, as a percentage of the advances outstanding to the member, as a percentage of the other business activities conducted with the member, on any other basis approved by the Finance Board, or on any combination of the above.

(4) The minimum investment established by the capital plan shall be set at a level that, when applied to all members, provides sufficient capital for the Bank to comply with its minimum capital requirements, as specified in part 932 of this chapter. The capital plan shall require the board of directors of the Bank to monitor and, as necessary, to adjust, the minimum investment to ensure that the stock required to be purchased and maintained by the members is sufficient to allow the Bank to comply with its minimum capital requirements. The plan shall require each member to

comply promptly with any adjusted minimum investment established by the board of directors of the Bank, but may allow a member a reasonable time to do so and may allow a member to reduce its outstanding business with the Bank as an alternative to purchasing additional stock.

(b) *Classes of capital stock.* The capital plan shall specify the class or classes of stock (including subclasses, if any) that the Bank will issue, and shall establish the par value, rights, terms, and preferences associated with each class (or subclass) of stock. A Bank may establish preferences relating to, but not limited to, the dividend, voting, or liquidation rights for each class or subclass of Bank stock. Any voting preferences established by the Bank pursuant to § 915.5 of this chapter shall expressly state the voting rights of each class of stock with regard to the election of Bank directors. The capital plan shall provide that the owners of the Class B stock own the retained earnings, surplus, undivided profits, and equity reserves of the Bank, but shall have no right to receive any portion of those items, except through declaration of a dividend or capital distribution approved by the board of directors or through the liquidation of the Bank.

(c) *Dividends.* The capital plan shall establish the manner in which the Bank will pay dividends, if any, on each class or subclass of stock, and shall provide that the Bank may not declare or pay any dividends if it is not in compliance with any capital requirement or if after paying the dividend it would not be in compliance with any capital requirement.

(d) *Initial issuance.* The capital plan shall specify the date on which the Bank will implement the new capital structure, and shall establish the manner in which the Bank will issue Class A and/or Class B stock to its existing members, as well as to eligible institutions that subsequently become members. The capital plan shall address how the Bank will retire the stock that is outstanding as of the effective date, including stock held by a member that does not affirmatively elect to convert or exchange its existing stock to either Class A or Class B stock, or some combination thereof.

(e) *Stock transactions.* The capital plan shall establish the criteria for the issuance, redemption, repurchase, transfer, and retirement of stock issued by the Bank. The capital plan also:

(1) Shall provide that the Bank may not issue stock other than in accordance with § 931.2 of this chapter;

(2) Shall provide that the stock of the Bank may be issued only to and held only by the members of that Bank;

(3) Shall provide that the stock of the Bank may be transferred only in accordance with § 931.6 of this chapter, and may be traded only between the Bank and its members;

(4) May provide for a minimum investment for members that purchase Class B stock that is lower than the minimum investment for members that purchase Class A stock, provided that the level of investment is sufficient for the Bank to comply with its regulatory capital requirements;

(5) Shall specify the fee, if any, to be imposed on a member that cancels a request to redeem Bank stock; and

(6) Shall specify the period of notice that the Bank will provide to a member before the Bank, on its own initiative, determines to repurchase any excess Bank stock from a member.

(f) *Termination of membership.* The capital plan shall address the manner in which the Bank will provide for the disposition of its capital stock that is held by institutions that terminate their membership, and the manner in which the Bank will liquidate claims against its members, including claims resulting from prepayment of advances prior to their stated maturity.

(g) *Implementation.* The capital plan shall demonstrate that the Bank has made a good faith determination that the Bank will be able to implement the plan as submitted and that the Bank will be in compliance with its regulatory total capital requirement and its regulatory risk-based capital requirement after the plan is implemented.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069-0059 with an expiration date of November 30, 2003.)

#### § 933.3 Independent review of capital plan.

Prior to submitting its capital plan, each Bank shall conduct a review of the plan by an independent certified public accountant to ensure, to the extent possible, that the implementation of the plan would not result in any write-down of the redeemable stock owned by its members, and shall conduct a separate review by at least one NRSRO to determine, to the extent possible, whether the implementation of the plan would have a material effect on the credit rating of the Bank. The Bank shall submit a copy of each report to the Finance Board as part of its proposed capital plan.

#### § 933.4 Transition provisions.

(a) The capital plan of a Bank may include a transition provision that would allow a period of time, not to exceed three years, during which the Bank shall increase its total and permanent capital to levels that are sufficient to comply with its minimum leverage capital requirement and its minimum risk-based capital requirement. The capital plan of a Bank may also include a transition provision that would allow a period of time, not to exceed three years, during which institutions that were members of the Bank on November 12, 1999, shall increase the amount of Bank stock to a level that is sufficient to comply with the minimum investment established by the capital plan. The length of the transition periods need not be identical.

(b) Any transition provision shall comply with the requirements of § 931.9.

### PART 956—FEDERAL HOME LOAN BANK INVESTMENTS

19. The authority citation for part 956 is revised to read as follows:

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a), 1429, 1430, 1430b, 1431, 1436.

20. Amend § 956.1 by removing the definition of the term “NRSRO” and by adding, in alphabetical order, definitions of the term “derivative contracts” and “repurchase agreement” to read as follows:

#### § 956.1 Definitions.

\* \* \* \* \*

*Derivative contract* has the meaning set forth in § 930.1 of this chapter.

\* \* \* \* \*

*Repurchase agreement* has the meaning set forth in § 930.1 of this chapter.

21. Revise the last sentence of paragraph (b) of § 956.3 to read as follows:

#### § 956.3 Prohibited investments and prudential rules.

\* \* \* \* \*

(b) \* \* \* A Bank may participate in consolidated obligations denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, provided that the Bank meets the requirements of § 966.8(d) of this chapter, and all other applicable requirements related to issuing consolidated obligations.

22. Add a new § 956.5 to read as follows:

**§ 956.5 Authorization for derivative contracts and other transactions.**

A Bank may enter into the following types of transactions:

- (a) Derivative contracts;
- (b) Standby letters of credit, pursuant to the requirements of 12 CFR part 961;
- (c) Forward asset purchases and sales;
- (d) Commitments to make advances; and
- (e) Commitment to make or purchase other loans.

23. Add a new § 956.6, to read as follows:

**§ 956.6 Use of hedging instruments.**

(a) *Applicability of GAAP.* Derivative instruments that do not qualify as hedging instruments pursuant to GAAP may be used only if a non-speculative use is documented by the Bank.

(b) *Documentation requirements.* (1) Transactions with a single counterparty shall be governed by a single master agreement when practicable.

(2) A Bank's agreement with the counterparty for over-the-counter derivative contracts shall include:

- (i) A requirement that market value determinations and subsequent

adjustments of collateral be made at least on a monthly basis;

(ii) A statement that failure of a counterparty to meet a collateral call will result in an early termination event;

(iii) A description of early termination pricing and methodology, with the methodology reflecting a reasonable estimate of the market value of the over-the-counter derivative contract at termination (standard International Swaps and Derivatives Association, Inc. language relative to early termination pricing and methodology may be used to satisfy this requirement); and

(iv) A requirement that the Bank's consent be obtained prior to the transfer of an agreement or contract by a counterparty.

**PART 966—CONSOLIDATED OBLIGATIONS**

24. The authority citation of part 966 continues to read as follows:

**Authority:** 12 U.S.C. 1422a, 1422b, and 1431.

25. Revise § 966.8 by adding new paragraph (d) to read as follows:

**§ 966.8 Conditions for issuance of consolidated obligations.**

\* \* \* \* \*

(d) If a Bank participates in any CO denominated in a currency other than U.S. Dollars or linked to equity or commodity prices, then the Bank shall meet the following requirements:

(1) The relevant foreign exchange, equity price or commodity price risks associated with the CO must be hedged in accordance with § 956.6 of this chapter;

(2) If there is a default on the part of a counterparty to a contract hedging the foreign exchange, equity or commodity price risk associated with a CO, the Bank shall enter into a replacement contract in a timely manner and as soon as market conditions permit.

Dated: December 20, 2000.

By the Board of Directors of the Federal Housing Finance Board.

**William C. Apgar,**

*HUD Secretary Designee to the Board.*

[FR Doc. 01-1253 Filed 1-29-01; 8:45 am]

**BILLING CODE 6725-01-P**